The Frontier Line

Thought leadership and insights from Frontier

Issue 192 | **April 2022**

Opportunistic ideas for a challenging return outlook – Part 2

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

James Gunn

Senior Consultant

James Gunn joined Frontier in 2019 as a Senior Consultant within the Equities Research Team. He has more than 15 years equity markets experience, including direct equities experience. Most recently, he worked as a buy-side equity analyst at Prime Value Asset Management and prior to that he held senior manager research roles with Standard and Poor's and Aviva. He commenced his career as a Financial Analyst with Lincoln Indicators. James recently completed his Masters of Accounting at Monash University and also holds a Bachelor of Commerce from Melbourne University and Graduate Diplomas of Applied Finance and Financial Planning with FINSIA.

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Head of Equities

Fraser joined Frontier in 2012 and is the Head of Equities. He was previously at Ibbotson Associates/ Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Analyst in its Melbourne and London offices. Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

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Background

Over the past two years, Frontier has introduced discrete, opportunistic strategy buckets to our domestic and global equity configuration frameworks. These allocations are designed for long-term investors targeting return enhancing ideas.

The key objective of this paper is to promote this broader lens where appropriate and provide illustrative examples of the types of ideas across developed and emerging markets that might resonate with some asset owners with high-to-moderate excess return objectives.

Additionally, the Frontier Equities Team continues to progress new ratings across a broad range of these 'opportunistic' type areas. While opportunities further down the capitalisation spectrum are typically most relevant to less capacity constrained small/ medium-size asset owners, larger investors are actively assessing a broader range of niche ideas, such as China A or specialist climate strategies.

We have broadly organised these ideas into three main opportunistic areas: China A-shares, 'activist', and a broader section on small caps. Frontier Line 190 Opportunistic ideas for a challenging return outlook – Part 1 considered the first two of these opportunistic areas. This edition, Part 2, is solely focused on small caps.

Summary

There are a number of steps investors should follow to establish an equities portfolio configuration in order to meet their underlying portfolio objectives.

This includes setting return objectives that align with the portfolio's investment purpose and investor-specific constraints (e.g. size, fee sensitivity, risk appetite (including YFYS considerations for superannuation funds), ESG objectives and tolerance for complexity). For investors with high-to-moderate excess return objectives, one of the key steps to establishing an equities configuration is determining how much to allocate to return-enhancing opportunities. For international equities, this will include the allocation to active broad-cap developed and emerging market equities but should also consider the allocation to more opportunistic areas, such as those discussed in this paper. This should include the suitability of various opportunistic ideas and how best to access these over time.

We consider a range of niche ideas scalable for small and mid-sized clients (typically down the cap spectrum) but also ideas relevant to large and growing super funds, for example across both developed and emerging markets.

From a timing perspective, we think the forward-looking environment presents a much more challenging return outlook for equity investors given the extended low interest rate, bull market environment that has persisted for large-cap growth stocks until more recently. The implication is that investors may not be able to rely so heavily on headline equity market returns (i.e. beta), hence an increasingly important role for index agnostic, opportunistic strategies delivering less correlated source of alpha/return in domestic equities, global developed and emerging markets.

For example, generating excess returns or alpha has mattered less when equity returns were strong as they have been for much of the period since the GFC, i.e. getting 1% or 2% extra is good, but proportionately small when equities more broadly are giving an end investor +10% from the market benchmark.

However, if market returns are a lot lower, say 2%, then getting excess returns of 2% essentially means the excess is 50% of an investor's overall outcome. In times of weak equity markets, excess return is more important than ever!

We have summarised some of our key strategy-specific opportunistic views within this summary for Part 2, along with portfolio construction and fee considerations.

Small caps

- Frontier maintains ongoing conviction in the merits of a dedicated allocations to small-caps, rather than relying solely on harvesting this alpha from broad-cap manager allocations, whether that be domestically, globally or within emerging market portfolios. However, we continue to view the primary source of return enhancement from small-caps (from a whole-of-sector perspective) to be the alpha opportunity rather than specifically tilting away from the benchmark by allocating to small cap beta, whether in developed or emerging markets. Internationally, we are most convicted in the active EM SC opportunity. However, we also endorse global small-caps.
- We have also incorporated a small section on both listed and private-to-public Australian micro-cap strategies. We historically have not advocated for a dedicated allocation to listed micro-cap strategies but do believe the hybrid unlisted/listed structure of so-called pre-IPO strategies can be a compelling opportunity for small-to-mid size asset owners wishing to access emerging companies. These strategies can provide exposure to difficult-to-access private market micro-cap opportunities still early in their growth cycle, while seeking to avoid the earlier-stage risk (and fees) associated with venture capital.

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Portfolio construction

The excess return expectations for satellite ideas have two components, a market component 'beta' and excess returns generated through manager skill 'alpha'. The market component represents the additional returns expected from investing in riskier and possibly less liquid sub-asset classes, i.e. the allocation itself would be expected to generate higher returns than the S&P/ASX 300, as an example.

While satellite ideas are clearly not homogenous, they share commonalities in that a greater 'alpha' and 'beta' return is expected given the nature of these opportunities – being typically less researched, less liquid (not always) and often more volatile investments relative to a more mainstream equities exposure.

Table 1 is an extract from Frontier's 2022 international equites configuration. For clients pursuing higher alpha in global equities as an example, Frontier has advocated that institutional clients invest between 5% to 15% of their global equities in these opportunistic ideas. We believe skilled managers in these areas, where active management is key, can be expected to generate a return of between 2-2.5% p.a. above an ACWI benchmark (incorporating both alpha and beta components).

However, some satellite ideas such as emerging market small caps or China A, for example, have been more favourable towards active management and therefore a higher excess return component would be expected. Frontier can assist clients in establishing return expectations for specific opportunistic allocations. Importantly, these base-case assumptions can be enhanced through superior manager selection.

Table 1: Portfolio construction guide – High alpha portfolio example

Strategy	Allocation ranges	Expected excess return over MSCI ACWI ex Au with special tax (net)	Tracking error range *	Indicative fees (% p.a.)
Active global equities [1]	55% - 75%	1.2%		
Indexed/enhanced index/ low carbon index [2]	0% - 15%	0.0%		
Emerging markets/Asia ex Japan	15% - 20%	2.0%		
Opportunistic ideas	5% - 15%	2.2%		
Total		1.4%	2.1% - 2.7%	0.63

* Indicative tracking error required to meet excess return objective. This assumes an information ratio of between 0.5 and 0.6, achieved through active management over the long-term. [1] Higher expected return from higher tracking error strategies. [2] We conservatively assume a 0% excess return from enhanced index.

Fees

Higher alpha seeking strategies are associated with larger fee loads reflecting their higher levels of discretionary research and more capacity constrained and less liquid nature (not always, i.e. China A). However, industry dynamics (including increased passive management, internalisation, underperformance of active management) continue to create an environment conducive to investors negotiating lower fees for active management, which includes some fee compression even for satellite strategies.

It is very hard to generalise across wide-ranging domestic and global opportunistic strategies however, our broad fee expectation for less liquid domestic micro-cap and pre-IPO strategies, or highly concentrated activist strategies, for example, is c0.80-1.10% (lower for domestic small caps) and c0.78-0.95% for institutional investors accessing global and EM small cap strategies, and potentially China A.

At the same time, some institutional investors will be able to negotiate meaningfully lower fees with managers in some cases depending on factors such as allocation size; how capacity constrained the strategy is; and whether a first mover opportunity exists (i.e. investor is a foundation investor).

Fee compression on active management is not going away with YFYS benchmarks, as one example, assuming a passive approach in their fee assumptions. However, we think there is an important implication here for higher fee strategies as they start to look increasingly good value (relative to passive) given the opportunity for return enhancement and downside protection in volatile markets.

YFYS

Many super funds under the constraints of YFYS performance benchmarking are likely to be focused on managing their tracking error, rather than seeking out higher tracking error opportunistic strategies. However, our view is that it is even more critical for super funds (given YFYS) to ensure they are deploying their active risk and fee budget in the most efficient means as it relates to portfolio return enhancement and diversification, albeit consistent with their specific tolerance for high active risk strategies and the associated fee load, additional monitoring/complexity and capacity constraints.

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Opportunistic ideas - small caps

The case for developed market small caps – still fertile ground?

The lure of small-cap investing is a powerful one when it comes to enhancing portfolio returns, conjuring-up visions of identifying the next Amazon.

Extreme examples are just that. However, genuine skill is rewarded over time in small-caps and Frontier maintains conviction in the small cap alpha opportunity via dedicated manager allocations. That being said, small-caps do tend to move in quite distinct cycles relative to large caps, depending on economic conditions and the general appetite for risk. As a result, we continue to view the primary source of return enhancement from small caps to be the alpha opportunity.

While there is limited evidence of a persistent small-cap premium in the Australian market this is much more persuasive and academically proven in global equity markets. However, small caps have generally lagged large caps in most jurisdictions over the medium-term at least, reflecting the outperformance of large /mega-caps in both developed and emerging markets (not in 2021) over recent years.

Whereas domestically both small and mid-cap allocations have actually been additive versus an investment in the broad-cap S&P/ASX 300 Index over the three and five-year periods to December 2021. However, given the cyclicality of such investments, it is again the median level of alpha or outperformance that continues to drive our conviction in having a dedicated allocation to active small caps domestically.

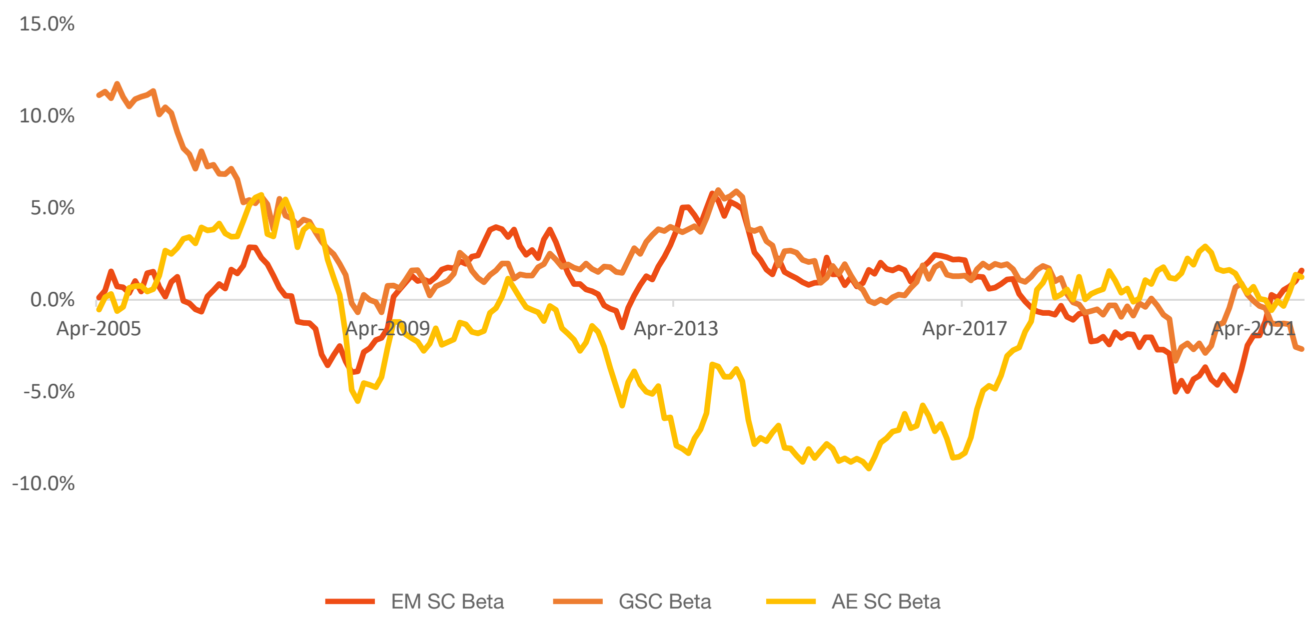
Table 2 shows the small-cap premium has gone missing in recent years, with global small caps underperforming global equities (developed markets, large-cap biased) over a ten-year period. This underperformance over a ten-year period has been driven by underperformance in the US (versus the S&P500). However, this is not surprising given the pronounced outperformance of mega-cap US growth stocks in recent years. As discussed, small-cap outperformance in Australia (versus the broad-cap S&P/ASX 300) has been more mixed over this time horizon, with more persistent excess returns from tilting to small caps in Europe and emerging markets. Frontier Line 188 US mega-caps effect on global active management discusses the dominant performance of large-cap US tech stocks and the impact of this narrow driver of market returns on the relative performance of other regions, particularly over the last five years.

Table 2: Global and regional small-cap index returns, volatility and reward-for-risk (to 31 December 2021 in AUD)

Index returns, volatility and reward-for-risk	1 year (% p.a.)	3 yr (% p.a.)	5 yr (% p.a.)	10 yr (% p.a.)
MSCI World Small Cap Index	22.9	17.9	12.3	16.2
MSCI World Index	29.3	20.4	14.9	16.6
Excess return (beta)	-6.4	-2.5	-2.7	-0.4
Volatility	6.2	15.2	13.7	12.6
Reward-for-risk	3.7	1.2	0.9	1.3
MSCI EM SC Index	26.0	15.2	11.4	11.2
MSCI EM Index	3.4	9.8	9.8	9.2
Excess return (beta)	22.6	5.4	1.6	2.0
Volatility	9.0	15.2	13.5	12.2
Reward-for-risk	2.9	1.0	0.8	0.9
Russell 2000	21.9	18.7	11.9	17.2
S&P 500	36.6	24.7	18.4	20.6
Excess return (beta)	-14.7	-6.0	-6.4	-3.4
Volatility	9.0	17.5	16.4	15.7
Reward-for-risk	2.4	1.1	0.7	1.1
MSCI Europe Small Cap	22.1	17.9	12.9	16.8
MSCI Europe	23.4	13.7	10.1	12.0
Excess return (beta)	-1.3	4.2	2.8	4.9
Volatility	10.5	16.6	15.1	14.9
Reward-for-risk	2.1	1.1	0.8	1.1
S&P/ASX Small Ordinaries Index	16.9	15.7	11.2	8.0
S&P/ASX 300 Accumulation Index	17.5	14.0	9.9	10.8
Excess return (beta)	-0.6	1.8	1.2	-2.8
Volatility	7.3	20.5	17.3	16.0
Reward-for-risk	2.3	0.8	0.6	0.5

Chart 1 illustrates the cyclicality of small-cap excess returns versus relevant mainstream large-cap biased indices. On a rolling five-year basis, , it can be seen that emerging market small caps (EM SC) has made a strong recovery over the past 18 months to retrace an extended period of underperformance (relative to the asset class benchmark). It is also evident over the presented period that domestic small caps have exhibited deeper and more extended periods of underperformance over rolling five-year periods.

Chart 1: 5-year rolling small cap beta (AE SC, GSC and EM SC)



Source: eVestment.

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Listed microcap strategies – worth the risk?

In Australia, micro-cap stocks are generally considered to be those companies that sit outside the S&P/ASX 300. However, some investors use size rather than index breakpoints to define this sub-sector. For example, any stock with a market capitalisation below $500 million. The key attraction to listed micro-cap investing is the prospect of identifying fast-growing, hidden gems from a broad opportunity set. Substantial alpha potential, compared to large and small-cap companies, is primarily a product of low institutional ownership and limited sell-side coverage. Micro-caps typically have low correlation to larger-cap companies, providing diversification benefits in the broader context of a mainstream Australian equities portfolio. A related point is that micro-caps, industrials at least, are typically driven by more company-specific factors, with less sensitivity to macroeconomic forces.

The micro-cap opportunity set also provides access to many innovative, unique opportunities in emerging industries not well-represented in large and small-cap indices (if at all). Some investors also view micro-caps as a (marginally) more liquid, lower-cost proxy for private equity characteristics – providing access to less-correlated, early-stage, higher growth companies. At the same time, private equity capital, at least within the micro-cap domain, is typically being allocated at an earlier stage of a company's life-cycle. Additionally, the liquidity of being publicly traded for listed micro-caps comes with the volatility of mark-to-market daily pricing.

Investors typically gain access to micro-caps from their small-cap manager exposures (to varying degrees) and Frontier has generally not advocated for a dedicated allocation to domestic micro-cap managers within our Australian equity configurations. Active small-cap and micro-cap managers have historically generated meaningful excess returns relative to their respective benchmarks, notwithstanding survivorship bias. For small-cap managers at least, higher risk-adjusted returns relative to the broader market index have typically compensated for the higher volatility. However, this has not necessarily been the case for dedicated micro-cap managers, in conjunction with heightened liquidity risks and problematic access for investors of any meaningful scale. At the same time, we recognise some funds/investors seeking to take advantage of their smaller size, can access institutional-grade, micro-cap managers that are capitalising on this less efficient opportunity set in pursuit of higher returns, while navigating the pitfalls of a generally lower quality investable universe and heighted liquidity risk. For these reasons, microcap strategies may have a role to play within an opportunistic bucket for some investors. We have not considered global micro-cap strategies here, which are not directly comparable to Australian micro-caps.

While micro-caps significantly outperformed in the post Q1 2020 market recovery (including 2021), the longer-term size premium argument has been relatively weak in Australia. Therefore, access to proven alpha generators is critical. Higher tracking error within a broader portfolio context heightens the importance of management selection, with greater implications for poor stock selection and risk management.

The case for private-to-public strategies

Frontier believes the hybrid unlisted/listed structure of so-called pre-IPO strategies can be a more compelling opportunity for small-to-mid size asset owners wishing to access emerging companies. Frontier's Real Assets Team recently released its private equity sector configuration however, the domestic focus of the Equities Team has primarily been these private-to-public strategies offering the potential for superior returns through an actively managed hybrid portfolio of unlisted, pre-IPO and listed micro caps. These strategies provide exposure to difficult-to-access private market micro-cap opportunities still early in their growth cycle, while seeking to avoid the earlier-stage risk associated with venture capital.

For some investors, this allocation may sit outside its core Australian equity portfolio, within a broader (cross asset class) opportunistic allocation. Given the micro-cap focus, we view the appeal of these strategies as more relevant to small-to-medium sized investors (rather than large funds) with a longer-term horizon and a tolerance for higher fees, active risk and reduced liquidity.

Another possible appeal of these strategies is the potential access to "impact" opportunities through the provision of primary capital (via unlisted deal flow) to some of the more innovative companies in the Australian economy, particularly as it relates to more difficult to access decarbonisation enablers within the listed Australian market.

The inclusion of unlisted assets introduces an additional level of illiquidity, complexity and other risks specific to private markets. These include, but are not limited to, reduced transparency (compared to listed markets), lagged valuations, deal complexity, along with the volatility associated with key liquidity events (e.g. IPOs or trade sales). In our view, these features require a deep understanding of the unlisted capital raising cycle, origination environment, deal structuring and above-all-else the ability to price and size these risks. However, our view is there are few managers appropriately resourced and focused for the deep research and operational demands of investing in both public and private microcap companies.

Frontier has a recommended rating on a hybrid unlisted/listed microcap strategy, with attractive Frontier negotiated fees.

Global small caps – where's the alpha?

We also view small caps as a viable option for return enhancement within a global equities portfolio as part of an opportunistic allocation. While there is still volatility in the size premium (as per recent years), there is longer-term persistence of a small-cap effect in global small caps. The primary case for global small caps is still, however, the alpha opportunity, although this has also become more muted over time (particularly relative to other value-adding ideas).

In contrast to a more manageable opportunity set for domestic/regionally focused small-cap managers (particularly Australian small-caps), the sheer size of the investable universe for global small-cap managers seems to prove more of a hindrance than an opportunity for some. This makes research prioritisation and well-considered idea screening critical elements of a global small cap process. This challenge might help explain why the median active manager in global small caps, shown in Table 3, has typically not added as much alpha as regional small-cap managers. This may stem from domestic/regional managers generating deeper stock insights by virtue of being more closely connected to these opportunities within a more manageable opportunity set. We think manager selection is extremely important in global small caps.

Table 3: Global small cap excess returns

Excess returns (AUD) to 31 Dec 2021	1 year (% p.a.)	3 yr (% p.a.)	5 yr (% p.a.)	10 yr (% p.a.)
Top quartile	8.6	6.0	5.8	2.9
Median	5.4	2.4	2.2	1.4
Bottom quartile	1.5	-0.1	-0.1	0.3
Number of observations	74	64	42	23
MSCI World Small Cap Index	22.9	17.9	12.3	16.2

Source: eVestment.

Chart 2 breaks down the ten-year return from the median active global small cap manager into effectively three components. The first is the return of the global equities asset class benchmark (the MSCI World Index), which has returned 16.6% over this period. The second is the beta or allocation component (the excess return above the asset class benchmark achieved from allocating to global small caps, which is represented by the MSCI Global Small Cap Index), which has been slightly negative over the presented period (-0.4%). The third component is the alpha of the median active manager in global small caps, which has been 1.4% pa over this period, which more than offsets the negative impact of allocating to global small caps versus the broader index. The net excess return above the asset class benchmark is 1% pa over this 10 year period or a total return of 17.6% pa.

Chart 2: 10yr GSC median alpha + beta v MSCI World (to 31 December 2021)

The somewhat underwhelming longer-term alpha of the median global small cap manager is likely impacted by this being a fringe product for a number of the universe constituents. We think this would be higher if the universe comprised more dedicated global small-cap managers.

There is a possible argument for combining regional specialists or utilising a big brand global small-cap manager able to construct a 'best ideas' portfolio from regional teams (although we have not conducted this analysis of regional manager excess returns). However, there are implementation challenges and complexity for asset owners combining regional managers for a small part (in all likelihood) of the overall equities portfolio, including the need for top-down regional asset allocation decision-making that may end-up detracting from the overall outcomes for investors. Also, in our view, there are increasingly few large managers with competitive advantages across separate regional small-cap teams. Therefore, our preference continues to be to seek out capacity with the best available, standalone global small cap managers with the necessary resourcing and capability to deliver consistently superior outcomes.

As in the case of Australian equities, some investors may prefer to allocate towards global SMID-caps (i.e. a combination of small and mid-caps). Key arguments in support of such a sub-allocation (at least relative to global small caps) would be less implementation and liquidity risks. Additionally, a key argument may be that a SMID portfolio achieves the best balance between the growth of small-caps and the quality of large-caps but perhaps (at this point) less valuation risk also. Interestingly, many of the US-based global small cap managers tend to be benchmarked to SMID indices in any event, which tends to be the market norm. As such, prospective investors need to be conscious of increased flexibility to invest up the cap spectrum but also the genuine level of small-cap exposure in some US-based global small cap portfolios. A high level comparison of the MSCI global small and SMID-cap indices is presented below.

Table 4: Comparison of MSCI small and SMID-cap indices

Excess returns (AUD) to 31 Dec 2021	Developed market small caps (DM SC)	Developed market smid-caps (DM SMID)
Total capitalisation (US$ billion)	7957	17206
Number of stocks	4543	5396
Top 10 combined weight	1.7%	2.3%
Top 10 avg market cap (US$ billion)	13.3	38.9
Average market cap (US$ billion)	1.8	3.2
Median market cap (US$ billion)	1.1	1.4

Source: MSCI, at 31 January 2022.

The case for emerging market small caps

Frontier also recommends investors consider allocating a proportion of their opportunistic allocation or overall EM exposure to an active, well-credentialled EM small cap manager. The case for EM Small Caps (EM SC) incorporates the sub-sector's expected premium (the beta or size effect versus the mainstream EM benchmark) but again is primarily driven by the alpha opportunity and gaining more direct exposure to the high growth, domestic fundamentals historically sought in EM, albeit the underlying drivers of that growth in EM SC have also evolved.

From our analysis, the level of EM SC alpha generated by the median manager is commensurate with the excess returns generated from a mainstream EM equities portfolio 15+ years ago, with increased evidence of alpha decay within EM large caps. There will continue to be periods when EM SC beta is weak (just as there is within developed markets). However, longer-term outcomes indicate the median active EM SC manager continues to make a return-enhancing contribution to both an EM and overall global equities allocation. Superior manager selection (e.g. top quartile) has naturally delivered more compelling outcomes.

The median active manager in EM SC, shown in Table 5, has added consistent alpha over the long-term, albeit excess returns have been dragged lower by weaker relative returns over the past few years. However, with the significant outperformance of EM small caps versus EM large caps in 2021, the return of the median EM SC manager has comfortably beaten the MSCI EM asset class benchmark over both five and ten-year periods. These longer-term outcomes show the median active EM SC manager making a return-enhancing contribution within an EM allocation. The contribution would be significantly higher from superior manager selection (e.g. top quartile).

Table 5: Emerging market small cap excess returns (to 31 December 2021)

Excess returns (AUD) to 31 Dec 2021	1 year (% p.a.)	3 yr (% p.a.)	5 yr (% p.a.)	10 yr (% p.a.)
Top quartile	2.8	3.9	3.7	4.6
Median	-3.0	1.4	1.4	2.7
Bottom quartile	-6.8	-2.2	-0.9	1.1
Number of observations	69	63	51	24
MSCI EM SC Index	26.0	15.2	11.4	11.2

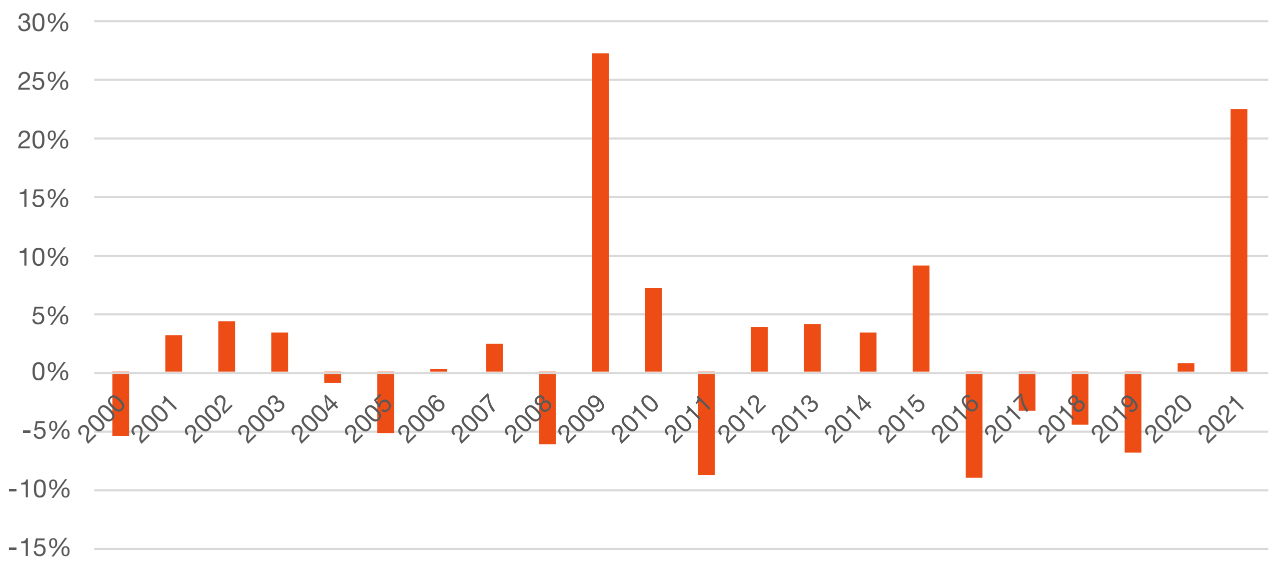
Source: eVestment.

Chart 3 breaks down the ten year return from the median active emerging markets small cap manager into its three components. The first is the return of the emerging markets asset class benchmark (the MSCI EM Index), which has returned 9.2% over this period. The second is the beta or allocation component (e.g. the excess return above the asset class benchmark achieved from allocating to emerging market small caps, which is represented by the MSCI Emerging Market Small Cap Index), which has been positive over the presented period (2%). The third component is the alpha of the median active manager in emerging market small caps, which has been 2.7% p.a. over this period. The net excess return above the asset class benchmark is 4.7% p.a. over this ten year period or a total return of 13.9% p.a. Notably, this has still been lower over this period versus the index return of the MSCI World, if a solely developed market asset class benchmark was applied.

Chart 3: 10yr EM SC median alpha + beta v EM LC (to 31 December 2021)

While the MSCI EM SC Index significantly outperformed the MSCI EM Index in 2021, it was a different story between 2016-2019 and the first half of 2020. We viewed this consecutive four-year period of EM SC underperformance (illustrated in Chart 4) to be more of an anomaly (at least relative to history), driven in part by the weight of money directed to an increasingly concentrated cohort of mega-cap EM stocks (and exacerbated by the COVID small-cap drawdown in 1H2020). While we ultimately expect a size effect premium to EM portfolio returns from an allocation to EM SC, there will clearly continue to be periods where the EM SC premium or beta is weak, reflecting the cyclical nature of factors like size across different economic and market conditions. This just reiterates the importance of a long-term investment horizon as well as identifying high conviction managers with demonstrated capacity to generate consistent and meaningful excess returns.

Chart 4: MSCI EM Small Cap Index excess returns versus MSCI EM index



Source: eVestment.

Institutional investors remain underweight EM Small Caps (EM SC), which together with low sell-side coverage provides fertile ground for active management and complementary exposure to concentrated, large-cap biased EM portfolios, both by stock and country. In our view, the long-term EM consumption story remains intact despite the potential for lasting COVID-19 impacts; the regulatory and geopolitical risks within Chinese equity markets; and the current conflict stemming from Russia's invasion of Ukraine (including its effective removal from EM indices).

Like DM small caps, the EM small caps opportunity is most relevant for less capacity-constrained small and medium-sized funds/ investors. EM small cap fees are higher than they are for standard EM portfolios and global small caps, however the difference in fees is not significant for institutional investors.

EM SC provide investors with direct exposure to the high growth, domestic fundamentals historically sought in EM, including the modernisation of emerging market economies and associate innovation. In aggregate terms, EM SC offer meaningfully higher forecast long-term growth at typically cheaper valuations than both the primary EM Index and developed market equities (although valuation is modestly higher at the moment as per the data shown in Table 5). However, our key conviction is driven by the view that EM SC can provide investors with high excess returns commensurate with those historically generated from mainstream EM equities 15-20 years ago. An investment in EM SC still requires a longer-term perspective, in recognition of sub-sector specific and EM-wide risk factors. We provide further comment on these areas in the following pages.

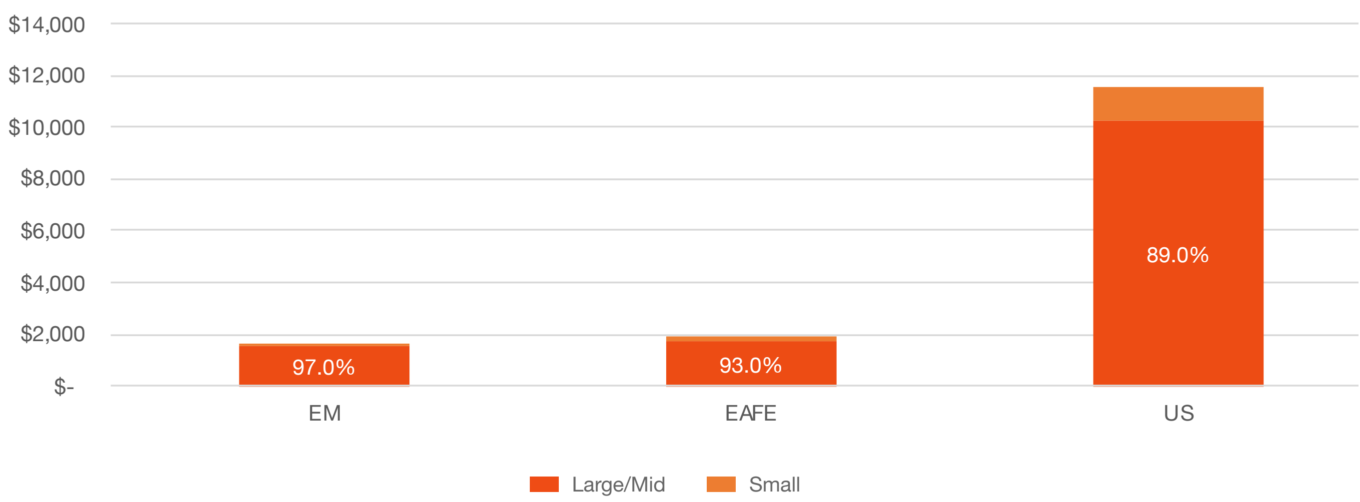
Table 6: Index fundamentals

	EM	EM SC
P/E (actual)	13.7	15.6
P/E (1yr forward)	12.2	12.3
ROE%	13.4	9.9
ROE% (1yr forward)	13.6	11.9
Price/book	1.8	1.6
FCF yield%	5.9	8.1
Net debt to capital	19.8	34.8
EPS growth% (1yr forward)	11.0	22.5
EPS growth% (3yr trailing)	11.2	11.1

Source: Lazard Asset Management.

Chart 5 shows institutional investors are underweight EM SC relative to GSC allocations within developed markets. Small cap liquidity (average daily turnover) is lower in emerging markets than it is within developed markets, which naturally constrains the allocation from larger institutional investors, amongst other factors. This lower index liquidity is a function of the smaller median market capitalisation of stocks in the MSCI Emerging Market Small Cap Index relative to global small caps (e.g. US$453 million versus US$1.1 billion currently).

Chart 5: Institutional investors underweight EM SC versus global SC

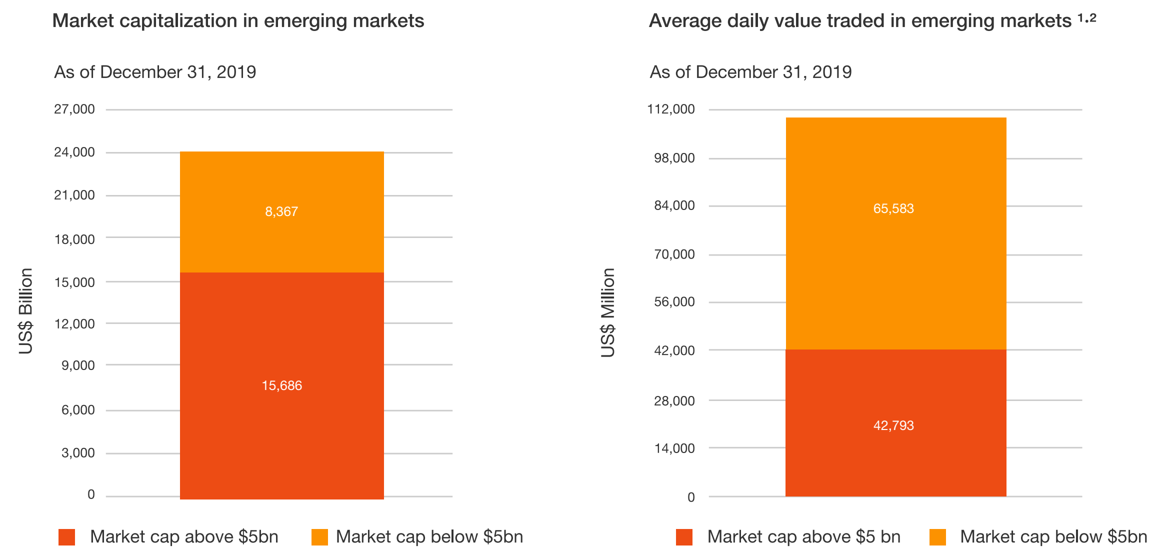


Source: Fisher Investments.

The flagship Emerging Markets Index, the MSCI Emerging Markets Index (MSCI EM Index) and the MSCI Emerging Market Small Cap Index (MSCI EM SC Index) are not dissimilar in their stock numbers (large 1422, small 1789). However, the investable universe of most EM SC managers extends well beyond the index constituents. This is an important point as most active EM SC portfolios will be constructed very independently to the index, which is much less concentrated to its largest stocks than the MSCI EM Index.

As can be seen in Chart 6, from a universe of 20,000 emerging market domiciled stocks (outside the MSCI EM Index), there are approximately 2,000 stocks with a market capitalisation above US$100 million and average daily turnover of at least US$1 million. The aggregate market capitalisation within a more broadly defined investable universe (defined by Franklin Templeton as all EM stocks below a US$5 billion market capitalisation including frontier markets) is lower than it is for the primary index. However, the average total trading turnover of that universe is larger (spread out over a much greater number of stocks) than it is for larger-cap EM stocks.

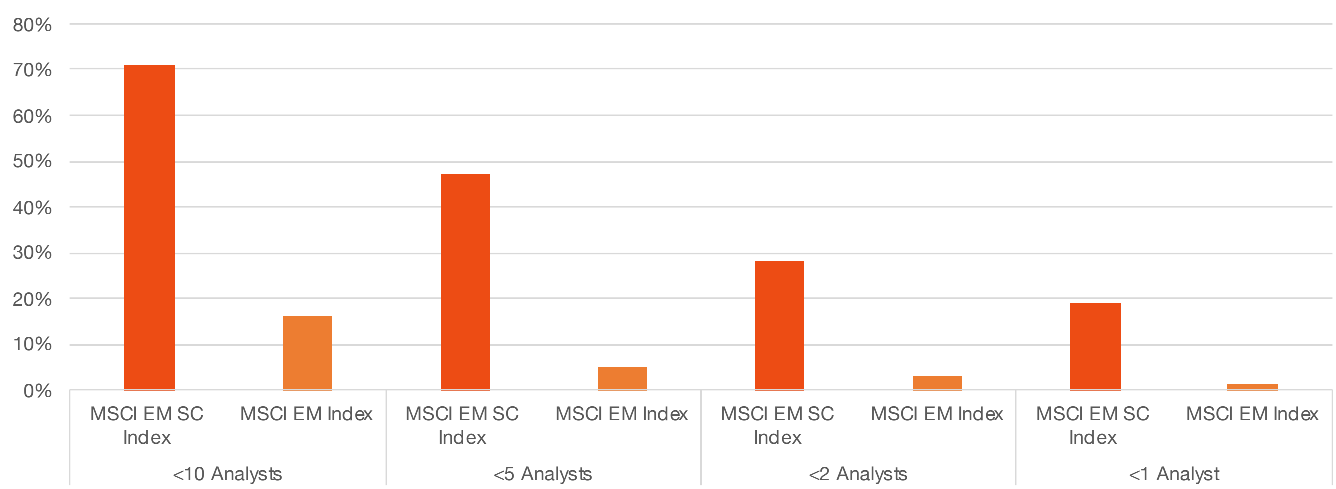
Chart 6: Emerging markets – large versus small



Source: Franklin Templeton.

Many EM SC companies and especially the broader opportunity set (outside the index) remain largely undiscovered by both the sell-side and buy-side, reflecting relatively low institutional allocations and lower trading volumes/liquidity (at the stock level). Stocks in the MSCI EM Index have an average of 17 covering analysts versus seven for the MSCI EM SC Index. A further comparison of sell-side coverage between the two indices shown in Chart 7, illustrates that almost 30% of stocks in the EM SC are covered by either one or no analysts (versus around 3% for the EM index). The relatively low sell-side analyst coverage and higher cross-sectional volatility of EM SC provides fertile ground for skilful, adequately resourced active managers.

Chart 7: Sell-side coverage in emerging market small caps (% of index covered)



Source: Ashmore Investment Management.

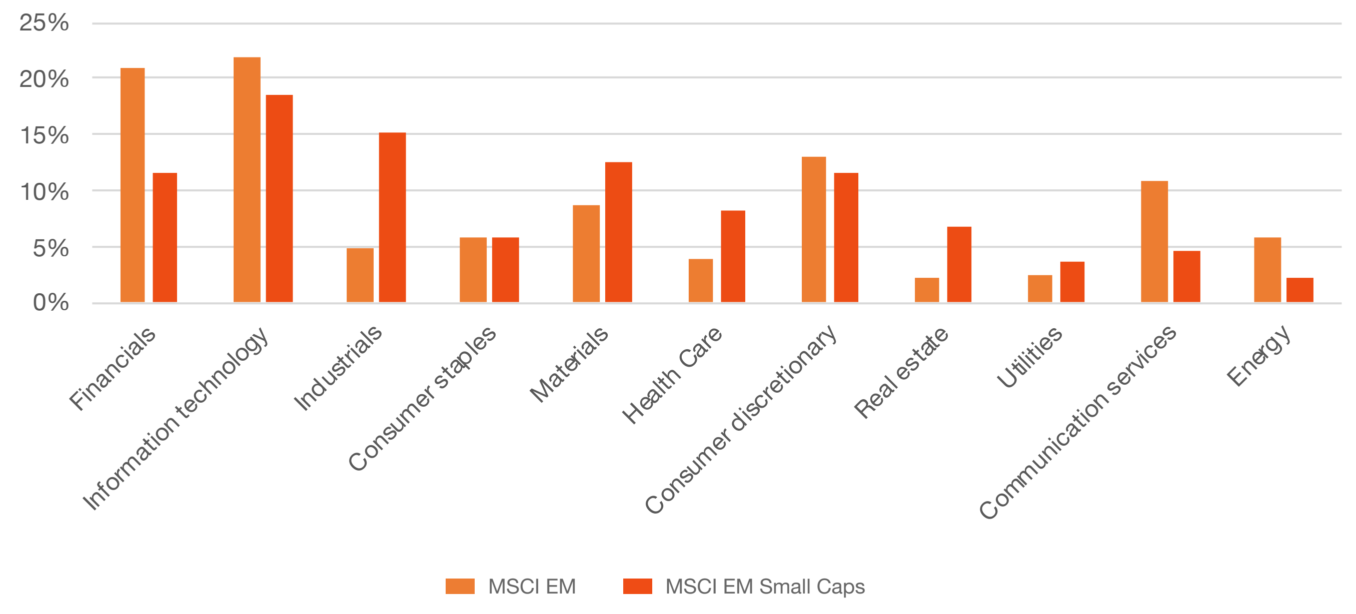
One of the key arguments for allocating to EM SC is more direct exposure to the high growth EM fundamentals historically sought (and lower representation of SOEs), including: favourable population demographics; greater ties to secular growth trends such as urbanisation; and higher leverage to the increasing purchasing power of the growing middle class. These thematics reflect EM SC companies generally being more domestically-orientated than their more mature, larger-cap multinational peers, with lower developed market revenues and greater exposure to localised/regional economic drivers (as opposed to global macro forces). In turn this provides portfolio diversification benefits from unique business drivers and relatively low correlation to both developed markets and the MSCI EM Index, which has no stock overlap to the MSCI EM SC Index.

The MSCI EM SC Index comprises higher exposure to domestic sectors tied to urbanisation and growing consumer demand for infrastructure. This is particularly evident in the higher exposure to industrials and health care, which in isolation are more insulated from global macro drivers than sectors like financials and energy. The MSCI EM SC Index also includes sub-industry exposure to these urbanisation trends which in some cases are unrepresented in the MSCI EM Index. Both indices have relatively high allocations today to information technology (circa 20%).

Notwithstanding, the rise of the dominant Chinese e-commerce platforms like Alibaba, along with other mega-cap domestic consumption stories like Meituan, are now a major component of the MSCI EM Index (despite the de-rating in 2H 2021). This upweighting of Chinese consumer discretionary stocks within the MSCI EM Index, which is now larger than the allocation within the MSCI EM SC Index, is indicative of the shift in EM index sector characteristics.

Like the MSCI EM Index universe, the MSCI EM SC Index was historically more heavily weighted towards the energy, resources and financials sectors. It is also now less commodities-driven, contributing to its lower volatility profile (relative to developed markets), at least until COVID. The relatively recent inclusion of Kuwait in EM indices from frontier markets goes against this trend, although this is more than offset by the recent removal of Russia. Chart 8 provides a comparison of current sector weights between the two indices, illustrating quite meaningful allocation differences in sectors such as financials, industrials and communication services.

Chart 8: Comparison of MSCI EM and MSCI EM SC sector composition



Source: eVestment

frontier

Like large cap developed market indices, the MSCI EM Index has become highly concentrated to a relatively small number of mega caps. By comparison, the MSCI EM SC Index is much less concentrated to its largest companies, as illustrated in Table 7. In saying this, the de-rating of Chinese mega-caps in 2021 has seen a reduction in the top five stock concentration of the MSCI EM Index (which was greater than 25%, now less than 20%), of which Alibaba and Tencent were previously almost 15% in aggregate). This compares to just under 2% for the five largest stocks in the MSCI EM SC Index.

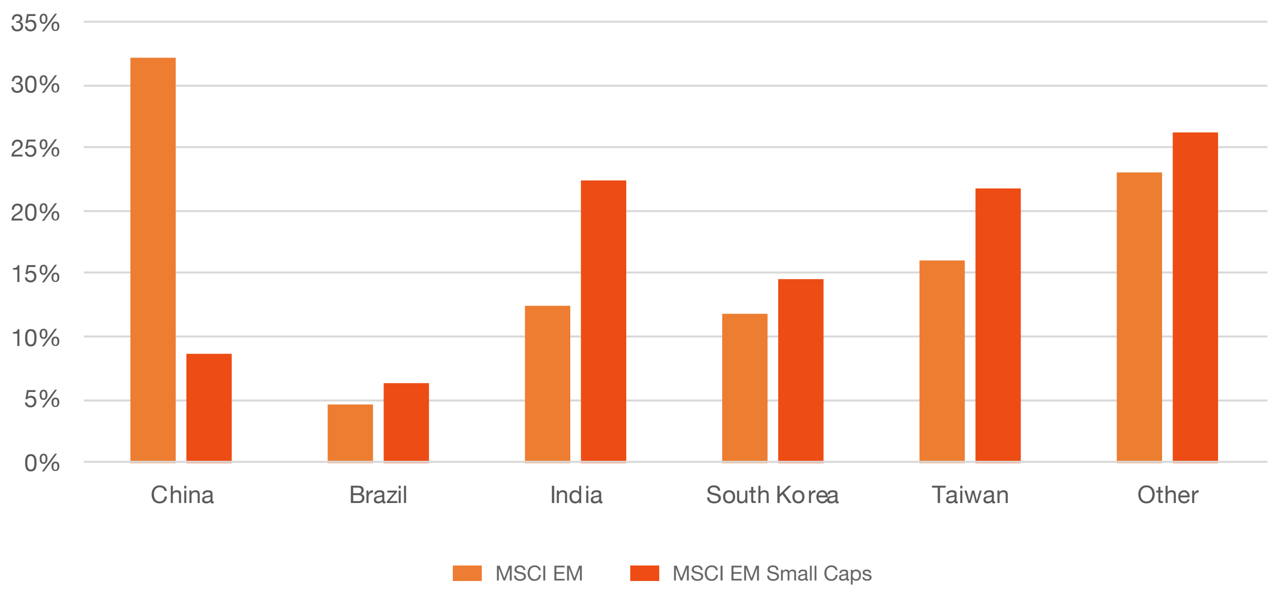
Table 7: Emerging markets – large versus small

MSCI EM	Index Wgt	MSCI EM Small Caps	Index Wgt
TSMC	7.3%	E Ink Holdings	0.4%
Tencent	4.5%	Sinoamerican Silicon	0.4%
Samsung Electronics	3.8%	Tata Elxsi	0.3%
Alibaba	2.9%	Voltas	0.3%
Meituan	1.5%	Zee Entertainment	0.3%
Reliance Industries	1.2%	Crompton Greaves	0.3%
Infosys	1.0%	Persistent Systems	0.3%
China Construction Bank	1.0%	Petro Rio	0.3%
Vale	0.8%	The Foschini Group	0.3%
JD.com	0.8%	Macronix International	0.3%
	24.8%		3.0%

Source: MSCI, at 31 January 2022.

Chart 9 shows the MSCI EM SC Index is also geographically less concentrated than the MSCI EM Index, which has a significantly higher weight to China. This is offset in the MSCI EM SC Index by higher weights to Taiwan, South Korea, India and Brazil, amongst other countries.

Chart 9: Index country exposure



Source: MSCI, at 31 January 2022.

Responsible investment in emerging markets small caps

We believe responsible investment is particularly important in emerging markets given heightened ESG risks, such as governance and modern slavery. This is something active management can seek to navigate, through engagement with investee companies and portfolio prospects. A potential ESG benefit of investing with active emerging market small cap managers is the better corporate access to management and the relatively limited government ownership. There is, therefore, greater scope to influence companies on ESG matters, including heightened modern slavery risks. However, the integration of responsible investment varies from manager to manager and there are still managers which remain weak in this area.

There are currently 87 EM small cap products (including manager duplicates) in the eVestment universe. However, the number of high-quality EM small cap capabilities is relatively limited in our view, due in part to capacity and associated resourcing constraints. While market breadth is an opportunity, as noted with GSC, the large investable universe can also pose challenges for many EM small cap managers spread too thinly. Manager selection is critical in capturing the alpha opportunity over time and navigating the risks and pitfalls of investing in EM small caps.

Portfolios are generally constructed very independently to the MSCI EM SC Index and therefore can yield quite divergent performance and portfolio attributes relative to the index, including fundamental characteristics, valuation metrics, size/liquidity and a broad spectrum of risk factors including ESG considerations.

Portfolio construction considerations

From a portfolio construction perspective, Frontier continues to support a core, overweight allocation to emerging markets relative to its MSCI ACWI Index weight. We recently re-affirmed our recommendation for a 15%-20% allocation to dedicated emerging market managers for moderate and high alpha international equity configurations, with higher resulting look-through allocations. We consider an exposure to EM SC to be a opportunistic idea, however, we also see the merit in viewing portfolio exposure to EM SC as a small strategic component of an investor's overall EM allocation rather than a component of an opportunistic exposure. EM SC can provide complementary exposure within an EM allocation – broadening portfolio exposures with differentiated return characteristics. EM SC are relatively lowly correlated to both the EM Index and particularly the MSCI ACWI Index, providing additional portfolio diversification benefits. With evidence of alpha decay within mainstream EM portfolios, we believe there is justification for allocating a proportion of a portfolio's EM portfolio or overall portfolio to an active EM SC manager. Chart 9 shows two index correlation matrices based on five-year monthly returns to December-end 2021 and 2016. While point-in-time, they yield some interesting outcomes:

- EM SC has a correlation of 0.81 to the MSCI EM Index, indicating some diversification benefits within an EM allocation. Interestingly, its correlation is lower than it was 5 years ago (0.85).
- While EM SC correlations are naturally much lower to the MSCI ACWI Index (0.71), interestingly they are higher than the correlation between the MSCI EM Index and MSCI ACWI (0.63), as they were (to a lesser degree) in 2016.
- The MSCI EM SC Index correlation to the MSCI ACWI Index is significantly lower than the correlation between the MSCI World Small Cap Index and the MSCI ACWI Index over these periods (c0.9 across both timeframes).

Chart 10: 5 year index correlations

To Dec 2021	MSCI ACWI	MSCI EM SC	MSCI EM	MSCI World SC
MSCI ACWI	1			
MSCI EM SC	0.71	1		
MSCI EM	0.63	0.81	1	
MSCI World SC	0.91	0.76	0.63	1
MSCI World	0.99	0.65	0.54	0.89

To Dec 2016	MSCI ACWI	MSCI EM SC	MSCI EM	MSCI World SC
MSCI ACWI	1			
MSCI EM SC	0.60	1		
MSCI EM	0.56	0.85	1	
MSCI World SC	0.90	0.51	0.43	1
MSCI World	0.99	0.54	0.47	0.91

0.9 - 1.0 (limited diversification benefits) 0.7 - 0.9 0.5 - 0.7 0.3 - 0.5 0.1 - 0.3 0.0 - 0.1 (greater diversification benefits)

Source: eVestment

While small caps, including EM SC, tend to underperform during major market drawdowns (as they did in Q1 2020), they also offer the potential to deliver significant outperformance in recovery periods (as they did post the GFC and post Q1 2020, particularly in 2021). Furthermore, with the reconfiguration of supply chains, the EM SC sub-sector may benefit (in places like India) from supply chain disruption away from China and/or the creation of dual supply chains, which could see EM SC companies in some regions (including frontier markets like Vietnam) thrive in a post pandemic world.

EM SC risks

When considering an allocation to emerging market small caps, there are a number of risks to be mindful of. These include:

- Larger drawdowns relative to EM large caps during major market sell-offs.
- Lower liquidity/higher trading costs compared to global small caps.
- EM-wide risks include:
  - elevated country-specific macro, trade, political and currency risks
  - susceptibility to USD strength
  - vulnerability to commodity price swings
  - lower corporate governance/transparency.
- The size of the investable opportunity set and lower index concentration risk are a positive starting point for active stock pickers however, this breadth can also pose resourcing challenges.
- Potential for long-term economic damage from extended COVID-19 shutdowns.
- Well-credentialled EM SC managers can help navigate these inherent sub-sector and EM risks more broadly however, a long-term approach is required to capture the return opportunities of the sub asset-class.
- EM SC can be a fringe product for some managers and not a truly dedicated product (i.e. assigned to limited resources or an untested portfolio manager). Our preference is for strategies where EM SC is an integral part of the business.

EM SC fees

As would be expected, EM small cap fees are higher than they are for a core EM large cap strategy, however the difference is not stark. We would expect institutional investors to pay around 0.80-0.90% p.a. for an active emerging markets small cap strategy versus the 0.60-0.80% for mainstream emerging markets. As always, there may be managers offering fee deals to achieve scale within their EM SC strategies.

Frontier markets

Naturally, some opportunistic EM investors may also consider an allocation to frontier markets if considering emerging market small-caps. A frontier market is considered less established than an emerging market (effectively pre-emerging), which in the case of MSCI is determined by a country's economic development, accessibility and liquidity. The MSCI Frontier Emerging Markets Index currently captures large and mid-cap companies across 32 frontier markets.[1] There are implementation challenges in frontier markets (if index oriented) with often limited stock-specific liquidity and more concentrated country, industry and single stock concentration risk.

These risks are not insurmountable within a broader EM portfolio and can enhance the opportunity set for those managers with the capability across both EM and frontier markets. However, as standalone allocations, we are reluctant to recommend a dedicated allocation to frontier markets over say EM SC, which we view as having positive long-term growth attributes. Table 7, shows 1789 index constituents (versus 90 for Frontier markets), limited or no research coverage, broad opportunities and still meaningful and consistent alpha over time in EM SC. In comparison, the MSCI Frontier Markets Index is highly concentrated, with c37% in financials, including c32% in the banks, which is a very similar level of concentration to our market. There is also significant exposure to oil and nations whose economies are tied to energy (i.e. the financials are also oil-price sensitive). Heightened risks around political instability, regulation, reporting and currency fluctuations also detract from the appeal of a dedicated allocation to frontier markets.

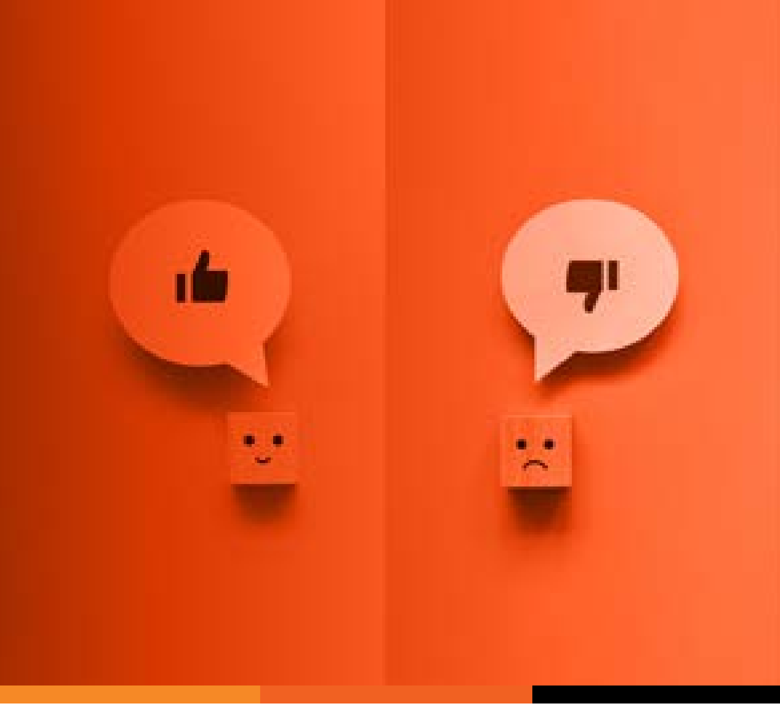
Table 8: EM index comparison

USD ($ millions)	EM	EM SC	Frontier
Number of stocks	1422	1789	90
Total capitalisation (US$ billion)	7705	1086	99
Average market cap (US$ million)	5418	607	1103
Median market cap	1996	453	654

Source: MSCI, at 31 January 2022

[1] These countries are Bahrain, Bangladesh, Burkina Faso, Benin, Colombia, Croatia, Estonia, Egypt, Guinea-Bissau, Iceland, Ivory Coast, Jordan, Kenya, Kazakhstan, Lithuania, Mauritius, Mali, Morocco, Niger, Nigeria, Oman, Peru, Philippines, Pakistan, Romania, Serbia, Senegal, Slovenia, Sri Lanka, Togo, Tunisia and Vietnam.

The final word



This paper presents a focused list of niche ideas for expanding into return-enhancing areas. However, there is a much broader range of strategies that could fit under an investor's opportunistic bucket (depending on fit).

This could extend to a dedicated allocation to other regional strategies like Indian equities; private equity; other activist opportunities benefitting from major reforms (like Japan) just to name a few. Specialist climate-focused strategies is another area that is sometimes bucketed as opportunistic, given they tend to share a number of characteristics common to niche strategies by virtue of their typically higher tracking error approaches. Notwithstanding, Frontier generally views these specialist 'green' strategies as one of the building blocks of a portfolio's overall decarbonisation strategy rather than a standalone, return-enhancing opportunistic idea.

While our research to date has been limited to manager engagements in some of these areas, within other areas like climate specialist or small caps we have a number of open and recommended strategies for clients. We intend to continue to rollout a steady pipeline of new ratings within the most relevant and compelling opportunistic areas for all investor types, albeit superannuation funds will need to be cognisant of Your Future Your Super (YFYS) considerations.

Want to learn more?

If you want to learn more about opportunistic ideas for a challenging return outlook, Frontier can help. Please reach out to your consultant or a member of the Equities Team.

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