## THE BENEFITS OF ACTIVE MANAGEMENT IN AUSTRALIAN SMALL-CAPS

There has been considerable debate around active versus passive management in the equities space, a debate which only gains greater traction during periods of modest equity market returns (where fees grow as a proportion of total return) and/or during periods of median manager underperformance. This research paper and presentation argue the case for active management in the Australian smaller companies segment, highlighting that historically median small cap managers have solidly exceeded the relevant benchmark and talking to some of the reasons as to why an active small cap manager can provide a valuable addition to an investors portfolio.

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## Emerging companies: valuable for the economy, valuable for the investor

Smaller, or perhaps more appropriately termed “emerging”, companies are a key foundation of any economy, critical to both job creation and innovation. Quality emerging companies are focussed. They do not have the bureaucratic shackles that can slow down the decision making process in larger companies. This makes smaller companies more nimble, enabling them to make timely, efficient business choices, drive innovation, and ultimately achieve solid earnings growth. Successful emerging companies either “grow up” to become mid-cap companies, or become acquisition targets such that larger companies can exploit the innovation leverage developed in smaller companies at the coal face of the economy.

From an asset allocation perspective there are several reasons cited as to why this segment of the market may represent an attractive component of an investors’ portfolio. These include:

- Emerging companies are typically focussed, less diversified, business models which in many cases offer a pure and often more leveraged exposure to the real economy and its sub sets;
- As the term suggests, a significant proportion of emerging companies are at earlier stages of their growth and development. As such quality emerging companies may offer the potential for significant earnings growth and therefore capital appreciation; and
- It is in this less intensively researched segment of the market where there is greater scope for pricing inefficiencies and therefore capacity for investment manager value add through effective stock selection.

Of critical importance is effectively ascertaining the quality of companies within the investment universe and identifying and exploiting available pricing inefficiencies, and it is here where active investment management plays a critical role. Good active managers will operate under a disciplined, research driven process. Key elements of this process should include high-levels of company contact, a framework for detailed analysis, and a robust peer review process, coupled with appropriate risk controls to deliver a well diversified portfolio of opportunities.

Good active managers within the smaller companies space can deliver attractive alpha returns which not only outstrip alpha return potential in larger companies, but also form a significant portion of total return. As the balance of this paper will assist in demonstrating, the smaller companies segment should be considered a genuine “alpha asset class” where solid alpha returns can be systematically exploited.

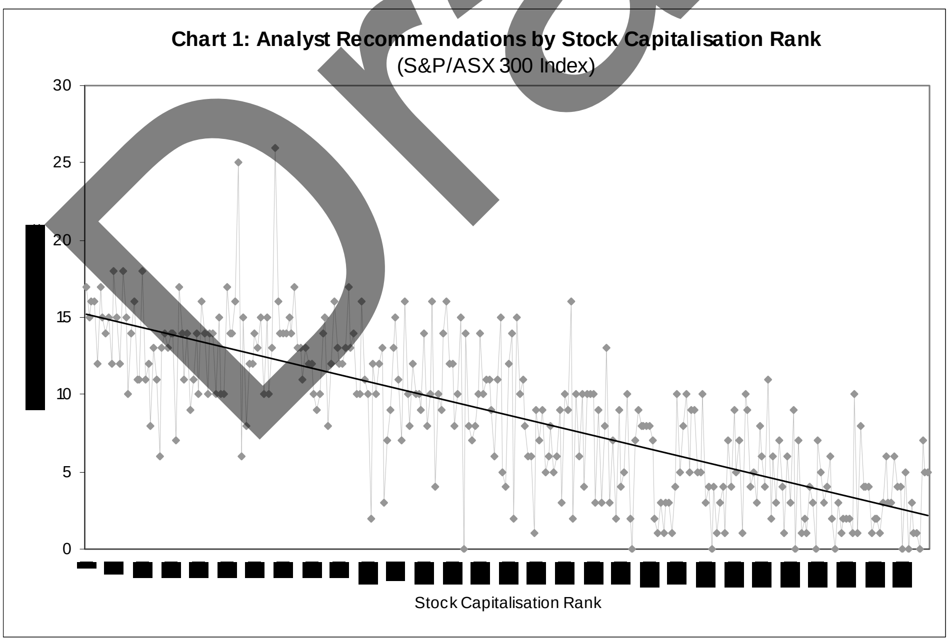
## Exploiting information efficiency is key in small cap investing

The Efficient Market Hypothesis (EMH) suggests that at any given time, stock prices reflect all available information and the market is therefore efficient. On this basis investors should look to passive management as systematic generation of alpha returns through active management is unlikely. However, the smaller companies segment of the market mounts a strong case against the EMH.

The objective of active funds management is to exploit pricing inefficiencies which exist within the market. Broadly speaking these inefficiencies may arise as a result of the various behavioural biases exhibited by investors and/or through inefficiencies of knowledge or analysis.

One of the key characteristics of the small caps sector is that it remains less intensively researched by brokers and the market in general. With many companies within the smaller companies segment at earlier stages of their growth or development, the markets awareness or appreciation of this is often limited, as may other developments or changes for a company be less widely understood or appreciated by the market.

This more limited information awareness can be best illustrated by considering the number of broker analyst recommendations covering stocks across the market from large cap to small cap stocks. The following chart maps the total number of analyst recommendations by stock across the S&P/ASX 300 Index ordered by market capitalisation.




*Source: Fairview Equity Partners / Bloomberg*

The chart's linear regression clearly shows a downward slope, signifying that the smaller the market capitalisation of the stock, the lesser the extent of coverage represented by declining analyst recommendations.

Whilst there are 200 companies within the S&P/ASX Small Ordinaries index (stocks 101-300), the actual investible universe of most smaller or emerging companies funds will be at least double this number. This further amplifies the available information inefficiencies as these additional, non-index, stocks generally have even less or no broker analyst coverage.

This dearth of coverage provides active small cap managers the opportunity to exploit market inefficiencies through detailed research of these companies and the markets in which they operate. Historical performance of active managers in this sector strongly supports an argument that the proprietary insight and skill of active smaller company managers can be translated into solid returns for investors and more substantial and more consistent outperformance relative to the large cap sector. A disciplined research driven investment process, undertaken by highly experienced managers, combining high levels of company contact, detailed analysis, a robust peer review process, and appropriate risk controls is critical to discovering and exploiting the available opportunities and constructing an appropriately diversified smaller companies portfolio.

## The small cap universe allows efficient capital allocation to drive portfolio performance

Meaningful active risks need to be taken to generate returns in excess of a benchmark. The construct of the S&P/ASX Small Ordinaries is highly supportive in this respect. The following chart shows the cumulative capital allocation across small and large cap benchmarks, where stocks are ranked in order of size.

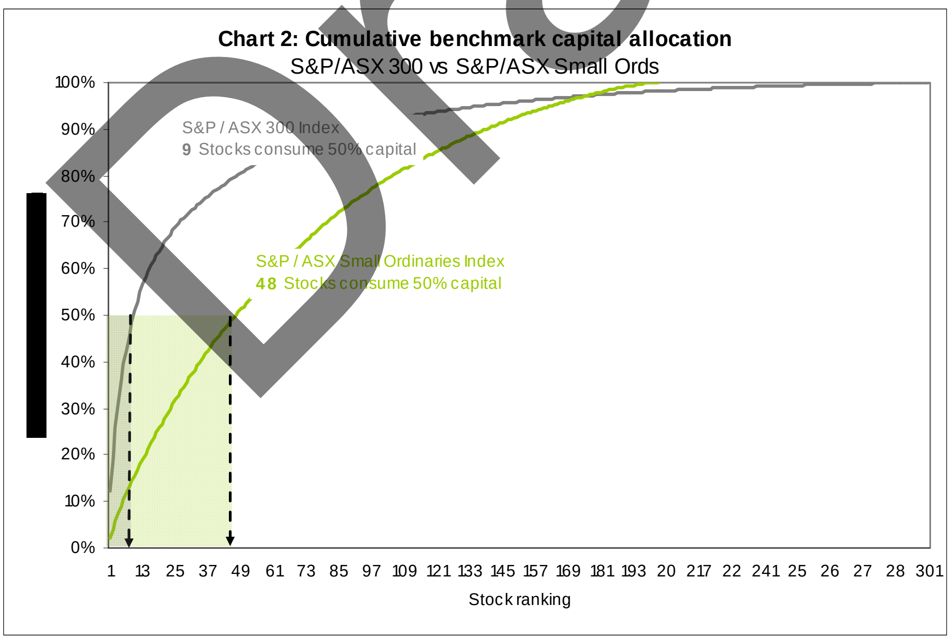



**Chart 2: Cumulative benchmark capital allocation**

*Source: Fairview Equity Partners / Bloomberg*

Currently the largest 10 companies within the S&P/ASX Small Ordinaries Index comprise 16% of the benchmark. This compares to the top 10 companies representing 52% of the S&P/ASX 200 Index (Top 5 is 37%).

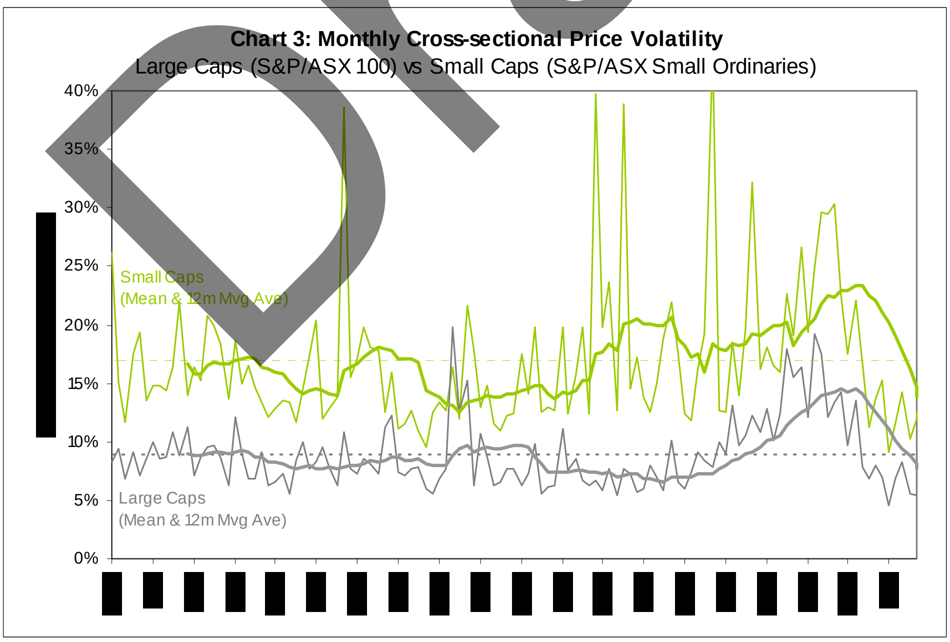
At a stock level, the largest individual stock within the S&P/ASX Small Ordinaries, currently Resmed, equates to 2.2% of the benchmark; whereas BHP is 12.7% of the S&P/ASX 200 Index. The issue here, of course, is that if a large cap investment manager wanted to take a meaningful active position in BHP, a large 15% of the portfolio's capital is likely to be consumed – only 17% of this allocation relates to excess return seeking objectives – 83% is basically a passive decision.

One of the arguments made by proponents of passive funds management is that in many instances investors are paying active management fees for passive risk taking. The widely dispersed nature of the S&P/ASX Small Ordinaries benchmark certainly facilitates efficient allocation of investor capital and one where the majority of the portfolio is likely to represent active risk.

## Cross sectional volatility highlights a returns differential capable of being exploited

We have discussed the fundamental arguments for investing in small caps. We have also identified that capital is more efficiently allocated toward generating excess returns within a small caps portfolio. Now we seek to identify whether there is a persistent variance in the availability of actual excess return opportunity.

In conjunction with a widely dispersed benchmark, resulting in a more significant proportion of active risk being available, the dispersion of stock returns within the small cap investment universe highlights a significant returns differential which is capable of being exploited by well resourced, experienced and disciplined active small cap managers.




*Source: Fairview Equity Partners / Bloomberg*

The above chart shows a cross sectional volatility comparison of small caps vs large caps over the past 10 years. What is highlighted is that there is a persistent and significant dispersion differential between small cap and large cap stock returns.

The greater cross sectional volatility of small cap stocks facilitates a greater ability for investment managers to capture this dispersion and generate superior excess returns.

Not only is there a greater return differential available for small cap managers to exploit, but also an increased active risk availability due to the more diverse benchmark construct relative to large caps. This of course translates into significant attribution leverage and hence alpha generation potential.

### The scorecard for active small cap managers

We have noted that there is scope for greater informational inefficiency within the small caps space, that the benchmark construct provides for an efficient allocation of capital toward generating excess returns, and that cross sectional volatility of returns is suggestive of a returns differential capable of being exploited. The next question is whether active managers have indeed generated solid excess returns in the past, and have they beaten their large cap peers?

Using a 10 year history, and including only those active investment managers that have had a continuous track record over this period, it is clear that small cap managers have indeed delivered.

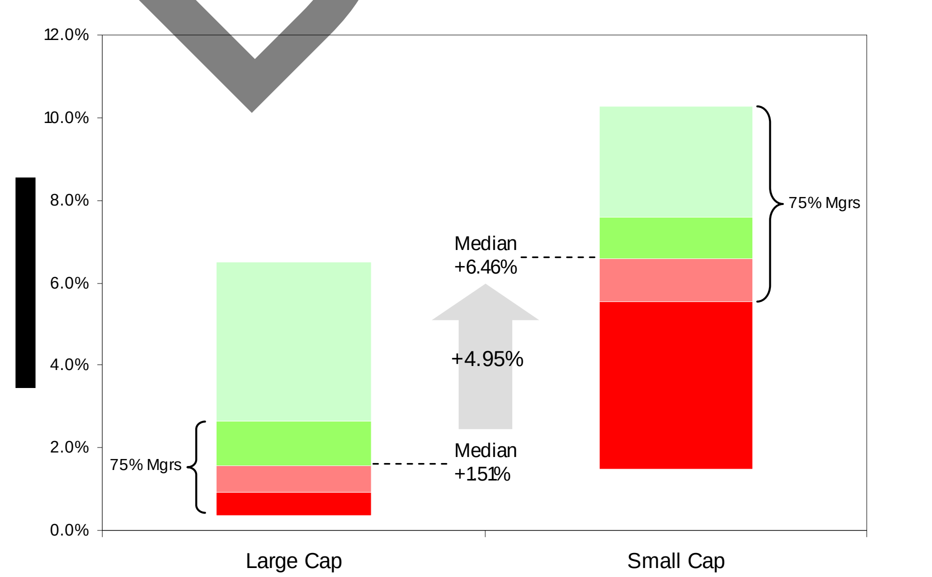
The following chart 4 highlights the level and dispersion of excess returns generated by both small and large cap managers during this 10 year period, which ended 31 December 2009. The colours break the managers into investment manager quartiles based around those excess returns. There are two key points to draw from this chart:

1. The median small cap manager has exceeded the benchmark by a significant 6.5% p.a over this period; compared to a more modest 1.5% excess return for the median large cap manager;

2. The worst performing small cap manager still managed to beat the relevant benchmark and also delivered stronger excess returns than the median large cap manager.



**Chart 4: Comparison of Manager Excess Returns (Manager Quartiles)**




*Source: Fairview Equity Partners / Mercer MPA*

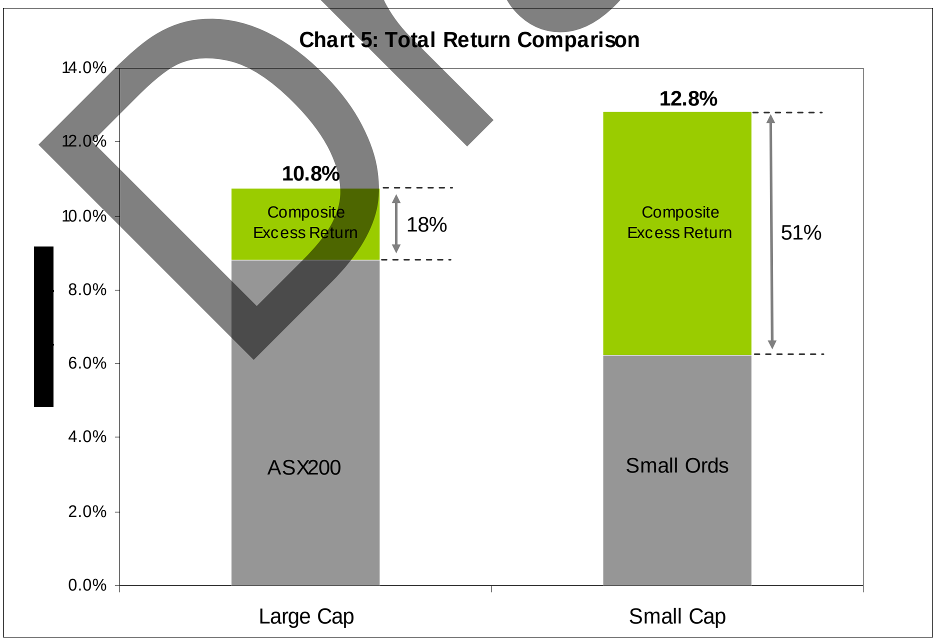
The chart also demonstrates a high level of excess return compression in the 2nd, 3rd, and 4th manager quartiles for large cap managers. The excess return range from large cap managers was around 6% (maximum of 6.5%), however 75% of managers delivered excess returns of less than 2.6%. The picture for small caps is very different: firstly the range of excess return outcomes is much greater at close to 9%, and secondly the majority of managers (75%) delivered excess returns in excess of 5.5% and up to 10.3%.

This highlights that in even generating a modest level of excess return from large cap managers, manager selection is critical.

The key purpose of this chart, however, is to support the argument that small cap managers have been shown to systematically deliver significant levels of excess returns to investors, over and above those generated by their large cap peers.

Another way to illustrate the extent of value generated by active small cap managers is to look at the proportion of total returns represented by excess return versus the market or benchmark return component. Chart 5 below highlights that over this same 10 year period, whilst the small ordinaries benchmark did, in fact, under perform the S&P/ASX 200, the total return delivered to investors was still stronger than that deliver by large cap active managers.

This was due to the far superior excess return delivered by small cap managers. A significant 51% of total return was delivered through excess returns for small caps, whilst for large caps excess return accounted for only 18% of total return. Note that an equally weighted investment manager composite was constructed to determine excess return for each category.




*Source: Fairview Equity Partners / Mercer MPA*

## Is there a limit to funds under management?

This paper has demonstrated the availability of alpha in the smaller companies universe, however can this be exploited indefinitely, or is there a limit?

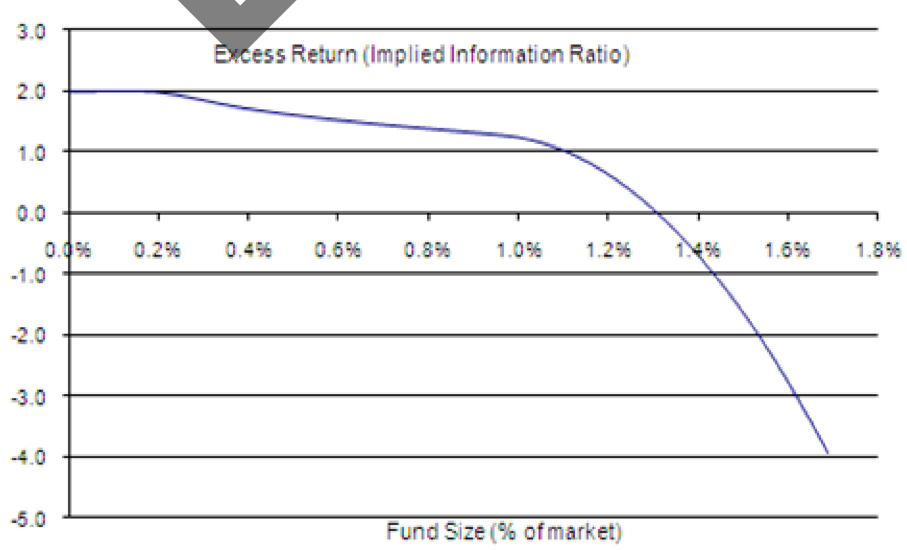
Chart 6 below highlights what is intuitively correct; that the capacity to generate excess returns (relative to risk) is inversely correlated with the size of the underlying fund (measured here as a proportion of the benchmark). In essence this relates to the extent of any limits or constraints around a manager's attempts to exploit available pricing inefficiencies. This includes the inter-related practical limitations around the investible universe of the fund, as well as implementation costs associated with efficiently constructing and managing the portfolio.

The amount of funds under management (and therefore underlying individual stock position sizes in absolute dollar terms), relative to available liquidity in the market, directly impacts the timeliness and flexibility in entering and exiting investment positions, and consequently indirectly impacts the investible universe for a manager. In addition, some funds may have explicit limits around the proportion of an investee's register that a single holding is permitted to represent, effectively ruling out lower capitalisation stocks or limiting position sizes as funds under management expand.

By definition smaller companies have lower market capitalisation and typically exhibit a lower absolute dollar value of turnover relative to large caps. So long as this lower turnover at an individual stock level is proportionate to the level of funds under management this does not in itself necessarily create an issue. However, the higher the proportionate consumption of daily turnover volume, or liquidity, in order to enter or exit portfolio positions the greater the likely market impact or implementation cost, which should have a direct impact upon investor returns.

One conclusion to be drawn here is that an investor would be best placed to access a quality small cap manager who understands this relationship between the level of funds under management and the capacity for sustained alpha generation and whose business model is appropriately aligned to ensure that investor returns are not comprised by efforts to grow funds under management.

**Chart 6: Excess Return Potential vs. Fund Size**




*Source: Macquarie Bank*

## Are fee budgets used efficiently when directed to small cap investment managers?

It is prudent to address the issue of fees and incentive alignment when considering active investment management services. In summary, there are four key areas where small cap managers can demonstrate good use of fee budgets for their clients:

1. Fee budgets are directed to active research and proprietary insight within a segment with greater informational inefficiencies;

2. Given the construct of the relevant benchmark, capital allocation is efficient with the fee budget clearly directed towards specific alpha return generating opportunities (ie. not paying active fees for passive decisions);

3. Persistent excess cross-sectional volatility exists to confirm that excess returns opportunities are there to be systematically exploited;

4. The historical results of small cap investment manager excess and total return generation support a solid net return opportunity for investors.

It was identified earlier that increasing funds under management is detrimental to alpha return exploitation to a point where alpha becomes increasingly unavailable as funds grow. It is therefore critical that fee structures address the economic needs of active managers, whilst ensuring that clients do not suffer deterioration of alpha returns as the investment management business grows.

The ideal outcome would appear to be one that sufficiently rewards successful active managers and satisfies their economic objectives, whilst remaining consistent with and aligned to the ongoing generation of excess returns to investors.

The historically common model within the funds management industry to charge purely asset based fees, and through which scale of funds under management is the sole determinant of business profitability, is unattractive for all parties within the smaller companies segment. Boutique structures, whereby the investment team are significant fund co-investors and performance fee structures are in place, would appear to provide for a greater alignment of interests toward ensuring that funds under management do not grow beyond a level where investment performance is compromised.

## Conclusions

- Given the more limited broker coverage relative to the size of the investible universe, the smaller companies space is one that favours the proprietary insight of experienced teams of investment managers operating under a disciplined research driven process.

- The construct curve of the smaller companies benchmark strongly favours active management and ensures an efficient allocation of investor capital, whilst the dispersion of available returns highlights the extent of alpha generating opportunities for active managers.

- Over time active small cap managers have indeed been shown to systematically generate excess returns for investors, and by some considerable margin.

- There is an inverse correlation between the amount of funds under management and the capacity to consistently deliver excess returns. Performance fee structures should ensure that interests are sufficiently aligned to ensure that investor returns are not compromised.