January 11, 2013

Dear clients and colleagues,

One of the most researched topics in the last 30 years is the size effect. Numerous academic papers have shown that small caps earn a higher risk-adjusted return as compared to larger companies over the long-term. Yet some investors perceive them to be risky and do not have a set allocation to this asset class. This week we revisit global small cap as an asset class.

Small cap stocks are often perceived as risky relative to their large-cap counterparts; however, as an asset class they provide several benefits beginning with the opportunity set. When investors move beyond the large and mid-cap stocks they triple the opportunity set in terms of the number of stocks available. Small cap stocks represent over 85% of publicly traded companies.

Small caps are often covered by fewer analysts and some institutional investors cannot invest in them due to liquidity thresholds. As small cap companies continue to grow at double digits, they attract analyst coverage. Like any self-fulfilling prophecy, as they are more researched liquidity increases and more institutional investors can then invest in them.

Smaller companies are also often undervalued compared to larger ones. As they grow the valuation gap begins to reduce which equates to impressive investment performance. They often experience a double whammy as earnings grow together with earnings multiples.

Globalization has increased correlations between national stock markets, hence reducing the diversification benefits of large-cap global investing. A small company may be small from a global perspective. From a country or regional perspective, however, small cap include companies that have been in business for decades, operate well established brands or have strong positions in their local market.

Management of small cap companies often own larger share of the company as compared to large caps. High ownership ensures that management interests are aligned with those of shareholders. This concentration may create liquidity constraints and price moves when a large shareholder buys and sells. This risk can be mitigated by having an in-depth knowledge of the shareholder register.

Small companies are relatively more likely to be the target for mergers and acquisitions (M&A's). Larger companies are constantly looking to acquire innovative and fast-growing companies, for which small cap is a fertile ground. 99% of M&A targets are smaller companies.

The prospect for global small cap is bright. Institutional investors will likely increase their allocation due to the renewed focus on the asset class and better understanding of the diversification benefits.

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The Global Alpha team takes a long-term approach. Our turnover rate – excluding companies acquired or reaching our upper market cap limit – is around 20%. Combined with our search for growth in many industries, we believe it is a source of sustainable added value. We have a diversified portfolio of 59 companies in 13 countries and 37 different industries.

Have a nice weekend.

The Global Alpha Team

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