INVESTMENT

Bouncing back stronger

As the world's financial markets look to recover from the coronavirus pandemic, Jack Gray **explores the possibilities that global small-cap investments present for pension schemes**

WRITTEN BY JACK GRAY

Immediately following the outbreak of the coronavirus pandemic, many European pension schemes saw their investment returns plummet as the world's economy reeled from the shock. As time has passed, markets have shown tentative signs of recovery. Although much uncertainty remains, investors have seen opportunities arise to help schemes bounce back stronger. However, it is not just following times of financial hardship that global small caps present an attractive investment opportunity, with evidence showing their long-term risk-adjusted returns outperforming many other asset classes.

Risk and reward

"When you take a look at small caps, you see that small caps deliver superior risk-adjusted returns over time," begins American Century Investments vice president and senior portfolio manager, Trevor Gurwich.

"You have a higher annualised return, you have a slightly higher standard deviation, but ultimately the value proposition and Sharpe ratios confirm superior risk-adjusted returns. Looking back over 20 years (1 January 2001 to 30 September 2020), small caps have delivered a far more compelling Sharpe ratio of 0.37 versus large caps, whose Sharpe ratio was 0.24."

Gurwich notes that although the standard deviation of small caps is slightly higher than large caps, 17-18 per cent compared to 15-16 per cent, annualised returns for small caps average 8 per cent, compared to 5 per cent on large caps.

"I would say it is much higher return versus slightly higher risk," he says. "That is what gives you the superior risk-adjusted returns over long time periods.

"To mitigate the risk, I think what you do is portion the size of the allocated amount of small cap exposure you want in your portfolio. If you are a more aggressive type of pension fund, you take a larger slice.

"Global small-cap exposure is something you must have in this world where rates are low and you are seeking growth opportunities. Also, if one wants to get exposure to 90 per cent of the world's initial public offerings (IPOs) and 90 per cent of the world's mergers and acquisitions (M&As), small caps are your ultimate destination."

Legal & General Investment Management fund manager, Andrzej Pioch, adds that small-cap exposures can provide an additional return driver (size premium) from a factor investing approach due to the theoretical reasons of reward for additional risk, and familiarity and availability bias.

Furthermore, there appears to be a global small-cap premium going forward, according to AP1 head of equities and strategy, Mats Larsson. He continues: "The market for small caps also offers a better potential for positive alpha, which might be more important than ever as the expected return for equity beta is relatively low over the next decade."

Russell Investments head of multi-asset EMEA, Alain Zeitouni, echoes this positivity. He notes that, in annual rolling 10-year returns, smaller companies have always outperformed large caps, and investing in them provides a good opportunity for growth for pension schemes with long investment horizons.

"The second benefit of investing in smaller companies is the breadth of the market," he explains. "The MSCI ACWI Small Cap Index has almost 6,000 constituents, while the MSCI ACWI (large caps only) has fewer than 3,000 stocks. Investors have almost twice as many stocks to choose from when seeking out the best risk-adjusted returns.

"Thirdly, smaller companies are less followed by the analyst community, offering better opportunities for active stock-pickers."

Active managers

When looking to incorporate small caps into a pension scheme investment portfolio, Gurwich recommends hiring an active small-cap manager rather than going passive, as there is a lot of room to exploit the inefficiencies in the small-cap world and deliver additional excess returns.

"People sometimes look at the annualised return and the standard deviation and they think it is risky," he adds, "but ultimately your risk-adjusted returns are highly compelling, especially when you take an active manager."

Zeitouni notes that, when looking at managers' performance dispersion, the impact of picking the right manager is even higher for small caps than in the large-cap space, which he attributes to heterogeneous performance. However, he states this can be overcome by using a multi-manager approach to mitigate idiosyncratic risk and therefore build a strong portfolio of proven experts in the asset class with a solid investment process and robust risk management expertise.

Bouncing back

Small caps have historically performed well following an economic shock, with Bloomberg data showing that after both the dot-com crash and the 2008 financial crisis, global small caps bounced back stronger than large caps.

Gurwich explains that global small caps have this ability as they are nimbler at cutting costs and re-positioning their business. Additionally, rates appear to be low and are expected to continue to be low for a long time, which allows firms to refinance, replenish cash reserves and engage in more M&A.

"We are expecting, after negative 10 per cent growth in 2020, almost 32 per cent earnings growth in 2021, so a dramatic acceleration in earnings growth in a small cap is higher than what is going to happen in the large cap universe," says Gurwich. "I think that you are poised, if you believe we are in an economic rebound phase, to get a strong recovery in small caps."

Larsson agrees that the current economic situation presents opportunities for global small-cap investments "in relative terms", while LGIM global equity strategist, Lars Kreckel, notes that small caps are part of the equity universe that is more sensitive to the economic cycle and benefits the most from early recovery dynamics.

"In the early parts of the year, as the pandemic spread, small caps were among the stocks suffering the largest drawdowns," he adds. "But they have also bounced back more sharply than large caps in most regions as economies began to recover and risk appetite returned. Looking ahead, we continue to like the prospects of some recovery trades."

As the current economic environment is characterised by lower yields for longer periods of time, Zeitouni says, borrowing costs will remain low, which is supportive for smaller companies given their need to grow and invest into future growth.

"Having lower yields should help them expand at a cheap price," he explains. "Moreover, in a low-growth environment, as we stand, and with companies still holding significant buffer of cash on their balance sheets, smaller companies are potential targets for M&A activities (given the cheaper funding costs) which should benefit the asset class."

Gurwich concludes: "A global small-cap allocation is something that should be in everybody's portfolio, ultimately it is delivering almost private equity-like returns with daily liquidity and at a fraction of the fee. Our 20-year track record in our non-US small cap product has compounded at above 13 per cent per year on average vs the index at 8 per cent." ■

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