THE FORGOTTEN ASSET CLASS – CASE FOR CANADIAN SMALL CAP EQUITY

Over the past decade, there has been a shift from Canadian equities to global equities, coinciding with an emergence of dedicated global small cap allocations to further enhance portfolio diversification. Taken together these changes have resulted in Canadian small cap equities becoming a forgotten asset class. Despite the reduction to Canadian equity allocations, many investors have a significant dollar commitment to the asset class.

This article discusses the merits of Canadian small cap equities and how investors can benefit from its potential contribution.

Background on Canadian Small Cap

As a general rule, small cap companies offer investors more room for growth, but also confer greater risk and volatility than large cap companies. The S&P/TSX Small Cap Index is a float adjusted and market capitalization (cap) weighted index, which was developed as a leading benchmark for those with small cap exposure in the Canadian equity market.

At the end of December 2020, there were 202 constituents in the index with a total market cap of CAD $153 billion. The mean market cap of the constituents was CAD $757 million, but there was quite a range in the size of companies with the smallest being valued at CAD $76 million and the largest at CAD $2.7 billion.[i]

With the fallout from the COVID-19 pandemic, the smallest company in the S&P/TSX Composite Index is now Cineplex with a market cap of CAD $587 million. At the other end of the size spectrum is Shopify, the largest stock in the index, which has a market cap of CAD $175 billion[ii].

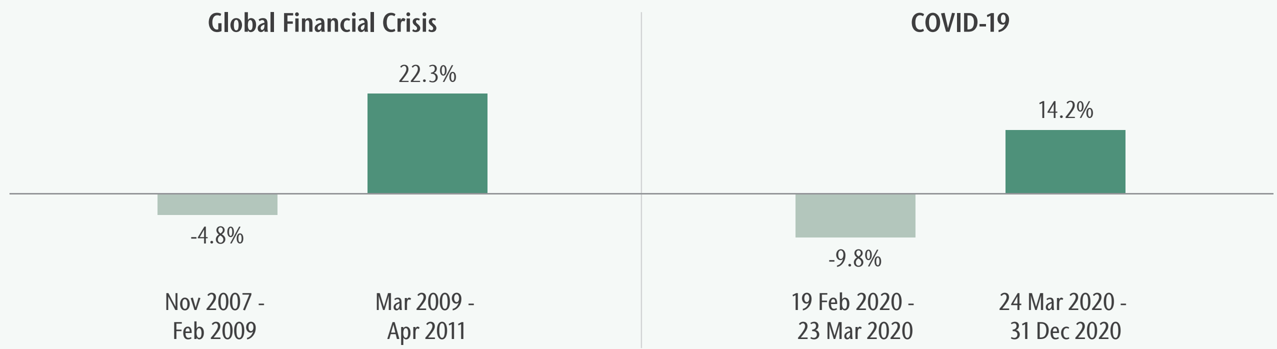
The S&P/TSX Composite Index is concentrated in a small number of companies. The largest 10 companies comprised over 38% of the index at the end of 2020. Shopify alone represented 6.4% of the index. In contrast, the small cap index is more diversified with the top 10 companies comprising less than 15% of the index. The largest stock was the Great Canadian Gaming Company, which represented 1.9% of the small cap index.

Small versus Large Cap Performance

Whether smaller or larger companies perform better varies over time based on the broader economic climate. Looking back over the last 40 years, a relative constant has been that small caps tend to fall a bit further than large caps in bear markets.

For example, global large cap companies outperformed when markets crashed during the global financial crisis, as well as during the large declines experienced in the early part of 2020 due to the COVID-19 pandemic (Figure 1). However, in both examples, small caps significantly outperformed large caps in the recovery stage.

Figure 1: Performance of MCSI World Small Cap less MSCI World Index*



*Cumulative returns were used for all periods. Light green represents periods drawdown for MSCI World Index and green represents recovery.

Source: MSCI, FTSE Russell & Thomson Reuters.

The extent of the small cap recovery in 2020, particularly Canadian small caps, is evident in Figure 2. It shows the Canadian small cap index was up over 80% in the last nine months of 2020, resulting in a full calendar return more than double that of the S&P/TSX Composite Index.

Figure 2: Index Returns During 2020 (in CAD)

Asset Class	Market Index	Q1 Return %	9 Months Ended December 31, 2020 %	Calendar Year 2020 %
Canadian Equities	S&P/TSX Composite	-20.9	33.5	5.6
Canadian Small Cap Equities	S&P/TSX Small Cap	-38.1	82.4	12.9
Global Equities	MSCI World	-13.2	31.9	14.4
Global Small Cap Equities	MSCI World Small Cap	-23.1	48.1	13.9

Source: MSCI, FTSE Russell & Thomson Reuters.

Potential Benefits

While small cap stocks are generally more volatile, there are a number of offsetting benefits.

- **Growth opportunities:** Smaller companies tend to have greater flexibility to respond to opportunity or adversity and their potential growth can continue much longer when they have a desired product or service.

  Large companies start small. If you can find the next generation of small companies that grow faster and graduate into a larger cap segment, the reward is significant. It is easy to forget that the market capitalization of Shopify, the largest Canadian equity listed company, was less than CAD $1.5 billion in June 2015[iii].

  Smaller companies also tend to have a more focused line of business and higher insider ownership, resulting in greater alignment of interests between the owners and shareholders.

- **Sector Differences:** The S&P/TSX Small Cap Index is not a microcosm of the larger S&P/TSX Composite Index. Therefore, investors can benefit from the different sector representation offered by the small cap index, which introduces opportunities that may not be present in the large cap segment of the market (Figure 3).

  For example, in 2020 the S&P/TSX Composite Index consumer staples sector returned a little over 4%, while the S&P/TSX Small Cap Index sector return was over 33%. The small cap food companies rebounded more quickly than grocers that make up more of the large cap exposure and which tend to be more defensive.

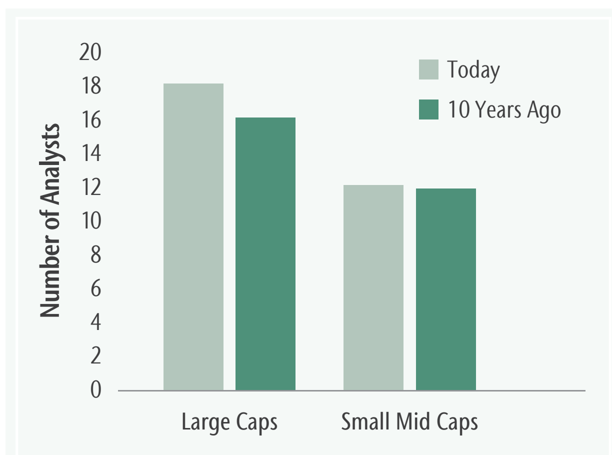
Figure 3: Canadian Equity Sector Allocations

Sector	S&P/TSX Composite Index %	S&P/TSX Small Cap Index %
Energy	11.2	13.6
Materials	13.7	27.4
Industrials	12.5	12.7
Consumer Discretionary	3.9	8.1
Consumer Staples	3.8	5.1
Health Care	1.1	8.2
Financials	30.2	10.1
Information Technology	10.3	3.2
Communication Services	4.9	2.2
Utilities	5.1	0.4
Real Estate	3.1	9.0
Total	**100.0**	**100.0**

Source: MSCI, FTSE Russell & Thomson Reuters.

- **Less researched:** Small cap companies are generally less researched by the external analyst community. The number of research analysts covering large cap stocks has grown over the last 10 years, while the number covering smaller cap companies has barely changed and is much fewer (Figure 4).

Figure 4: Analyst Coverage of TSX Companies

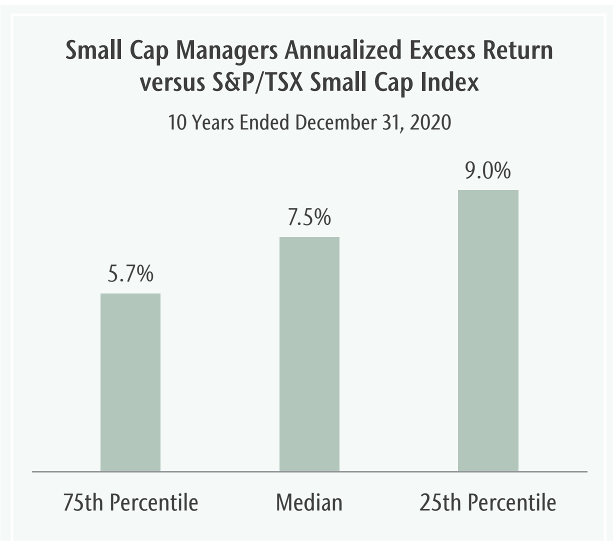


Source: Bloomberg.

Often the research analysts covering small cap companies are less senior and experienced compared to their large cap analyst counterparts. These differences create greater opportunities for active managers to outperform the index benchmark by undertaking independent due diligence on these less researched companies, whose share price may not fully reflect their intrinsic value or growth prospects.

Collectively, active small cap equity managers have delivered significant added value above the small cap index. More than three quarters of the active managers delivered at least 5.7% per annum above the index for the 10-year period ended December 31, 2020. The median added value over the 10 years was 7.5% per annum (Figure 5).

Figure 5: Active Management Excess Returns



Source: eVestment.

Case for Canadian Small Caps

Despite a general reduction in Canadian equity allocations, there are many institutional investors with a significant dollar exposure. When reviewing potential changes to portfolios, there is a case to be made for Canadian small caps. By including Canadian small caps, investors can tap into a different type of market exposure, as well as the added value potential from active management.

(i) S&P Global
(ii) As at January 18, 2021. Source: Bloomberg.
(iii) Macrotrends.net

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