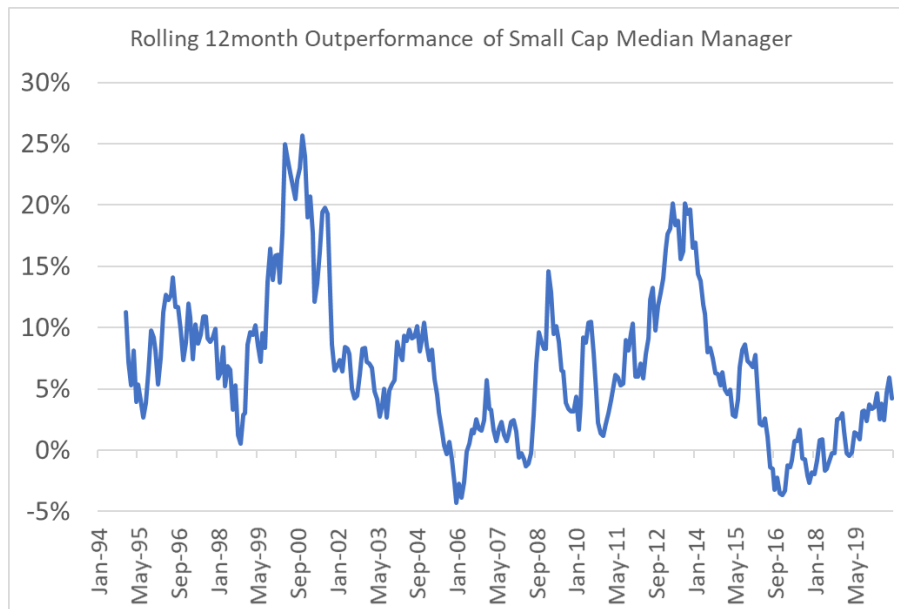


Actively Managed Small Caps are a Core Portfolio Holding

We have chosen the 5-year anniversary of the Flinders Emerging Companies Fund to review the performance of active managers in the Australian Small Cap sector. It is important to note that historically, active management has consistently delivered outperformance against the S&P/ASX Small Ordinaries Index as illustrated in Chart 1, a time series of rolling 12 month outperformance* of the median small cap manager.

The last five years has actually been one of the tougher periods for the active small cap manager (a period that has coincided with a lower than usual level of cross-sectional volatility, which measures the spread of stock returns. See our earlier note [here](#)). Despite this, the median manager has still outperformed the benchmark (11.8% p.a. vs 10.5% p.a., Table 1), and pleasingly for our investors, the Flinders Emerging Companies Fund has delivered top quartile performance with a return of 14.2% p.a. Importantly, the asset class continues to provide vast opportunity to deliver returns for investors.

Chart 1. Outperformance of the median small companies' manager (rolling 12 months)



Source: Mercer, Flinders Investment Partners

When comparing across asset classes, while the Small Ordinaries Index has outperformed the ASX 200 benchmark in the last five years, it has underperformed over the last 10 years (Table 1). Interestingly, the median small cap manager has outperformed both benchmarks, as well as the top quartile large cap (Australian Equities) manager over the 10-year period. In fact, the median small cap manager exceeded the return of both indices over all periods, including the top quartile active manager in large caps.

* performance data used in this report are before fees

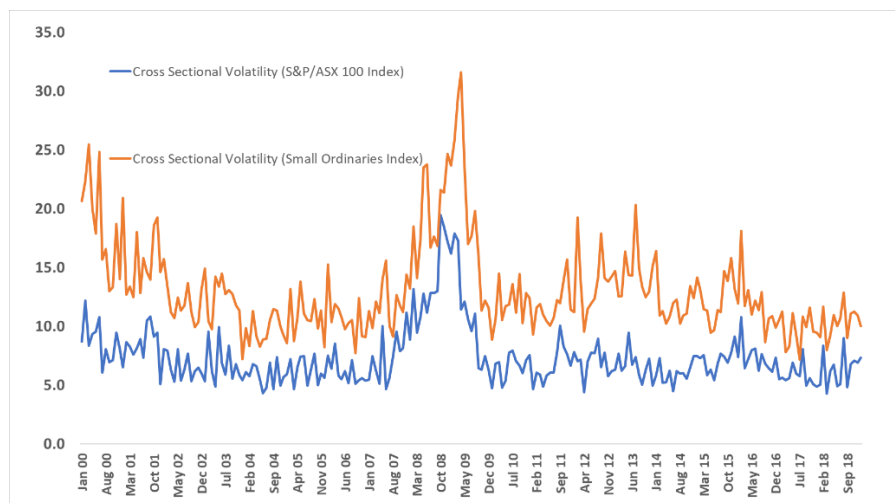
Table 1. Australian Small Company and Australian Equity Manager performance (to August 2020)

	1 yr (%)	2 yrs (% pa)	3 yrs (% pa)	5 yrs (% pa)	10 yrs (% pa)
Small Caps					
S&P/ASX Small Ordinaries	2.1	1.5	8.0	10.5	4.7
Upper Quartile	11.2	7.8	14.8	14.1	12.7
Median	7.0	4.5	10.7	11.8	10.8
Large Caps					
S&P/ASX 200	-5.1	1.7	6.1	7.5	7.8
Upper Quartile	-0.9	3.3	8.2	9.7	9.9
Median	-3.9	1.5	6.2	7.9	8.7

Source: Mercer, Flinders Investment Partners

This outcome is not surprising. We have highlighted [previously](#), that the cross-sectional volatility of the small companies sector is materially higher than the S&P/ASX 100 sector (which constitutes ~90% of the S&P/ASX 200 index, see Chart 2). The cross-sectional volatility represents (amongst other things) the opportunity set available to the investor. The higher the dispersion of returns, the higher the opportunity to add value. As the small cap asset class exhibits higher dispersion than large caps, there is the opportunity to provide higher returns.

Chart 2. Cross-sectional volatility for the S&P/ASX 100 (large caps) and the S&P/ASX Small Ordinaries (small caps) Indices



Source: Flinders Investment Partners

The debate about the level of small company exposure in a portfolio has typically revolved around an assessment of their characteristics relative to large caps. As demonstrated in Table 1, the average Australian Equities manager has delivered returns close to the benchmark (and probably under the benchmark, after fees). This cannot be said of the small cap sector, where the median manager return has consistently and materially exceeded the benchmark.

Therefore, an asset allocation decision on the viability of a small cap allocation based purely on analysis of the benchmark returns, ignores the demonstrated alpha opportunity available

for investors over time. Hence, a small cap exposure is core to any portfolio allocation to equities.

A final point on valuation. Markets have rallied strongly since the trough on 23 March 2020. Suffice to say, equities have re-rated aggressively. From this perspective, it is prudent to assess the current valuation and growth characteristics of the market segments to determine suitability for continued investment. Table 2 illustrates FY21 consensus expectations for large caps (S&P/ASX 100), mid caps (stock 51 to 100 within the S&P/ASX 100), small caps (S&P/ASX Small Ordinaries i.e. stocks 101 to 300) and finally the Flinders portfolio (based on FactSet consensus data). The key outcome here is the attractiveness of the small cap sector from both a growth perspective (compared with large caps) and from a valuation perspective (compared with mid caps). It is also important to note that the earnings growth illustrated below has been achieved off positive earnings growth for small caps in FY20, while large caps delivered negative growth in FY20.

Table 2. Market fundamental attributes

FY21 Attributes	ASX 100	Mid Cap	Small Ords	Flinders
EPS GROWTH	11.8%	13.4%	24.5%	23.6%
SALES GROWTH	2.5%	5.0%	8.0%	17.6%
PE	18.3	27.1	16.6	15.0
DIVIDEND YIELD	3.6%	2.2%	3.3%	2.6%
PRICE CASH FLOW	15.0	15.3	10.4	10.0
EV / EBITDA	9.4	13.6	9.3	6.9
ROE	11.4%	9.4%	9.4%	13.3%

Source: FactSet, Flinders Investment Partners

Importantly, the opportunity set presented by the small cap sector allows the fund manager to demonstrate both their stock selection and portfolio construction skill. Pleasingly, Table 2 also illustrates that a portfolio of high earnings growth companies can be identified with attractive valuation characteristics. This has been a feature of the Flinders Emerging Companies Fund since inception.

Flinders Investment Partners 1 October 2020

Disclaimer and Disclosure

The material contained in this communication (and all its attachments) has been prepared by Flinders Investment Partners Pty Ltd ("Flinders"). Flinders is a Corporate Authorised Representative of EQT Responsible Entity Services Limited ("EQT", AFSL 223271). You should not act on any information (if any) made in this communication without first consulting your investment advisor in order to ascertain whether the information (if any) is appropriate, having regard to your investment objectives, financial situation and particular needs. Nothing in this communication shall be construed as a solicitation to buy or sell a security or to engage in or refrain from engaging in any transaction. Flinders and EQT believe that the information (if any) contained herein is correct at the time of compilation. However, Flinders and EQT make no representation or warranty that it is accurate, complete, reliable or up to date, nor does Flinders or EQT accept any obligation to correct or update the opinions (if any) in it. The opinions (if any) expressed are subject to change without notice. Flinders and EQT do not accept any liability whatsoever for any direct, indirect, consequential or other loss arising from any use of the material contained in this communication. This communication may refer to the past performance of a person, entity or financial product. Past performance is not a reliable indicator of future performance. If applicable, investors should obtain the relevant product disclosure statement and consider it before making any decision to invest.