GOOD THINGS COME IN SMALL PACKAGES

The case for global small cap equities: Canadian pension plan sponsors have embraced a global approach to large cap non-domestic equity investing. In some cases, a global approach has replaced separate US and non-North American mandates, while in other cases a global approach has been added to complement the separate regional mandates. Extending this global shift to small cap equities can lead to good things - enhanced portfolio diversification and improved odds of beating the index benchmark. The key merits of global small cap highlighted in this note include:

Key insights

Not that small	Over 1,500 global small cap companies have a market capitalization greater than US $1 Billion
Breadth and depth	Largest stock is only 0.16% of the index and there is broader sector diversification compared to other major market indices.
Risk complement	Inclusion of global small cap equity would have historically enhanced the return of a balanced portfolio, albeit with a slightly higher volatility.

BACKGROUND TO GLOBAL SMALL CAP

There are different definitions for global small cap. The MSCI World Small Cap Index defines small cap as stocks in the US $100 million to US $5 billion range. Many of the stocks in the global small cap universe are household names in their local market, and some even have a global brand such as Abercrombie & Fitch (U.S.), Flight Center (Australia) and Vitasoy (Hong Kong).

In a global context, small cap is not that small; there are over 1,500 companies with a market capitalization greater than US $1 billion at June 30, 2012. There are only 188 such companies in the S&P/TSX Composite Index.

The largest individual stock in the global small cap index represents only 0.16% of the index. In contrast, the largest individual stock in the S&P/TSX Composite Index represents 5.4% of its index and the largest 15 stocks account for 44% of the index.

To achieve a similar representation in a global small cap context, you would need to invest in 616 global companies. We are not suggesting a portfolio should hold that many stocks, but it highlights the broad investment opportunity set of the global small cap universe.

The diversification benefits of global small cap go beyond individual stocks. While the major Canadian indices are heavily skewed to the energy, material and financial sectors (see Table 1), the global small cap markets provide representation across a broader range of sectors, including higher exposure to consumer discretionary (e.g., companies in the restaurant, luxury goods and travel industries) and health care.

Table 1 – a different opportunity set (June 30, 2012)

	MSCI Global Small Cap Index	MSCI Emerging Market	S&P/TSX Composite
Energy	6.4%	12.6%	27.1%
Materials	8.9%	12.5%	21.6%
Industrials	17.2%	6.8%	5.5%
Consumer Discretionary	15.7%	7.9%	4.1%
Consumer Staples	4.2%	8.5%	2.6%
Health Care	9.3%	1.1%	1.5%
Financials	21.1%	24.8%	29.5%
Information Technology	12.7%	13.8%	1.3%
Telecommunication Services	0.9%	8.2%	4.8%
Utilities	3.5%	3.9%	1.9%

Source: MSCI and Datastream.

The global small cap market also provides diversification benefits relative to emerging equity markets.

OPPORTUNITIES KNOCK

While global small cap represents a different opportunity set, does "different" imply a good opportunity? Consider these three potential benefits.

Growth opportunity

The most basic premise supporting an allocation to small cap equities is that large companies start small. If you can find the next generation of small companies that will grow faster and graduate into the large cap segment, the reward is significant.

It may be hard to believe, but only in November 2004 did Apple Inc. graduate into the MSCI US Large Cap Index.

Global small cap companies 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 opportunity

Plan sponsors can benefit from the higher consumer discretionary and health care sector representation offered by the global small cap index relative to other major indices.

The spending patterns in developed and emerging markets should see the consumer discretionary sector perform well over the long term.

The health care sector should also benefit from aging baby boomers in the developed world and from demands in emerging markets for better health care services.

Active opportunity

Small cap companies also tend to be less externally researched by the analyst community. As a result, active managers have a greater opportunity to outperform their index benchmark by identifying companies whose share price does not fully reflect their intrinsic value or growth prospects.

For example, active managers over the past 3 years ended June 30, 2012 have on average delivered 1.6% p.a. added value over the MSCI World Small Cap Index (Source: eVestment Alliance).

NOT WITHOUT RISKS

Global small cap equities are not without their risks. While active managers can mitigate some of these risks through research and careful selection of individual stocks, investors should consider the following risks.

Liquidity risk

It can take longer to trade a small cap stock compared to large cap stocks.

Small cap stocks also tend to be more sensitive to changes in market sentiment such as a change from a bullish to bearish outlook for a particular sector, which can contribute to the more volatile performance.

Information flow

While higher insider ownership aligns with the interests of investors, it can also lead to lack of transparency and lack of flow of information that would be common with large cap investments.

Large competitors

Small companies do not have the same access to credit markets as larger companies as a result of their size.

This can sometimes limit a small company from realizing its potential at the expense of a larger competitor

CASE FOR GLOBAL SMALL CAP EQUITIES

The need for growth while being ever mindful of total portfolio risk is still at the forefront of the minds of institutional investors. Recently, institutional investors have shifted to a global focus for large cap non-domestic equity portfolios. By extending this global focus to small cap equities, investors may benefit from a broader opportunity and enhanced portfolio diversification, not to mention the improved odds of beating the index benchmark.

Authors:

Robert Beauregard, MBA, CFA, CMA
Chief Investment Officer
Global Alpha Capital Management
514 490-2788 | rbeauregard@cclgroup.com

Peter Muldowney
Senior Vice President, Institutional Strategy
Connor, Clark & Lunn Financial Group
416 304-6810 | pmuldowney@cclgroup.com

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