

Sector Report

Australian Shares - Small Companies

February 2022





Executive summary

“The first rule of fishing is fish where the fish are”, according to Charlie Munger.

If investors followed a similar approach to investing, the Australian smaller companies asset class would be one of the most popular fishing spots!

The Australian smaller companies universe is full of fish, making it one of the most attractive asset classes for active management. While active smaller companies funds rated by Zenith have demonstrated persistent benchmark outperformance over the long term, we have seen an acceleration of excess returns in recent years.

In this year’s sector report, Zenith explores the dynamic and diverse nature of the asset class that has underpinned the acceleration of outperformance.

Over the five years to 31 December 2021, over 100 opportunities made their way into the S&P/ASX Small Ordinaries Index, with 2021 being a particularly notable year for index inclusions. Specifically, there were 55 constituent changes in the index last year, leading to a plethora of new opportunities for active investors to exploit.

Furthermore, we analyse the performance of stocks entering and exiting the S&P/ASX Small Ordinaries Index and how they can be a source of outperformance for active smaller companies funds. Our analysis found that promoted microcap and demoted midcap companies outperformed the benchmark by 6.0% and 10.0%, respectively, over the 12 months after being considered a small cap stock.

Over the 12 months to 31 December 2021, Zenith’s rated Australian small cap managers produced an average return of 22.3% (after fees), comparing favourably to the S&P/ASX Small Ordinaires Index, which returned 16.9% over the same period.



2. Key Themes & Issues

The fisherman's advice to the billionaire...

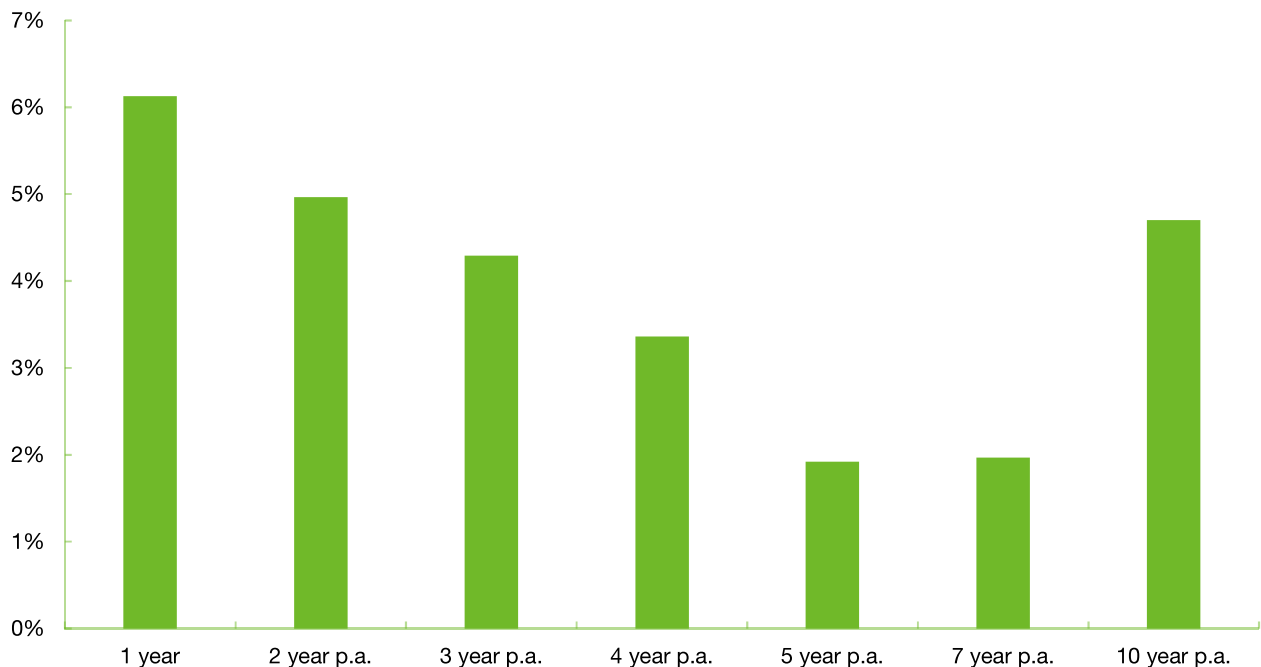
Years before he became a billionaire hedge fund manager, William "Bill" Ackman, founder of Pershing Square Capital Management, trekked 10,000 kilometres to go fishing. Although Ackman had never fished a day in his life, the trip was a success due to his guide, Oliver White.

While White had no prior knowledge of the investment industry, his ability to find fish was key to impressing Ackman. Drawing upon a wise teaching of legendary investor, Charlie Munger, "the first rule of fishing is fish where the fish are", Ackman offered White a role in his investment team.

Where is the best place to fish in Australian equities?

Zenith believes the best fishing spot for active managers is the Australian small cap pond, which is represented by the S&P/ASX Small Ordinaries Index. A diverse and under-researched opportunity set gives an active manager the best chance of outperforming. The chart below highlights the persistent outperformance profile of Zenith's rated small cap managers.

Zenith's rated Small Cap Manager average outperformance (after fees)



Source: Zenith Investment Partners, FE fundinfo

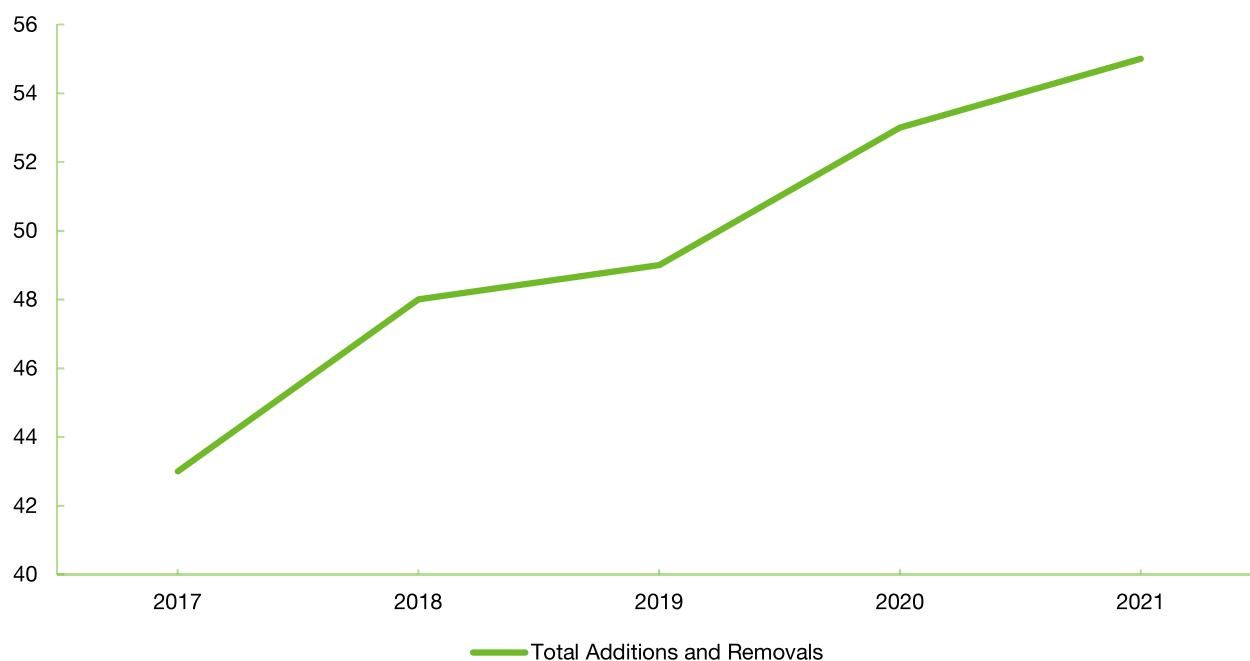
What has accelerated this outperformance profile in recent years?

The Australian small cap universe is dynamic and diversified, and increasingly so.

Over the past five years, constituent changes for the small cap index have gradually increased, reaching a peak of 55 in 2021.



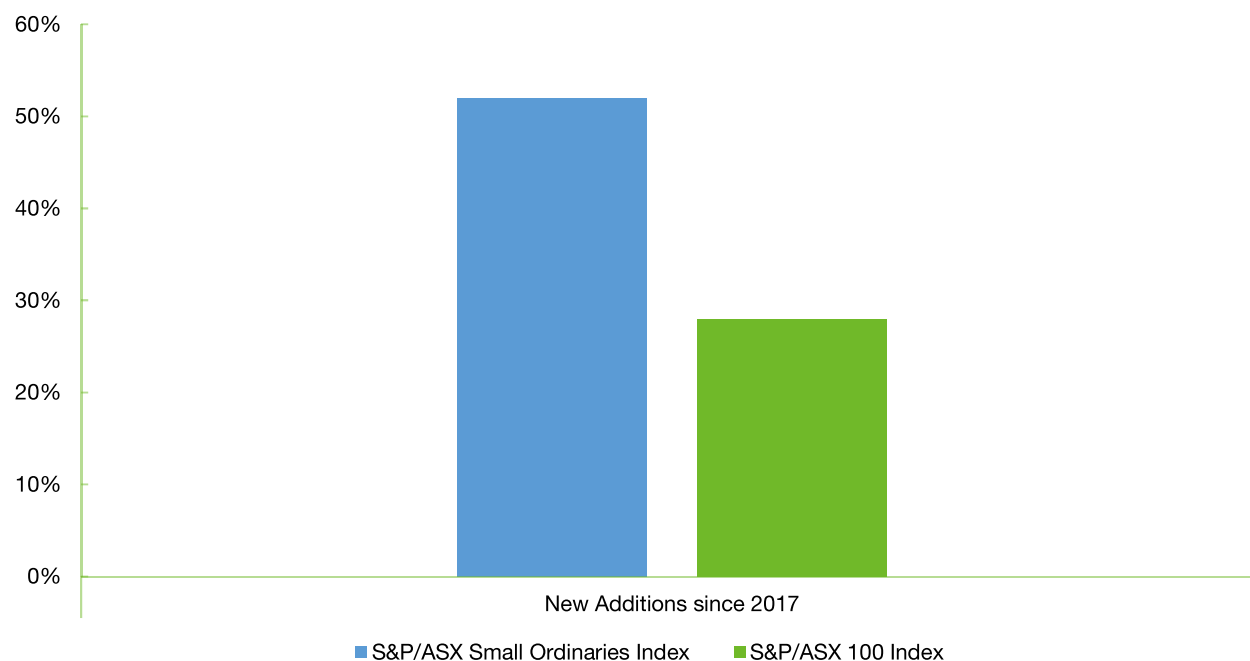
Constituent changes within S&P/ASX Small Ordinaries Index



Source: Bloomberg

Furthermore, we found that over 50% of constituents in the small cap index were not there five years ago, equating to over 100 new opportunities for investors. That is a *lot* of new fish!

Evolution of Australian Indices



Source: Bloomberg

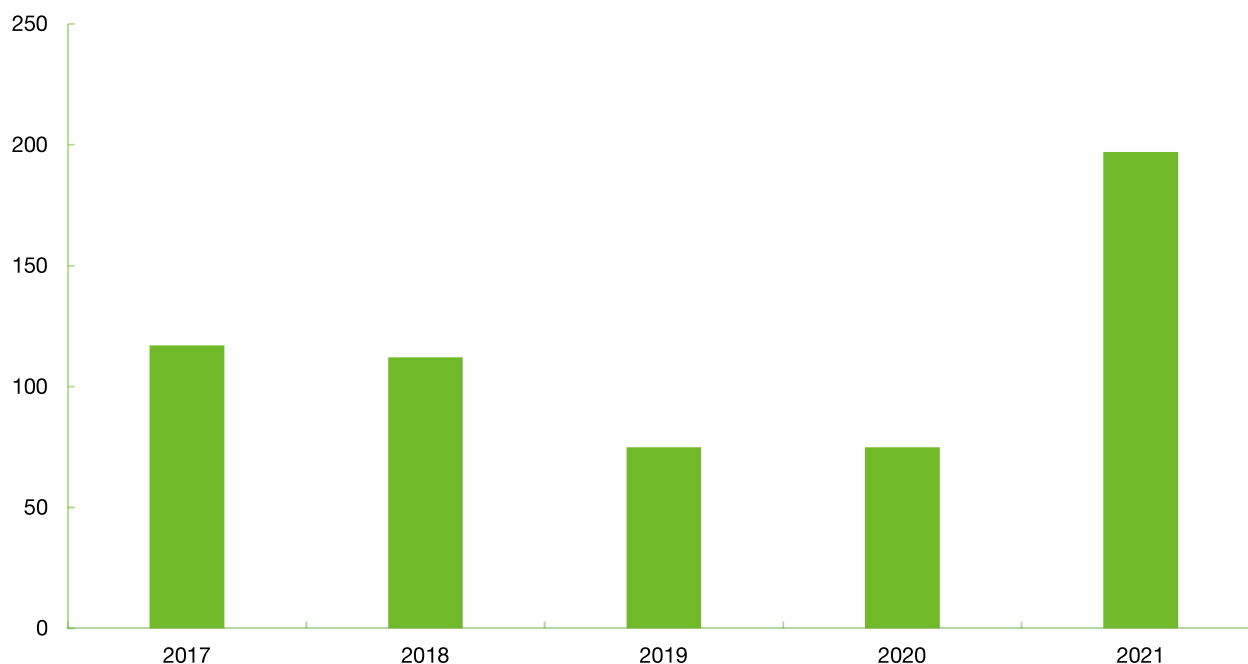
This refresh rate was almost double that of the large and midcap benchmark, as represented by the S&P/ASX 100 Index over the period.



Where are the new fish coming from?

These new opportunities can come from a variety of channels, including initial public offerings (IPOs), whereby a company issues its shares publicly on an exchange. Over the past five years, investors have seen an average of 110 new companies list per year, which are typically opportunities that fall within small and microcap managers' universes, due to liquidity and size constraints. The chart below details the number of IPOs on the Australian Stock Exchange (ASX) over the most recent five-year period.

Number of Australian Stock Exchange IPOs



Source: Bloomberg

As can be seen from the chart, the 12 months to 31 December 2021 were particularly active, with almost 200 companies listing on the ASX.

Another channel for new opportunities is through index constituent changes. Specifically, microcap companies graduating to small caps and midcaps falling into small caps. *More on this later.*

A third channel is through corporate activity, which generally comes in the form of emerging and smaller companies being acquired. When stocks are removed from the index, it is replaced at the next index reconstitution, leading to further opportunities for active investors.

Afterpay is a great example of a company that passed through all the channels above. It was listed in 2016 and grew rapidly, which led to it eventually being promoted to the large cap index. In 2022, it was acquired by US payment giant, Block (formerly known as Square).

Plentiful fish = strong excess return

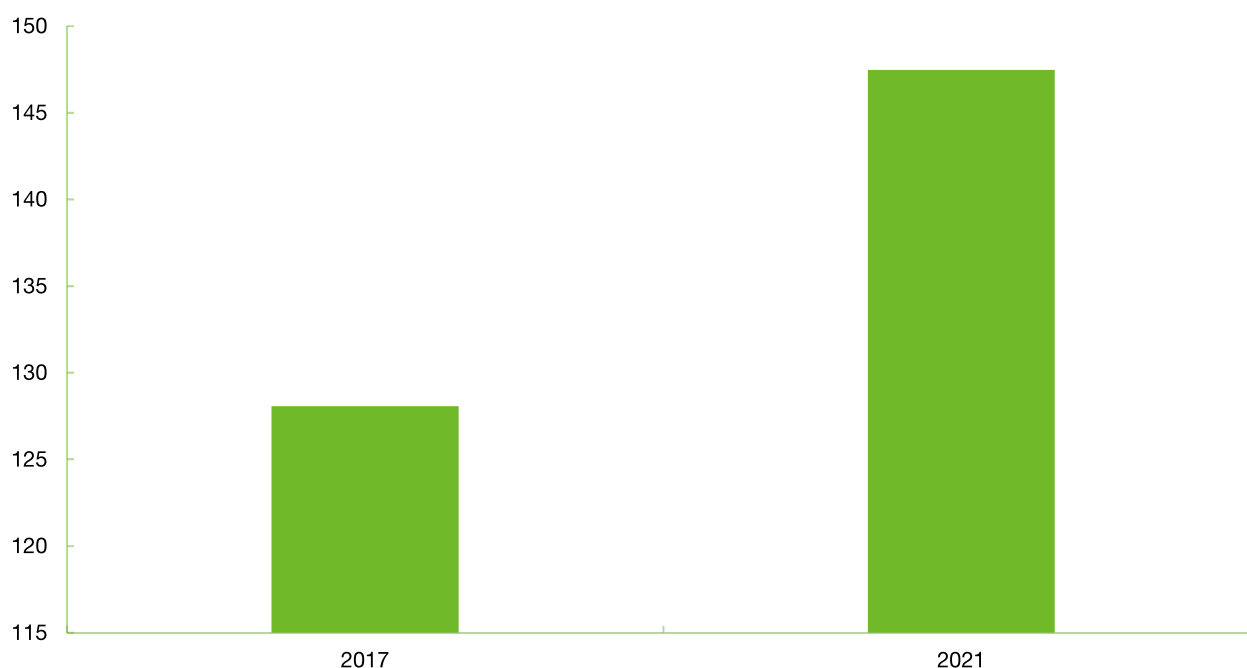
The law of active management suggests that managers are better positioned to generate excess returns with greater investment breadth, holding all else equal. That is, the higher the 'effective' number of holdings in an index, the greater the investment breadth.

The chart below shows the change in the effective number¹ of stocks within the small cap index over a five-year period to 31 December 2021.

¹Calculated by 1 divided by the Herfindahl-Hirschman Index



Effective Number of Stocks - Small Cap



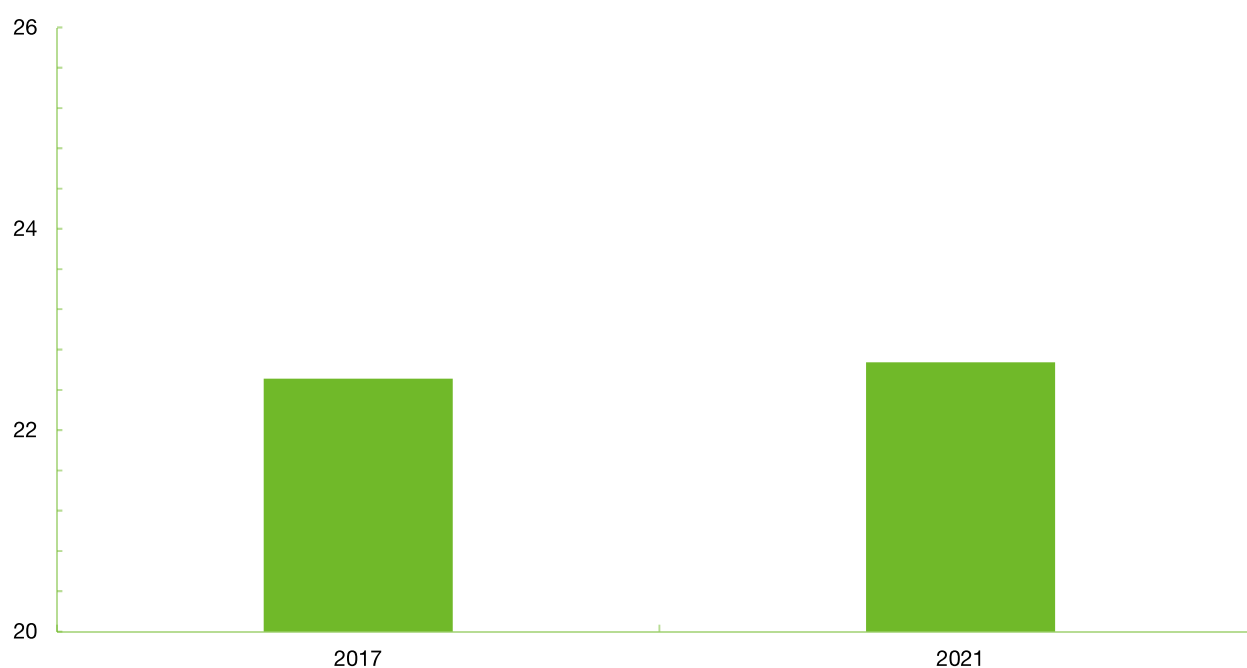
Source: Bloomberg

Although the small cap index typically comprises approximately 200 stocks, the diverse nature of the index results in an effective holding of 148 equally-weighted stocks, as at 31 December 2021. Compared with five years ago, when the effective number of holdings was 128, there has been a material increase in breadth and diversity in the index, which improves an active manager's ability to generate outperformance.

How does this compare to large caps?

Taking the S&P/ASX 50 Index as a representation of large caps, we find that the dynamics are very different.

Effective Number of Stocks - Large Caps



Source: Bloomberg



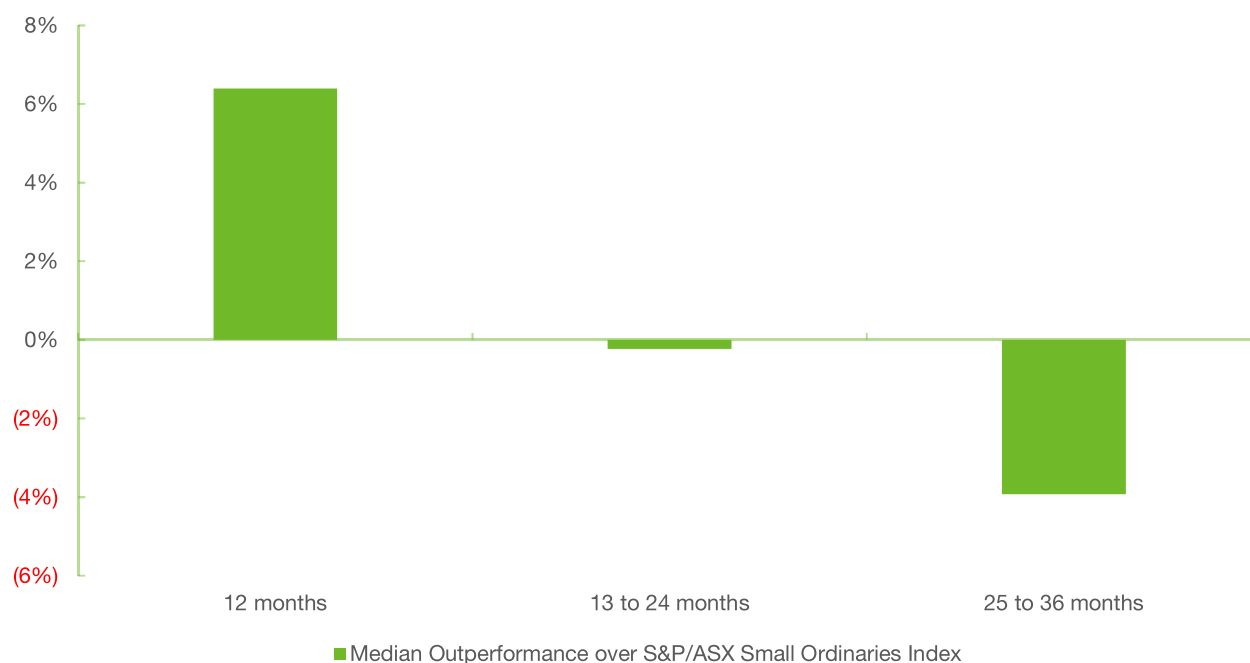
The effective number of stocks within the large cap index was 23 (or approximately 45% of 50 stocks in the index) in 2021, which remains virtually unchanged since 2017.

You're promoted!

How do stocks perform when they get promoted from the small cap index to the midcap index?

The chart below shows the one, two and three-year median outperformance of stocks graduating from small caps (S&P/ASX Small Ordinaries Index) to midcaps (S&P/ASX MidCap 50 Index).

Small Cap Stocks Promoted to the MidCap Index Since 2017



Source: Bloomberg

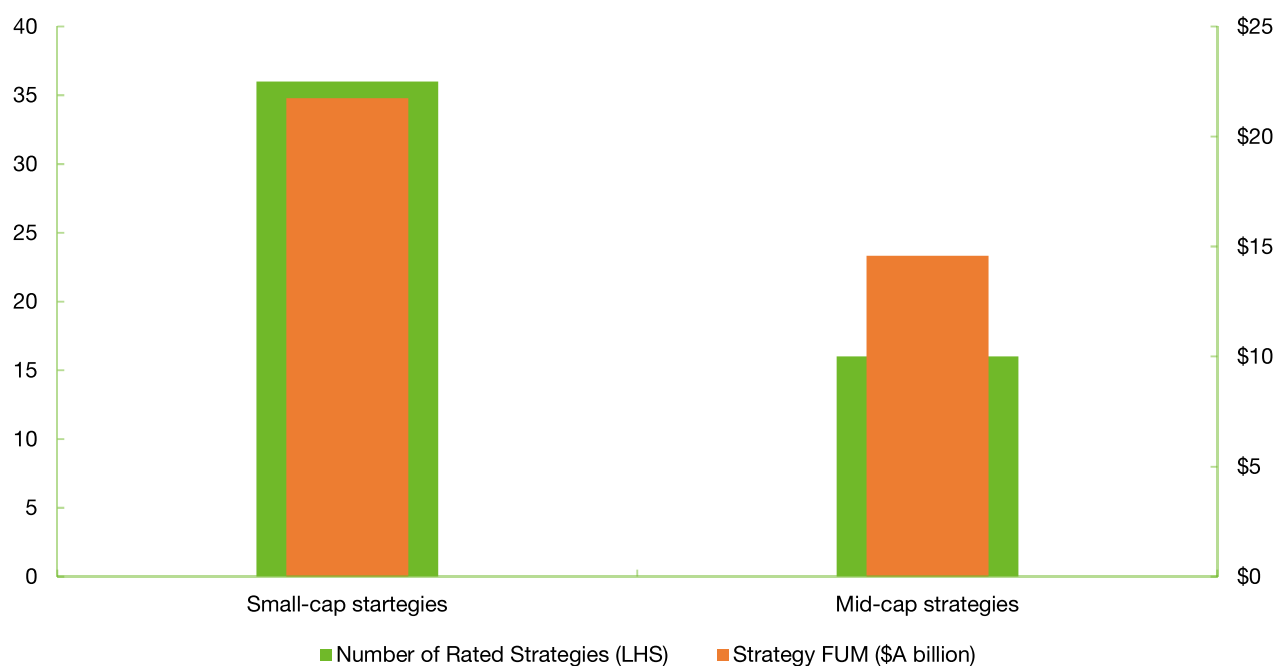
Over a one-year period, promoted stocks experienced a median outperformance over the small cap index of over 6.0%. Zenith believes this short-term outperformance is driven by structural reasons, such as continued momentum from passive index funds buying as stocks enter mid and large cap indices.

However, promoted stocks typically underperformed following the initial 12-month period, which Zenith considers to be underpinned by structural issues.

The small cap fund manager universe in Australia is significantly more mature than its midcap counterpart. The chart below shows the number of small and midcap strategies rated by Zenith and their corresponding aggregated funds under management (FUM).



Market position of Australian small and midcap strategies



Source: Fund Managers, Zenith Investment Partners

This dynamic has the effect of leaving promoted stocks stranded, no longer available to small cap funds and unable to be supported in a material manner by midcap funds.

To remain true to label, small cap funds are typically mandated to divest stocks that get promoted within a certain time frame, which is generally set at 12 months. Zenith believes this time frame ensures that small cap funds remain true to label and allows investors to benefit from the capital gains discount.

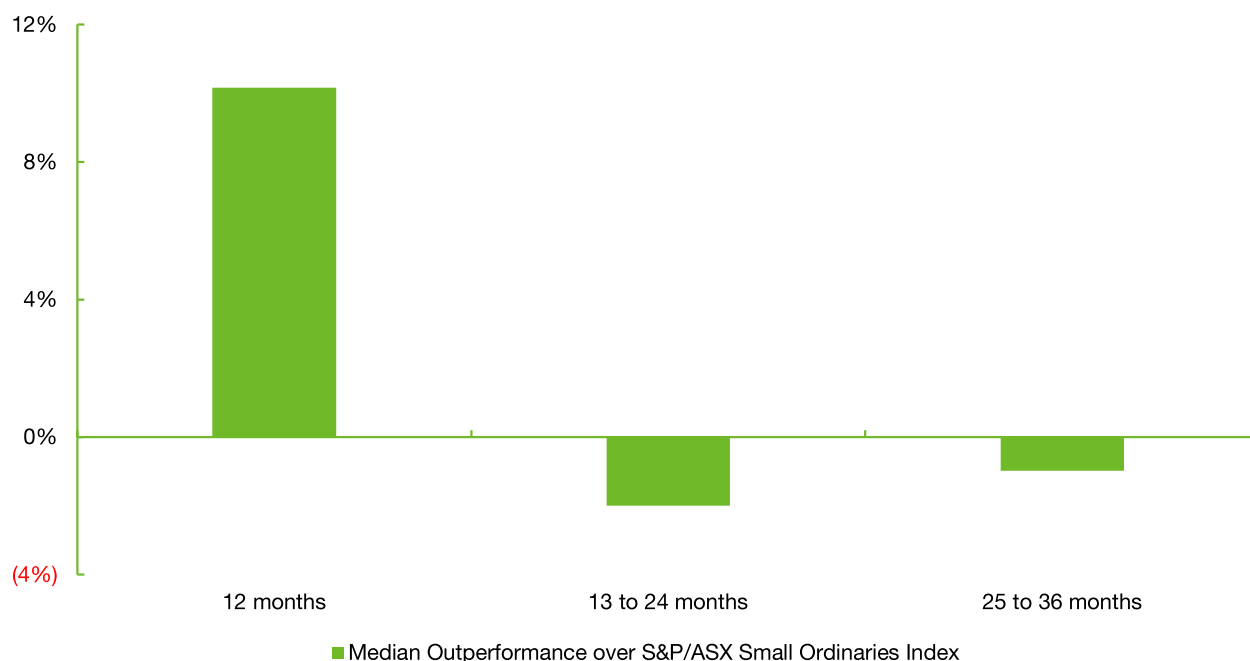
Oh, and you're demoted...

If promotions result in short-term outperformance, is the opposite true for demotions?

Zenith found that this assertion is false for midcap stocks that are demoted. The chart below shows the performance profile of demoted mid cap stocks.



Stocks demoted to the S&P/ASX Small Ordinaries Index since 2017



Source: Bloomberg

Over a one-year period, demoted stocks experienced a median outperformance over the small cap index of over 10.0%. Zenith highlights the immediate tailwind associated with small cap funds becoming eligible to buy these companies once again, especially given demoted stocks can (and often do) have a meaningful weight in the benchmark.

Australian small caps - the place for active managers to fish!

After putting in 100-hour work weeks at Pershing Square Capital Management, White moved back to the Bahamas, seeking the best fishing waters in the world.

Using his newly-acquired skills, he found an old, dilapidated hotel, and made his vision to build a fishing lodge a reality. With Ackman as his backer, White created a highly profitable business, hosting high profile visitors and the ESPN fishing show Pirates of the Flats.

The playbook for Zenith's rated Australian small cap managers is similar – fish for attractive opportunities in some of the best waters in the world.



Contributors:

Fund Reports

Quan Nguyen	Head of Equities
Stephen Colwell	Senior Investment Analyst
Tom Goodrich	Senior Investment Analyst
Jock Allen	Investment Analyst
Adele O'Shannassy	Investment Analyst
Harje Ronngard	Investment Analyst
Sean Currie	Associate Investment Analyst

Sector Report

Stephen Colwell	Senior Investment Analyst (Sector Lead)
Quan Nguyen	Head of Equities
Tom Goodrich	Senior Investment Analyst
Jock Allen	Investment Analyst
Adele O'Shannassy	Investment Analyst
Harje Ronngard	Investment Analyst
Sean Currie	Associate Investment Analyst

Contact Details:

(03) 9642 3320

info@zenithpartners.com.au

DISCLAIMER:

Zenith Investment Partners ("Zenith") (ABN 27 103 132 672, AFS Licence 226872) is the provider of General Advice (s766B Corporations Act 2001). General Advice provided by Zenith is limited to Wholesale clients only. This document has been prepared exclusively for Zenith clients without taking into account the objectives, financial situation or needs of any specific person who may read it, including target markets of financial products, where applicable. It is not a specific recommendation to purchase, sell or hold any relevant product(s) and is subject to change at any time without prior notice. Investors should seek their own independent financial advice before making any investment decision and should consider the appropriateness of any advice in this document in light of their own objectives, financial situation or needs. Investors should obtain a copy of, and consider, any relevant product PDS or offer document before making any decision and refer to the full Zenith Product Assessment/s available on the Zenith website. This document is confidential and subject to copyright and may not be reproduced, modified or distributed without the consent of the copyright owner. The information contained in this document has been prepared in good faith and is believed to be reliable at the time it was prepared, however, no representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document. Except for any liability which cannot be excluded, Zenith does not accept any liability, whether direct or indirect arising from the use of information contained in this document. Past performance is not an indication of future performance. Zenith usually charges the product issuer, fund manager or related party to conduct Product Assessments. Full details regarding Zenith's methodology, ratings definitions and regulatory compliance are available on our Product Assessments and at Fund Research Regulatory Guidelines