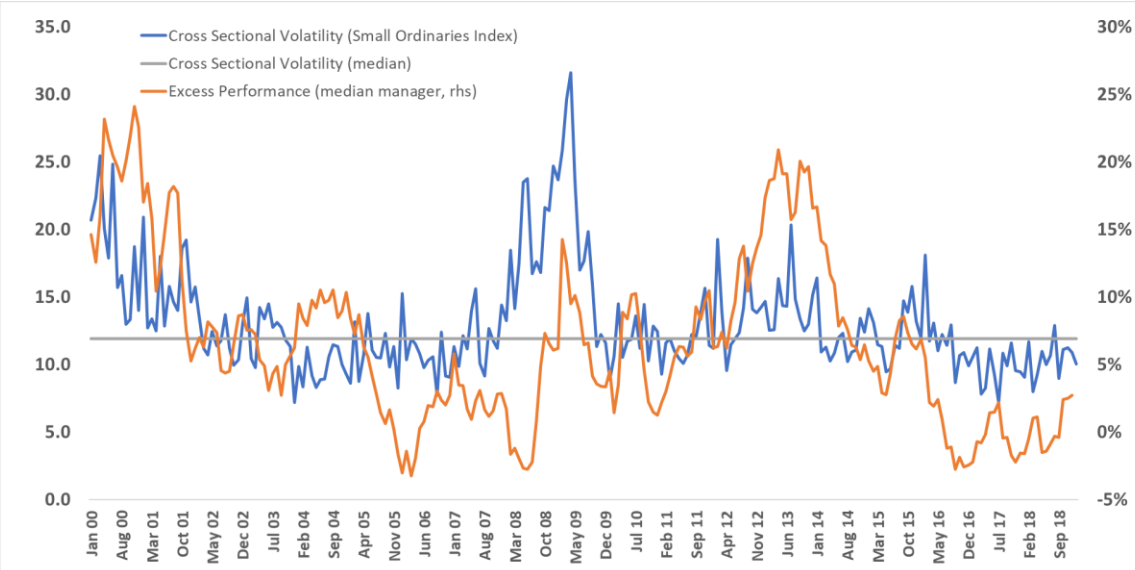
Active Management in Australian Small Companies – Skill versus Style

In our first note on Active Manager Skill in Australian Small Companies (February 2019) we highlighted that in order to determine if a manager can deliver long-term alpha over the cycle, we must assess their performance in conditions of low cross-sectional volatility. Specifically, the active manager must respond to the subdued environment by increasing active positions in the portfolio so as to offset low dispersion of returns and hence low idiosyncratic (stock specific) risk. Stock selection skill remains the primary driver of alpha generation, however, portfolio construction must respond to the prevailing volatility.

These conditions have prevailed over the last 3 years (Chart 1, as in other occasions over the last 20 years) and has coincided in the median manager underperforming the benchmark. Industry commentary around this underperformance has typically involved a discussion on investment style, specifically, that a value thematic has been out of favour and hence led to the underperformance for managers of this style. In this report we illustrate that the investment style of the manager cannot be used as a justification of manager underperformance.

Chart 1 S&P/ASX Small Ordinaries Index cross-sectional volatility and excess performance of the median Australian small company manager (Jan 2000 to Dec 2018)

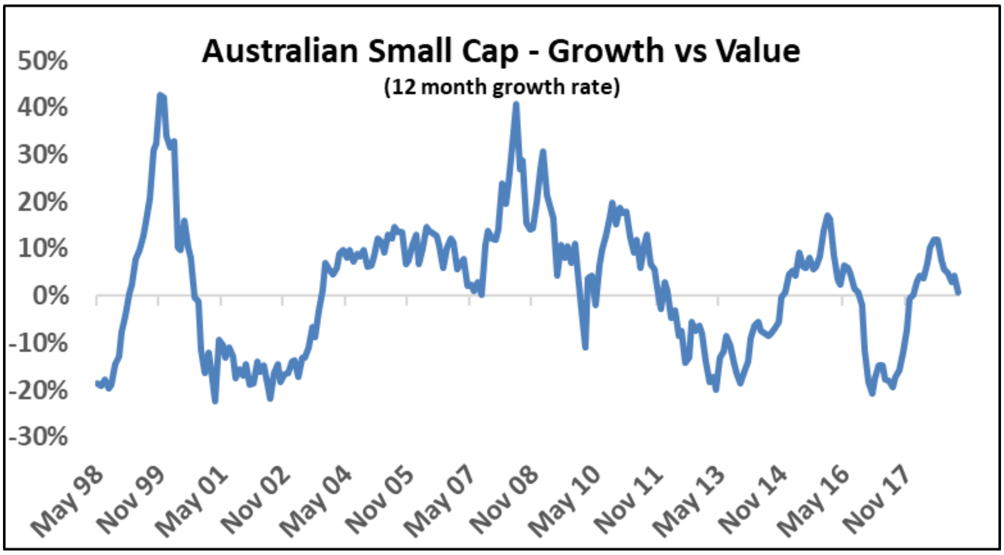


Source: Mercer, Flinders Investment Partners

Previously, we analysed Growth versus Value in Australian Small Companies (April 2017) and concluded that a fundamental growth approach is preferred in delivering outperformance in Australian small companies over time. We used an independent, factor based set of indices to define each group, namely the MSCI Australia Small Cap Growth index versus the MSCI Australia Small Cap Value index. Chart 2 shows the relative performance of the growth versus value indices since inception (Jun 1997). Growth remains positive ~61% of the time over the time series (a reading greater than 0%), indicating that of the fundamental factors, growth is a stronger alpha signal in the small company's universe.

Reviewing the period since 2016 to date (which coincides with a period of low cross-sectional volatility and the median manager underperforming), we note that over the 38 months, growth outperformed value in 16 months and value outperformed growth in 22 months. The indices themselves have delivered 8.7%pa for growth and 15.4%pa for value, suggesting that from a fundamental perspective, value factors were not in themselves a constraint on adding value. To the contrary, value characteristics performed well in the period.

Chart 2. Relative performance of the MSCI Australia Small Cap Growth versus Value Accumulation Index (Jun 1998 to Feb 2019)



Source: MSCI, Flinders Investment Partners

This is an interesting outcome. We recognize that over time, growth characteristics tend to dominate Australian small cap performance, however in the recent history value signals have performed better. Therefore, the market perception that a value style has led to manager underperformance is contrary to the fundamental evidence.

<u>Growth versus Value</u>

The labelling of managers with growth and value styles has led to a number of mis-representations. The key mis-representation is that growth stocks are high PE stocks. High PE stocks are simply expensive stocks relative to the market. These may have growth characteristics but this is an assumption rather than a quantitative measure. Conversely, value stocks are companies that are cheaper than the market but is not a comment on their growth characteristics.

To improve understanding of this, we have undertaken an analysis of the current small companies' universe to demonstrate their attributes as so far as growth and value is concerned.

With reference to growth, growth is fundamentally a comment on earnings. If we rank small cap stocks according to their 1 year forward earnings growth (Table 1), we see that the top quartile is characterised by growth of 56% and a PE of 16.4x. The Australian small companies' market is currently trading on a 1 year forward PE of 16.9x. Therefore, at least half of the strongest growing (top quartile) stocks in the index are trading at a 1 year forward PE cheaper than the market. This suggest that growth stocks may be expensive but can also exhibit value characteristics.

Table 1. S&P/ASX Small Ordinaries Index 1 year forward earnings growth ranked by quartiles together with the associated PE (median values)

Quartile	EPS Growth	PE
1	55.5%	16.4
2	13.5%	16.2
3	4.9%	15.7
4	-2.4%	14.6

Source: Factset, Flinders Investment Partners

This is intuitive given the nature of the small companies' universe. The constituents are aspirational growing companies. As businesses mature from loss makers to profits, the valuation that the market ascribes to the company increases. And so, early stage growth businesses can trade on attractive, cheap valuations.

Therefore, concluding that expensive stocks are growth stocks may be correct, but they are only a limited proportion of what constitutes growth and arguably the least attractive from an investment returns perspective.

Conclusion

Having a value investment style has been cited by some as a basis for a manger underperformance over the last 3 years. In fact, what has been observed, is that stocks with value characteristics have performed better than growth stocks over this period. We have demonstrated, that stocks within the small cap universe capture both growth and value characteristics. This is fundamentally linked to the maturity and consistency of the company and therefore how it is valued by the market.

Above all else, we recognize that given the diverse nature of the Australian small companies' universe (industry, stock count, business maturity), active management has delivered strong returns for investors. However, to determine if a manager can deliver long-term alpha over the cycle, we must assess their performance in conditions of low volatility (which can persist for significant periods), where opportunities are scarce, in order to validate the manager's stock selection and portfolio management skill.

Flinders has demonstrated a consistent ability to construct portfolios with materially higher growth characteristics then the market yet at a significant discount to the market valuation. This has assisted the fund in delivering outperformance against the S&P/ASX Small Ordinaries Accumulation Index, and compare favourably to our peer group.

Flinders Investment Partners
2 April 2019