Why Now is the Time to Invest in Listed Australian Small Companies

By Prime Value Asset Management:
Focusing on the Prime Value Emerging Opportunities Fund

Introduction

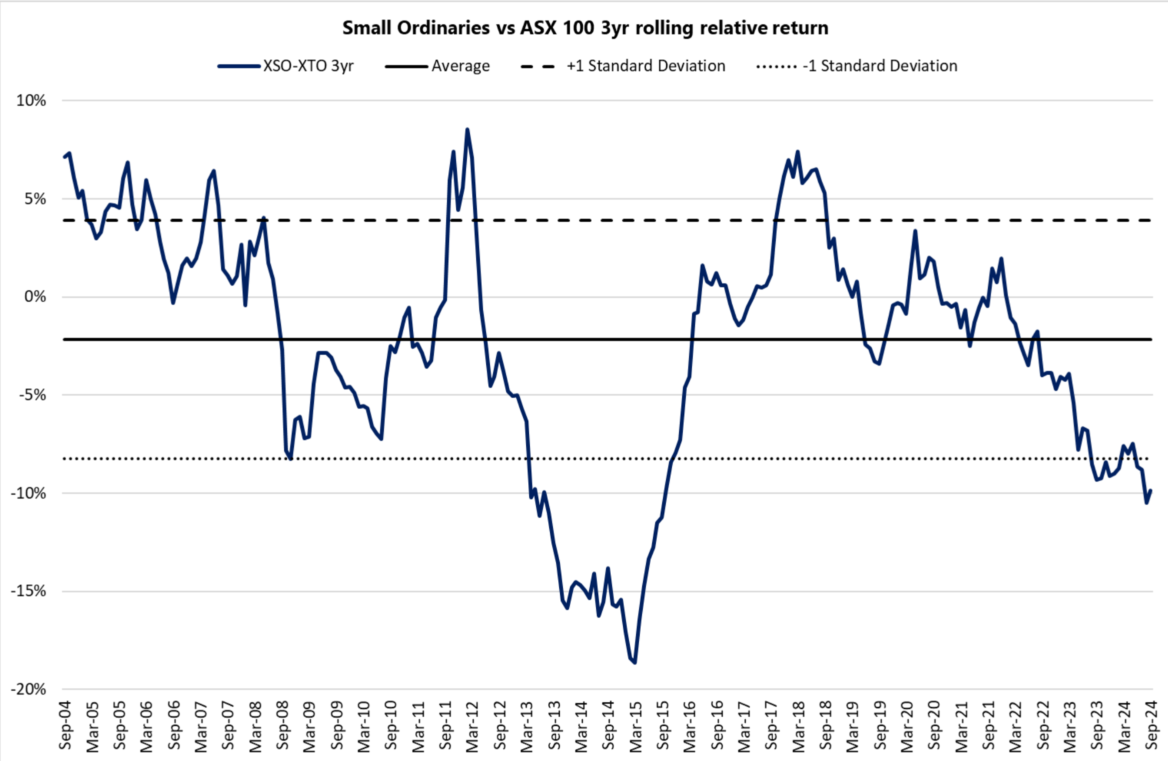
There are compelling reasons why now is the right time to invest in listed Australian small companies. And it's not just the extreme underperformance or supportive valuation of small cap stocks vs large caps in recent times, though these are factors. This white paper explores critical factors including the strong performance of small caps in declining interest rate environments (both absolute and relative to large caps), superior earnings growth of small cap stocks, greater diversification in the small cap universe, and the consistent alpha generation of Small Cap Managers.

Additionally, this paper highlights the importance of portfolio construction and minimising investment mistakes, which can lead to superior, consistent risk-adjusted outcomes for investors.

1. Extreme Relative Underperformance of Australian Small Caps vs Large Caps

One of the most compelling reasons to consider Australian small caps right now is their recent relative underperformance compared to large caps since the interest rate hiking cycle began in early 2022. Over the past 3 years, small cap stocks (XSO) have underperformed large caps (XTO) by 10%pa – a level that is >1 standard deviation below the long-term average. The only previous observation in the last 20 years where this occurred was during 2013 – 2015. As illustrated in Figure 1, the relative performance can mean revert quickly given favourable fundamentals.

Figure 1: Australian Small Caps Have Underperformed Large Caps by 10%pa Over the Past 3 Years

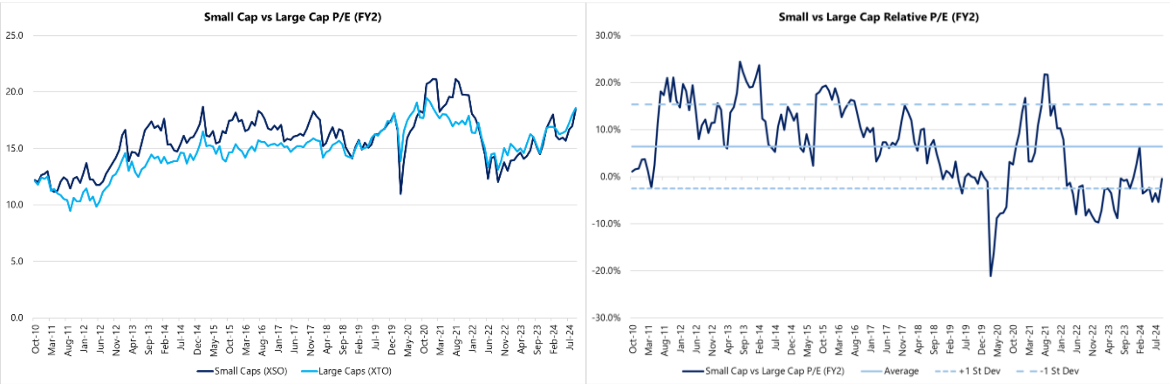


Source: FactSet, Prime Value Asset Management. Data to 30 September 2024.

This relative underperformance has been a function of two factors that we believe have a strong probability of switching from headwinds to become tailwinds for Australian small caps: (i) the impact of rising interest rates on equities broadly (as relative risk-reward in other asset classes improved), but with an exacerbated impact on small caps due to the flight to liquidity that ensued. We note that, based on Morningstar data, Australian Small Cap managers saw net retail outflows of -A$2.6 billion over the last 3 years (or a c10% decline in starting FUM) as the interest rate hiking cycle progressed; and (ii) deteriorating earnings performance relative to large caps, which is set to reverse in coming years (see section 3 below).

With regards to valuation, as at 30 September 2024, Small Caps traded on a FY2 P/E of 18.5x, broadly in line with the Large Cap P/E of 18.6x. This compares with the average Small Cap FY2 P/E premium over Large Caps of 6.4% since the Global Financial Crisis.

Figure 2: Australian Small Caps Trade at a P/E Discount to their Long-term Premium over Large Caps



Source: FactSet, Prime Value Asset Management. Data to 30 September 2024.

Given the reasons for small cap underperformance in recent years, the likelihood that this reverses, as well as small cap valuation support versus history, we see a current opportunity to allocate to high quality Australian small caps.

2. Australian Small Caps Typically Outperform in Interest Rate Cutting Cycles

Historically, equities have generally risen in environments characterised by declining interest rates, except in periods of severe economic recession. This is especially the case for small cap companies, which tend to outperform large cap companies during these periods.

The relationship between interest rates and small cap performance is driven by several factors:

Lower Cost of Borrowing: Smaller companies tend to be more reliant on external financing and are typically exposed to variable interest rates, so when interest rates fall, their borrowing costs decrease and access to debt markets generally improves, providing a boost to profitability and expansion opportunities.

Higher Growth Potential: Small caps are often growth-oriented companies that are still in the early stages of their lifecycle and can grow earnings strongly from a small base. Additionally, lower interest rates increase the present value of future earnings, making these companies more attractive to investors.

Operational Flexibility: Smaller firms tend to be more nimble and adaptable, allowing them to take advantage of lower borrowing costs and other favourable economic conditions faster than larger, more bureaucratic companies.

As shown below, over the past decade there have been 3 periods of RBA interest rate cuts, each case resulting in Australian small cap stocks rising strongly and outperforming large caps.

Figure 3: Australian Small Cap Outperformance vs Large Caps in Interest Rate Cutting Cycles

Period	RBA cash rate move	XSO move	XTO move
Jan 2015 - May 2015	-0.50bps	9.4%	3.0%
Apr 2016 - Aug 2016	-0.50bps	9.1%	3.0%
May 2019-Nov 2020	-1.40bps	7.1%	1.7%

Source: FactSet, Prime Value Asset Management.

The Exception: Recessionary Periods

While small caps generally outperform in a declining interest rate environment, they can underperform during periods of economic recession. Small companies often have weaker balance sheets and are more vulnerable to credit constraints and demand slowdowns. However, Australia is not currently facing a deep recessionary scenario, making this a potentially favourable period for small cap investors.

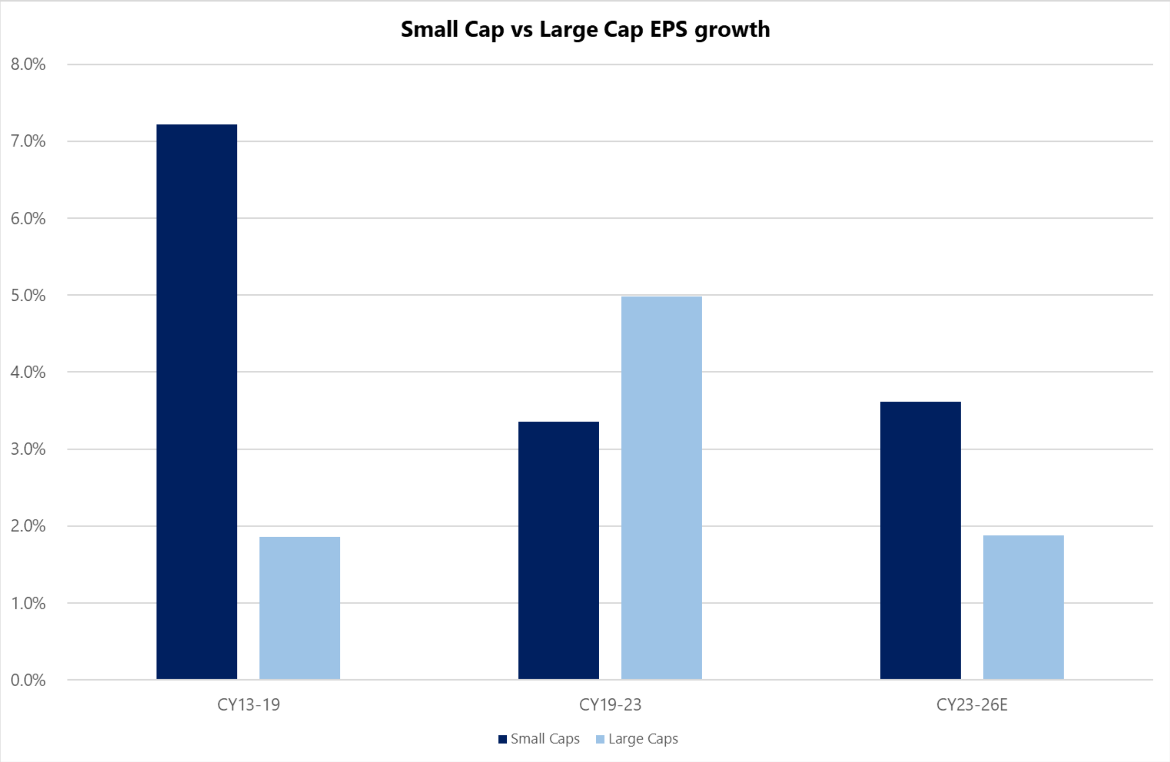
3. Small Caps Exhibit Superior Earnings Growth Over Large Caps

Historically, Small Cap companies have generated stronger earnings growth than Large Caps which is often a function of their relatively smaller earnings base and market share, with small improvements in market share having a more material impact on earnings growth vs larger companies. Additionally, Small Cap companies often reflect a pure exposure to niche industries, compared to Large Cap companies which tend to have more operational diversity. This typically sees small cap companies growing earnings more strongly than large caps in favourable market conditions, and conversely suffering greater earnings declines in weaker market conditions.

Looking back over the past 10 years, we split this timeframe into the “pre-Covid years” of 2013-2019 (i.e. favourable market conditions) and the “Covid years” of 2019-2023 (i.e. weaker market conditions). We can observe that the earnings (EPS) growth of small cap stocks outperformed large caps in the “pre-Covid years”, before underperforming in the “Covid years”, tying into the material index underperformance highlighted in Figure 1.

Equity markets look forwards, however, and consensus estimates once again forecast stronger EPS growth for Small Caps relative to Large Caps over the medium term as the economy normalises post-Covid.

Figure 4: Australian Small Caps Superior Earnings (EPS) growth vs Large Caps



Source: FactSet, Prime Value Asset Management.

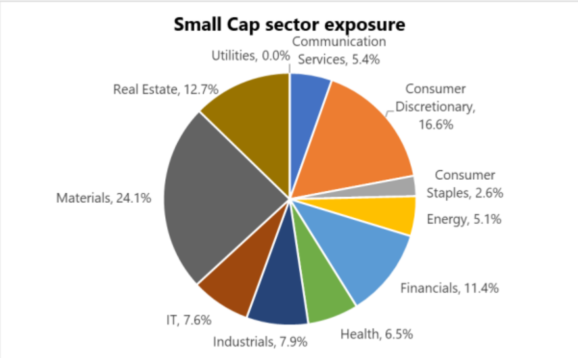
4. Australian Small Caps Offer Greater Diversification vs Large Caps

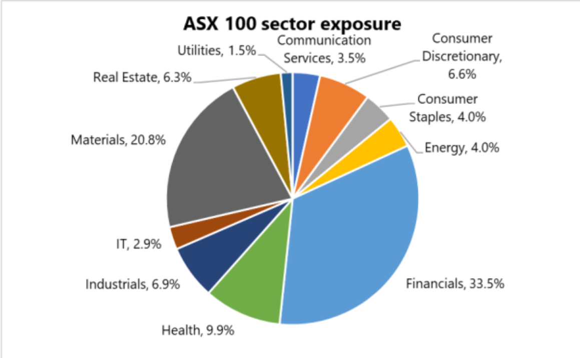
Australian small cap stocks offer greater diversification compared to large caps, both by sector and by single stock index concentration.

Within the Large Cap index (XTO), the largest single constituent is BHP Group (BHP), with a weighting of 10.3% as at 30 September 2024. By contrast, the largest constituent in the Small Cap index (XSO) is Life360 (360), with a weighting of 1.6%. The practical implication of this is that Large Cap investors with a benchmark aware mandate tend to hold positions in stocks they don't necessarily have conviction in for hedging purposes, for fear of underperformance. To illustrate the point, a 10% rise in BHP shares adds a very large 103bps to the Large Cap index return, and so has a large impact on a fund that doesn't own a position. By contrast, a 10% move in Life360 would add just 16bps to the Small Cap index's performance, and so has little impact on a fund that doesn't own a position, placing little pressure on Small Cap investors to own stocks they don't necessarily have conviction in.

From a sector perspective, the charts below highlight the greater diversity of Small Caps, with the largest two sectors (Materials and Consumer Discretionary) accounting for 40.7% of the index, compared to the Large Cap index where the largest two sectors (Financials and Materials) account for 54.3% of the index.

Figure 5: Australian Small Caps Offer Greater Diversity Than Large Caps





Source: S&P Global, Prime Value Asset Management. As at 30 September 2024.

This diversification can help investors capture growth across a wider spectrum of the economy and provides early access to fast-growing Australian companies at the cutting edge of technological advancements, developing disruptive products and services and becoming future leaders in their industries. Small Cap investors have been able to access some of the great Australian companies early into their lifecycles, such as Cochlear, CSL and Realestate.com.au. While more recent examples of such companies moving from the Small Cap index into the ASX 100 index include HUB24, Pro Medicus and Telix Pharmaceuticals.

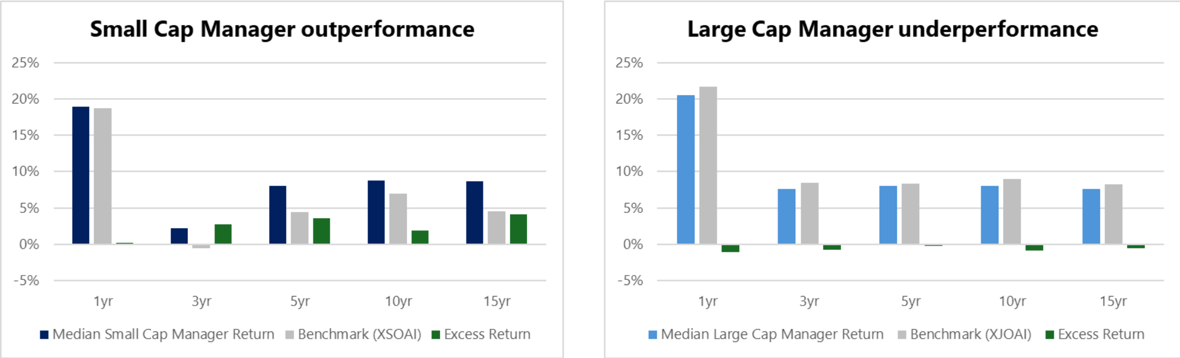
5. Australian Small Cap Managers Consistently Generate Alpha

A key argument for investing in small caps is the success active Small Cap managers have had in generating consistent alpha. The below chart highlight that as at 30 September 2024, the median Small Cap manager has outperformed their benchmark (XSOAI) across 1yr, 3yr, 5yr, 10yr and 15yr timeframes, while the median Large Cap manager has underperformed their benchmark over each of these timeframes (using the ASX200 index (XJOAI) rather than the ASX100 index given most large cap mandates are set to the ASX200 index).

This is a function of the relative inefficiencies in the small cap market, such as lower liquidity and less analyst coverage, combined with stronger earnings growth and a more fragmented index composition (as discussed earlier).

This contrasts with large caps, where the market is more efficient and the opportunities for alpha generation are relatively constrained.

Figure 6: Active Manager Outperformance in Small Caps vs Large Caps



Source: Morningstar, Prime Value Asset Management. Data to 30 September 2024.

While the extreme underperformance of Australian Small Cap stocks vs Large Cap stocks over the past 3 years has seen the Median Large Cap Manager deliver stronger absolute returns than the Median Small Cap Manager, the longer-term experience highlights the reverse is true over 10 year and 15 year periods.

6. The Role of Portfolio Construction in Generating Consistent Long-term Returns

The dispersion of returns is much wider in small caps than in large cap stocks. While there are high-growth companies that deliver outsized returns, there are also companies that significantly underperform or fail altogether. Therefore, avoiding investment mistakes — particularly companies that experience large drawdowns — is a key attribute that can contribute to consistent long-term returns.

A sensible approach to small cap portfolio construction is to focus on larger positions in companies with more stable business models that can achieve steady earnings growth, while taking smaller positions in companies with higher potential returns but greater associated risk.

This provides a more stable foundation for generating alpha while reducing the volatility typically associated with small cap investing, resulting in relatively consistent attribution across a larger number of stocks, as opposed to relying on outsized returns from just a few stocks in a performance period.

As shown below, this approach has provided significantly lower risk whilst still maintaining strong relative returns over the past 5 years.

Figure 7: Portfolio Construction can Drive Strong Returns With Low Risk

Source: Morningstar, Prime Value Asset Management. Data as at 30 September, 2024. Black dots represent Small Cap peer group funds.

Conclusion

Why Now is the Time to Invest in Australian Small Companies

Australian small caps offer a strong case for long-term capital growth:

- Underperformance vs Large Caps: Small caps have underperformed large caps by 10% annually over the past three years, creating potential for a rebound.
- Supportive valuation: Small Caps trade currently in line with Large Caps on a FY2 P/E basis, reflecting a discount to their long-term premium of 6.4%.
- Favourable Interest Rate Environment: Historically, small caps outperform in periods of falling interest rates (both absolute and relative to large caps), with stronger performance expected as we enter a rate-cutting cycle.
- Stronger Earnings Growth: Small caps earnings growth is forecast to outpace large caps over the medium term as the economy benefits from lower interest rates.
- Consistent Alpha Generation: Active management of small caps has delivered strong and consistent outperformance by the median manager over 1, 3, 5, 10, and 15-year periods.

While small caps tend to be more volatile than large caps, it has been demonstrated within small caps that investors can achieve strong, consistent long-term returns with reduced risk by focusing on mitigating downside risk through careful portfolio construction.

For investors seeking long-term growth and diversification, now is the time to allocate capital to Australian small caps.

Prime Value Asset Management is dedicated to delivering top-tier investment solutions for our clients. Our small-cap strategy showcases our best investment ideas, giving investors the opportunity to tap into the growth potential of Australia's most innovative and dynamic companies.

Our small-cap strategy has a strong track record of delivering consistent alpha and long-term returns that rank among the best in its peer group, all while maintaining a notably low risk profile, with reduced volatility and downside capture.

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