OPPORTUNITIES AND VALUE ON OFFER

Despite persistent fears of a recession and continuing market volatility, global small/mid caps still present investors with attractive opportunities. Three investment professionals share their views on this asset class, including the challenges of managing portfolios in an inflationary environment. Jayson Forrest reports.

Global equities are one of the mainstays of driving returns for investment portfolios, but at a time when global indices are down around 20 per cent year-to-date, managing this part of the portfolio is challenging, particularly in an inflationary environment.

However, for Co-Portfolio Manager of the Fidelity Global Future Leaders Fund and Analyst, Maroun Younes, a challenging market environment doesn't mean you abandon your investment philosophy.

> *For us, it's about picking really good active managers with a proven track record, while also being mindful that small/mid caps can be more volatile. That's because they're not mature companies with reliable dividends or earnings. It's also important to buy at fair value when stocks are reasonably priced."*
>
> SIMON WOTHERSPOON CFP®

"Regardless of market conditions, we focus on what we've always done," says Maroun. "Our process is quality orientated. With rising inflation and fears of a recession driving market volatility, we believe that if you have a quality-focused approach, with an emphasis on valuations, then that can help you navigate volatile markets."

According to Maroun, if a portfolio comprises of high quality companies that are mission-critical for their end customers and dominate their industries, then that can help recession-proof a portfolio. Likewise, if a company is mission-critical and is a dominant supplier for its customers, it has pricing power, which enables the company to pass on price increases to protect its profits in an inflationary environment.

This is the approach Fidelity uses in its Global Future Leaders Fund – a diversified portfolio of 40-70 small/ mid-cap global companies.

"We use a rigorous bottom-up stock selection process that focuses on finding attractively valued companies with strong competitive positioning and sound company management. There is a strong emphasis on building a diversified and balanced portfolio that aims to deliver more consistent returns through different market cycles," says Maroun.

"Having that quality and valuation discipline as a core pillar of our process helps us to navigate these challenging environments quite well. It allows us to outperform in market drawdowns. This means in the current market environment, there really has been no change to what we do from a portfolio construction perspective."

It's a similar view shared by Sarah Gonzales AFP® – Chief Investment Officer at Apt Wealth – who adds that Apt Wealth is definitely more cautious when making portfolio changes in times of volatility.

"Along with our investment philosophy, which is focused on protecting capital growth, we have a structured and highly repeatable investment process that allows us to use this process across different market cycles," says Sarah.

As it waits out market uncertainty, Adelaide-based Perks Private Wealth has increased its exposure to cash in its portfolios. According to Simon Wotherspoon CFP® – Director at Perks Private Wealth – around September last year, the business identified that markets were expensive, due to low rates and monetary stimulus.

"So, we increased our exposure to cash, went shorter duration on bonds, and more defensive in our equity allocations," says Simon.

And while Simon confirms that Perks hasn't adjusted its portfolios dramatically, it has changed a couple of managers and reallocated to more quality defensive investments. "Now, it's about riding through what's happening in the market, having a sense of where things might go, and being poised to use that excess cash to buy back into the market and take advantage of opportunities as they arise," he says.

DIVERSIFICATION IS KEY

With market volatility and global indicies significantly down, what does that mean for asset classes like global small/mid caps? Is now a good time

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for financial planners to be thinking about small/mid caps as part of their asset allocation?

"Absolutely," says Maroun, who believes planners should be looking closely at the opportunities and value available in this asset class.

"Unfortunately, most investors act in a cyclical fashion, where they tend to add more to asset classes that have been doing well. Instead, if they were to look at mean reversion - where asset prices and historical returns eventually revert to their long-term mean - they would recognise the capacity for global small/mid caps to deliver good risk-adjusted returns," says Maroun.

Ideally, he believes planners should be doing their homework on investments when an asset class is going through a tough period. By doing so, when the cycle eventually turns, they're in a better position to quickly take advantage of opportunities.

"Historically, when the cycle turns, small/mid caps tend to outperform their larger cap peers on the way up, making now the perfect time for planners to be doing their analysis, instead of waiting for the end of the bear market," says Maroun.

"Also, if you look at historical valuation ratios between the small/mid cap segment and large caps, the valuation discounts right now for small/mid caps are at record levels. We haven't seen these levels for over 20 years," he says. "And given the recent dominance of large and mega caps over the last decade, small/mid caps have actually outperformed large caps over much longer periods, while delivering a superior Sharpe ratio. It certainly makes a compelling case for this particular asset class."

While Maroun concedes that global small/mid caps do tend to have a slightly higher level of beta and are more sensitive to economic variables, compared to large caps, this is more than compensated for by the extra return investors can receive by investing in them.

"This is an under-researched part of the market, which does provide planners with plenty of opportunities to generate some significant risk-adjusted returns," he says.

Sarah agrees, adding that small/mid caps provide significant diversification benefits for a portfolio. "Diversification is key for any portfolio, particularly in terms of industry, sector, and geography. But in small/mid caps, you're also diversifying away from large and mega cap stocks. So, having a small/mid cap exposure complements an investor's larger cap exposures."

It's a view supported by Simon: "The reason for global small/mid caps in a portfolio is about creating greater sector diversification and investment opportunities. And ultimately, better performance."

While Perks currently does not have any exposure to global small/mid caps

Fidelity Global Future Leaders Fund

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in its portfolios, it is closely monitoring this asset class, with the possibility of gaining some exposure to this sector over the coming months.

"Small/mid caps tend to get beaten up quite heavily when markets are coming down, but equally, when markets are through the worst and are forward-looking, small/mid caps have the potential to recover quite strongly," says Simon. "It's at that point, you can capitalise on getting those higher returns from a low base, which should provide investors with good opportunities and value over the coming six months."

IMPORTANT CONSIDERATIONS

When allocating to global small/mid caps, Maroun believes it is essential that planners consider the style of management – active or passive – that a manager uses for its fund. He recommends active management.

"Remember, this is an under-researched segment of the market, so there are a lot more opportunities to use research to identify opportunities."

He concedes that in small/mid caps there is a higher prevalence of 'junk' IPOs and highly speculative concept stocks, which performed strongly during the post-COVID rebound but have subsequently dropped-off significantly in the recent correction, leaving investors with a passive exposure to this index exposed to junk names.

> *In the current environment, you need to be going after quality - strong earnings share growth, company stability, balance sheet strength, and low leverage. That's what you need to be considering when allocating to a small/mid caps manager."*
>
> | SARAH GONZALES AFP®

"So, you need to be selective in this space. Active management really allows you to get exposure to the high-quality end of town, avoiding exposure to the lower end, in a way that passive management can't do."

Sarah agrees, adding there aren't many passive strategies available in the global small/mid caps space. She also prefers active management, even though these assets might be a little less liquid than your large and mega cap investments.

Simon believes that in the current environment, as cycles begin to normalise, active managers are more likely to generate outperformance. He says in the case of small/mid caps, that has certainly proven to be the case previously, where there has been more scope to outperform the market, compared to simply hugging the index.

"So, for us, it's about picking really good active managers with a proven track record, while also being mindful that small/mid caps can be more volatile. That's because they're not mature companies with reliable dividends or earnings," he says. "It's also important to buy at fair value when stocks are reasonably priced."

When it comes to style biases, Sarah confirms that Apt Wealth has no particular bias to either value or growth. "Where we have a spot to allocate to a global manager, we look at the prevailing environment - like rising interest rates and inflation. The style we've been focusing on in this environment has been quality. That's because growth is being impacted by rising interest rates, which is affecting valuations, while value has underperformed for quite some time," she says.

"So, in the current environment, you need to be going after quality - strong earnings share growth, company stability, balance sheet strength, and low leverage. That's what you need to be considering when allocating to a small/mid caps manager," says Sarah.

Maroun adds that planners also need a disciplined process, without being biased either to a value or growth style of investing.

"If you are going to have targeted exposure to global small/mid caps, I would recommend planners stay away from managers or products that have an extreme style of investing. Instead, from a style perspective, go for something that is more balanced - like quality and value - which will provide you with a smoother return profile."

EMERGING MARKETS

One of the challenges for planners when allocating to global small/mid caps is knowing whether the manager is purely weighted to developed markets or has some allocation to emerging markets. This is particularly important for small/mid caps, as the invested companies might be at a different point in the business cycle compared to large caps.

"Therefore, you need to ensure you conduct your analysis and due diligence on the stock, or if you are partnering with a manager, that they are doing this analysis correctly. This includes considering governance issues and geopolitical risks that might impact particular parts of the market you're looking to invest in," says Sarah.

Apt Wealth does not invest directly in emerging markets, preferring instead to gain its exposure by partnering with a manager who has expertise in this part of the market.

Perks also uses an allocation of emerging market equities in its portfolios, which is done through a dedicated manager. Although the business remains underweight with emerging markets, Simon acknowledges the value he is currently seeing in emerging markets.

Fidelity does not have a huge amount of emerging markets exposure in its Global Future Leaders Fund, instead preferring to take a selective approach when it comes to emerging markets. That's because emerging markets can be quite volatile and some companies in this space may struggle in periods of global recession and downturns.

"We aim to capture a select handful of really good emerging market businesses that dominate their field. And this is particularly the case for businesses in economies like China and India that have a long growth runway ahead of them. We look for high quality names that we believe will provide strong structural growth to the portfolio over a long period of time, while limiting potential investment volatility," says Maroun.

MARKET OPPORTUNITIES

When looking at global small/mid caps compared to the MSCI World Large Cap Growth Index, small/mid caps are trading at a discount from a price earnings (P/E) perspective, which means there definitely is value to be found in the small/mid caps space.

This is one of the reasons why Maroun remains bullish on this asset class. "While it's a volatile market, this gives

us the opportunity to find quality companies at reasonable valuations. History shows that over the long-term, investors can expect higher risk-adjusted returns by investing in global small/mid caps. By including small/mid caps in a portfolio, it helps to diversify a portfolio and can provide an overall superior portfolio outcome."

Presently, Simon admits to being less excited by global small/mid caps, suggesting there is still some downside left in the market before it bottoms out. However, once markets have bottomed out, he believes this will create very good opportunities and value for investors in small/mid caps.

"When markets finally bottom out, we'll be more bullish on global small/mid caps, but we're not quite there yet. It's about finding the right sectors and cyclical stocks, which should bounce back strongly when markets normalise and interest rates start to come down. At that point, small/mid caps, emerging markets, and cyclical stocks should do very well, and that's when we're prepared to be bullish."

According to Sarah, global small/mid caps is probably one of the few areas in equities where fundamentals and valuations aren't too far apart. "While we don't have any direct small/mid cap holdings, by partnering with managers who have a similar investment philosophy as Apt Wealth, it enables us to have some exposure to this part of the market."

When it comes to investor opportunities, Fidelity particularly likes the energy and insurance sectors. It holds a position with Cheniere Energy – a Texas-based producer and exporter of liquefied natural gas.

"Cheniere has very sticky revenue and consistently generates high returns," says Maroun. "It's currently doing a lot to help Europe with its energy issues, as many European countries seek to reduce their dependency on Russia for gas."

Fidelity also likes the insurance sector. As Maroun explains, insurance is critical and touches all parts of society, and is not something that is skimped on in a recession. One company Fidelity likes in this space is Arthur J Gallagher (AJG) – a U.S. insurance brokerage, risk management and consulting firm that operates in over 60 countries.

"This is another sticky business that generates a lot of free cash at very high returns, and it uses a lot of its excess cash to buy and acquire smaller operators in this sector. AJG sits in the mid-market space below the larger players. This allows AJG to make deals that the bigger companies simply can't make, because the deals are too small for them. This makes AJG a very attractive holding for us."

LOOKING AHEAD

Although Sarah concedes that it's impossible to predict with certainty how any asset class will perform over the next 12 months, she accepts that if we do move into a recession, equities will be impacted. However, she maintains that for the small/mid caps space, there hasn't been a big dislocation between valuations and fundamentals, and they're trading at a much lower P/E than large cap indices, which will continue to provide investors with opportunities.

"In 2023, there will definitely be opportunities in the small/mid cap space, particularly if you are focusing on quality," she says. "If we do have persistent inflation, coupled with rising interest rates, and a slowdown in global growth – by focusing on quality in the small/mid caps space, it will enable investors to take advantage of companies with low leverage, and strong and stable earnings."

Simon anticipates markets may bottom out in the first half of 2023. However, he remains unsure that markets will bounce back like they did in 2020, when the COVID stimulus packages and rate cuts kicked in.

"It might be a slower and grinding recovery this time," says Simon. "At this point in time, our view is that 2023 will be challenging, but with really good value for global small/mid caps if you're taking a longer term view."

It's a similar view shared by Maroun. However, he cautions that the risk of recession depends on whether central banks are able to tackle inflation by pulling off a soft landing, although he concedes, this is increasingly looking unlikely.

"We're in a vulnerable window over the next six months. If we're able to bring inflation under control without tipping the economy into a recession, and if we continue to get good earnings growth coming through next year, then that will set up equity markets for quite a good year," he says.

However, even if the economy does slip into recession in the first half of 2023, Maroun remains confident that investors can probably still expect to see a solid second half from equity markets.

"Markets tend to bottom out and start to pick-up well before a recession is officially over, as they anticipate and price in the recovery," he says. "But irrespective of what happens between now and June next year, coming out the back-end of 2023, I believe that overall, equity markets – and particularly small/mid caps – will be looking better, and providing investors with plenty of opportunities and value."

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