Growth vs Value in Australian Small Caps – FY19 Update

With FY19 just behind us, it's an opportune time to revisit and update some of our previous research on style in the Australian small cap market. This is particularly relevant given the considerable commentary on investment style, specifically Growth vs Value, in the markets currently.

As we've historically done, we'll use the MSCI Australia Small Cap Growth and the MSCI Australia Small Cap Value indices as the basis for analyzing style. Table 1 highlights the performance of these two indices in recent years.

Table 1

	Growth	Value
FY19	7.0%	2.4%
FY18	25.2%	13.4%
FY17	0.9%	23.0%
FY16	15.8%	9.2%
4 years*	56.4%	55.9%
4 years p.a.*	11.8%	11.7%

* Performance to 30 June 2019

There are a couple of observations:

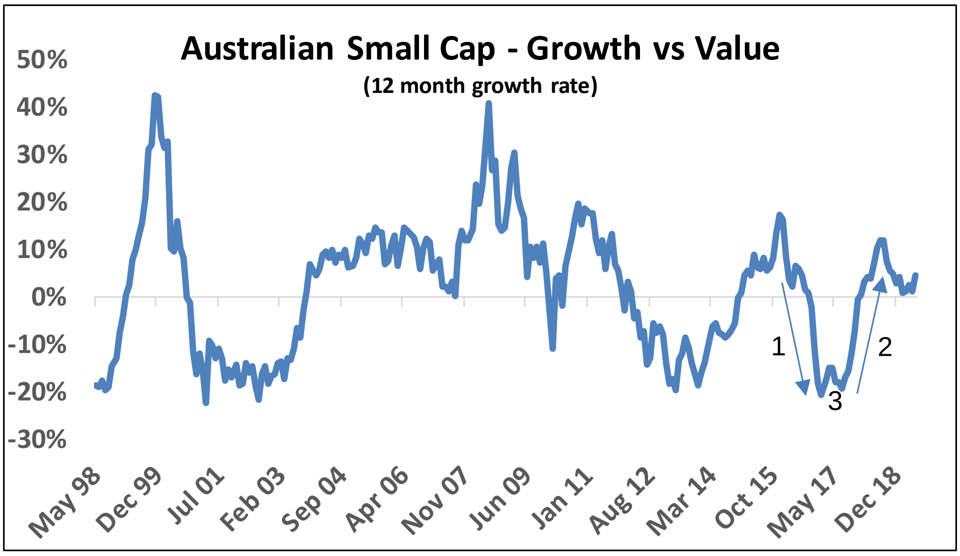
1. The last 1-2 years have indeed been a tough period for Value oriented stocks, with the Growth index delivering twice the Value index return in the last 2 years. This is in line with the prevailing market commentary, that 'value managers' have had a tougher time of late.
2. However, the last 3-4 years tell quite a different story. The Value index substantially outperformed the Growth index in FY17. And over the last 4 years, the two indices have roughly performed in line with each other. This point is something that has been missing from the recent market commentary – *Value stocks have done just as well as Growth stocks, over the medium term*.

Chart 1 is from our original Growth vs Value report from April 2017, updated to 30 June 2019. The chart is useful in that it illustrates clearly that different styles have outperformed over different time horizons. The last 4 years can be roughly divided into two halves – firstly where Value has outperformed Growth substantially (Arrow 1 in Chart 1), and secondly where Growth has outperformed Value substantially (Arrow 2 in Chart 1). Perhaps a critical question is, *how has a manager performed over the last four years, where the difference in the style indices has been negligible?*

As it turns out, over this 4-year period, the median manager (11.6% p.a.) has performed in line with the benchmark (11.6% p.a. return from the S&P ASX Small Ordinaries Accumulation index, the benchmark for most Australian small cap managers). It is also interesting to note that despite the performance of value factors over the period, generally speaking value managers have underperformed the benchmark. In addition, a number of these managers have closed down over the period responding to poorer performance.

Importantly, as we discussed in our Skill vs Style report from April 2019, given the benign nature of the market (coinciding with a period of low cross-sectional volatility), it is the stock selection and portfolio construction skill of the manager that has delivered above market returns. In fact, it has been a fortuitous period to assess these skills to determine a managers' capability to deliver long term returns once the market returns to more stable conditions.

Chart 1



As a final point, we highlighted in our April 2017 report that the timing was ripe for Australian small cap growth stocks to perform well, given their extreme underperformance up to that point (Point 3 in Chart 1, a level seen only a handful of times in the last +20 years). As we subsequently saw, growth stocks proceeded to outperform handsomely, and as it stands currently, we seem to be at a more neutral setting. To recall from that report, we determined that growth characteristics are desirable when investing in Australian small caps, given the growth index has outperformed value ~61% of the time (since the inception of the indices). So, while the chart suggests we are no longer at extreme levels, the current neutral level bodes well for investing in attractively priced, growing companies going forward.

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