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EQUITIES

Three Reasons to Consider a Long-Term Allocation to Small-Cap Equities

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BARINGS INSIGHTS

Recent volatility stemming from COVID-19 and the decline in oil prices has created an environment of uncertainty—but it has also provided a potential opportunity to make good, long-term investments at attractive prices.

Small-cap equity markets have certainly experienced challenges related to the coronavirus fallout and significant decline in oil prices. And while risks remain, the recent market volatility has also resulted in a potential opportunity—particularly for long-term investments in good businesses with solid growth potential that have seen their share prices weighed down as a result of the pandemic.

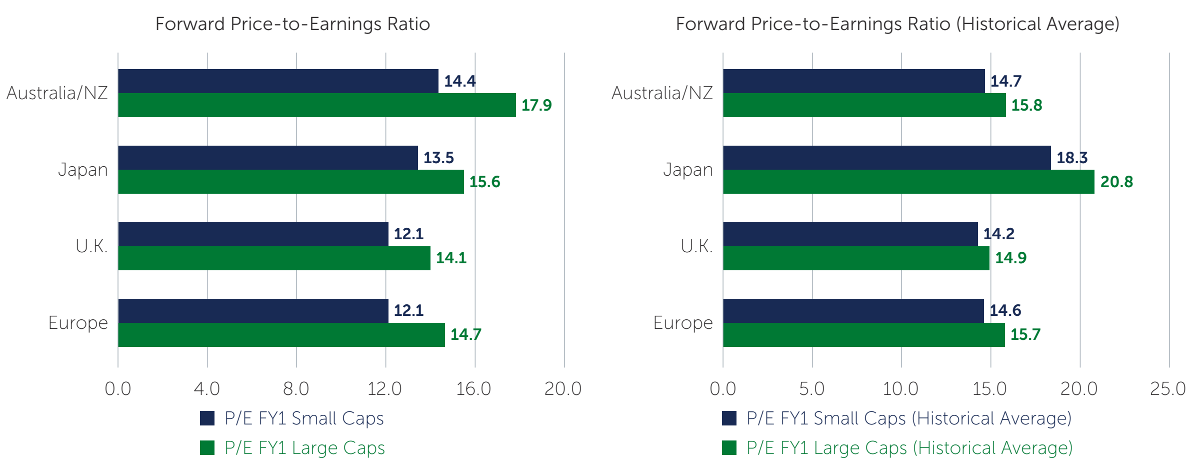
In particular, we think there are three reasons small-cap equities are worth consideration for long-term investors.

1. Valuations Look Attractive Relative to History

European and International smaller companies fell by more than 20% in the first quarter, a steep drop reflective of the concern surrounding the spreading coronavirus. The bulk of this decline came in March as business confidence around the world faltered in response to the lockdown conditions being imposed across a number of economies. The severity and longevity of this crisis, and its ultimate impact on the global economy, are impossible to predict with any certainty—indeed, economists continue to debate over a muddled alphabet soup of potential economic recovery slopes. The effect on corporate earnings is equally as uncertain, although it seems very likely that a swathe of downgrades may be coming.

But the picture isn't all negative. One result of the weaker performance and share price declines is that smaller companies have experienced an erosion of their price-earnings premium relative to larger companies. While small-cap valuations have not yet reached historic trough levels, they have become notably cheaper—and we believe they now look very attractive relative to history, and to larger companies **(FIGURE 1)**. Going forward, with interest rates across developed markets generally at historic lows, and amid intensifying quantitative easing by central banks, equity earnings yields should remain supported—as long as earnings do not fall more precipitously than what markets are currently pricing in.

FIGURE 1: Current And Historical Valuations—Smid Versus Large Caps



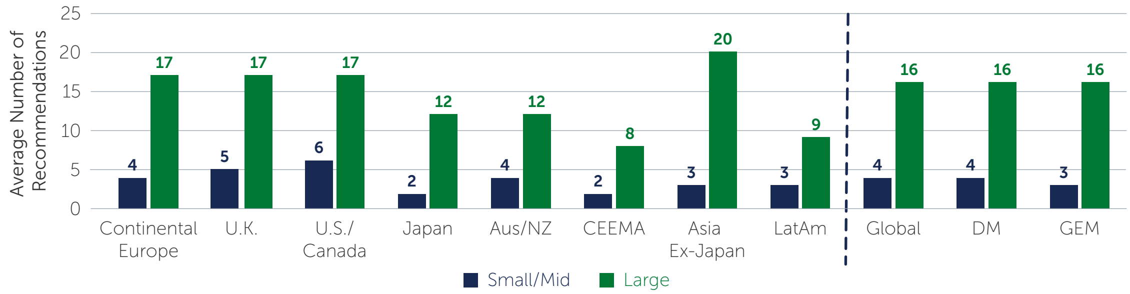
SOURCE: J.P. Morgan. As of April 9, 2020.

2. Extreme Price Movements Create Opportunities

The small-cap equity market tends to be less efficient than its large-cap counterpart—earnings forecasts are often adjusted more slowly and have therefore been less accurate historically than forecasts for larger companies. This is partly due to the relative lack of sell-side coverage of smaller companies compared to the volume of research available for larger companies. There are roughly 1,000 companies in the European small-cap index and around 2,300 in the International small-cap index, and despite the fact that many of these are often leaders in their niche industries, there tend to be far fewer sell-side analysts covering each stock—and the information and earnings forecasts that are published often focus solely on the shorter term. Therefore, it is almost inevitable that greater information gaps will exist within the smaller companies universe.

While this speaks to some of the risks of investing in small-cap equities, it also highlights the potential opportunity. In the current environment, share prices appear to have priced in expected downgrades to some extent, but how under or over-discounted those prices are remains to be seen. Ultimately, this inefficiency can result in attractive opportunities that active managers can exploit. Specifically, active managers who can generate their own models to forecast earnings over a longer time horizon may be able to better understand how discounted the expected change in corporate profits should be—and therefore may be better able to identify growth companies that are currently undervalued.

FIGURE 2: Sell-Side Analysts Per Stock—Smid Versus Large Caps



SOURCE: J.P. Morgan. As of September 9, 2019.

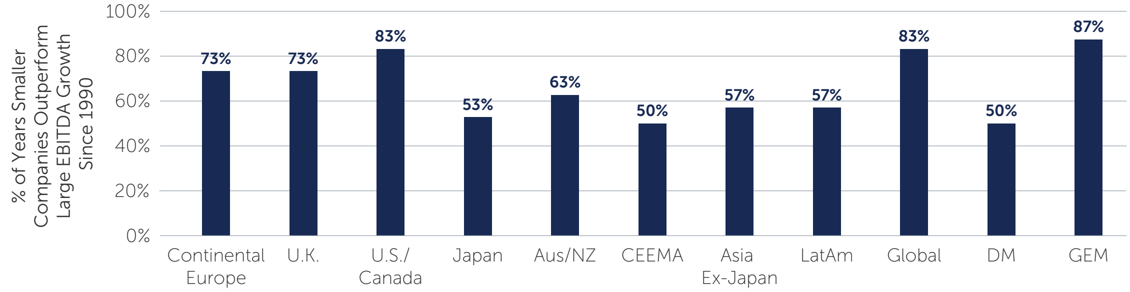
Smaller companies, while often exhibiting greater growth potential than their large-cap counterparts, also tend to be more vulnerable to short-term volatility. As a result, the asset class tends to experience more extreme price dislocations—evidenced recently as small-caps underperformed large caps amid the increased market turmoil. While not without risk, this also has resulted in what we view as a very attractive opportunity to buy into companies that are benefitting from long-term structural growth trends, in many cases at discounted prices.

During the first quarter's volatile market we identified companies whose long-term growth prospects and market-leading positions, were, in our view, not accurately reflected in their share prices following precipitate falls. Among these included a Dutch semiconductor production equipment company, which benefits from market leadership in its niche technologies and a very strong balance sheet, and an Australian internet classified advertising group, which has strong domestic leadership and is expanding quickly in South Korea and Brazil. We think such companies, which are market-leaders in niche industries, will likely see continued demand and growth.

3. Small-Caps Have Exhibited Strong Performance Over Time

Looking across the markets today, forecasts for smaller companies' earnings per share (EPS) growth typically assume declines in 2020 but anticipate moderate to strong recoveries in 2021 and beyond—of between 15% and 25%. Small companies, by nature, tend to be more nimble than larger companies and conglomerates, which gives them the flexibility to react and adapt more quickly to changing markets conditions. This characteristic has resulted in strong long-term performance relative to larger stocks. For example, in Continental Europe, smaller companies outperformed large caps at the index level in nearly 22 out of the last 30 years. In Japan, smaller companies outperformed large caps in roughly 16 of those years, while globally, outperformance was recorded in 26 of the last 30 years. Notably, in years when economic growth was slowing in Europe—2005, 2009 and 2012, for example—European smaller companies also outperformed.[1]

FIGURE 3: Smaller Companies Regularly Outperform



SOURCE: J.P. Morgan. As of September 9, 2019.

1. Source: J.P. Morgan. Data from 1990–2019.

Accessing the Opportunity

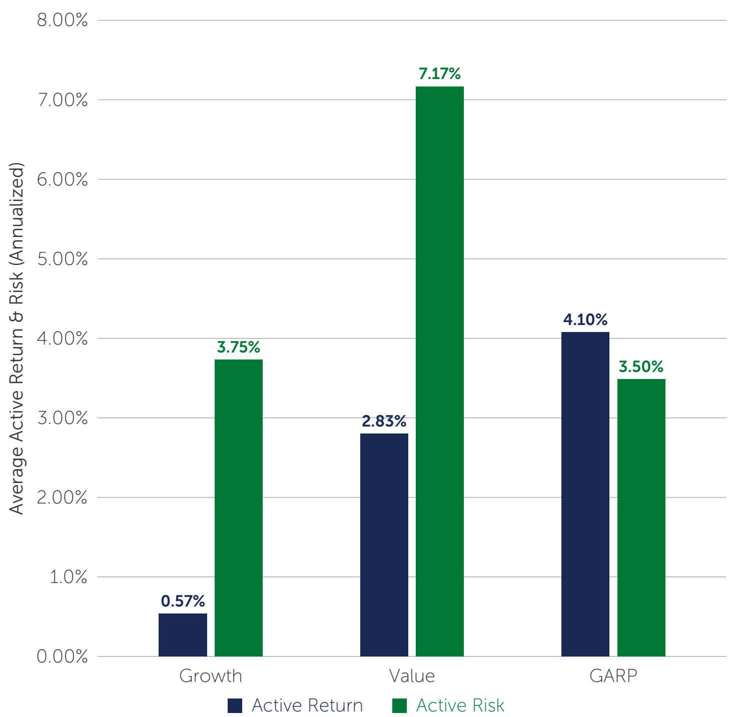
The current environment is wrought with challenges, and while volatility looks likely to persist in the near term, we think there is value in selecting companies that can withstand headwinds and deliver strong earnings growth over time. One way to assess the potential growth characteristics of a company is to forecast its earnings over a longer, 5-year time horizon. This approach allows for the integration of improving business models as well as structural growth trends that may benefit companies going forward—and, importantly, can help illustrate where these trends are not reflected in company valuations.

Of note, companies that have both growth and quality characteristics, as identified through a Growth at a Reasonable Price (GARP) strategy, tend to provide stronger risk-adjusted returns over the long term. For example, over the last 20 years, the average annualized return for GARP companies is 4.10%—almost twice as high as the average annualized return for value companies and well above the 0.57% return for growth stocks **(FIGURE 4)**.

At Barings, as a result of our GARP approach, we favor companies with well-established business franchises, proven management and strong balance sheets—in our experience, these companies offer a level of transparency and stability of earnings and share prices that help to reduce portfolio volatility and make it possible to forecast long-term earnings growth more accurately. Conversely, we tend to avoid highly cyclical companies, particularly those whose fortunes are tied to commodity price developments, as well as those with stressed balance sheets and/or those that have poor corporate governance and shareholder rights protection.

Given the size and diversity of this asset class, active management is also paramount. As mentioned earlier, the dearth of published research in the space presents an opportunity for managers with strong, bottom-up stock selection capabilities to dig deep and uncover solid companies with strong growth potential that are undervalued—something passive strategies cannot mimic. An active strategy can likewise help mitigate some of the risks and volatility associated with this universe. While small-cap returns at the index level have been more extreme over time, given the size and breadth of this space, it is very possible for a targeted, actively managed portfolio of high-conviction smaller companies to have a markedly different volatility profile than the index. In addition, by hand-picking companies based on fundamental research, we believe managers can put themselves in a better position to avoid excessively risky investments.

FIGURE 4: Average Annualized Active Return Since 2000



SOURCE: J.P. Morgan. As of September 9, 2019.

KEY TAKEAWAY

The recent moves in the equity markets, while certainly unnerving, have created what we view as a potential opportunity to invest in companies that stand to benefit over time from supportive structural growth trends. That is not to say the investment landscape is without risks—surely, the ongoing pandemic and related shock to businesses around the world will continue to weigh on markets. But for active managers with the ability and resources to dig deep into each company, and identify those less likely to experience major disruptions to growth and earnings, the volatile environment has given way to attractively priced investment opportunities for the long term.

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