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TRANSCRIPT

What's Driving Increased Interest in Small-cap Performance?

Featuring:

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Jenna:

Global stock markets have staged a remarkable recovery from their lows in March 2020, as economies around the world reopen. As we begin to see more healthy global financial conditions, pent-up consumer demand is being activated, and small cap stocks are benefiting from increased consumer confidence, outperforming STON's from recovering economies to create a positive environment for growth. Joining us now with more, we have Ana Harris, Executive Director, MSCI Index Product, and Raina Oberoi, Managing Director, MSCI Research. Great to have you both with us. And, Ana, kicking us off here, as economic recovery underpinned investor confidence in small caps, we're starting to see increased interest in small cap allocations to regional and global portfolios, could you share some of the advantages that make small cap indexes attractive to investors?

Ana:

I guess what's happening is that investors are looking at small cap indexes as a way to diversify their portfolios. So, we see it as a distinct exposure in equity markets, and so, investors, when they want to broaden their investment opportunity set, they will be looking to add small caps as a potential future source of return for their portfolios. So, for example, when you look at our indexes, our small cap indexes, the constituents of those are very much distinct and separate. They do not overlap with our kind of larger and mid cap indexes. So, we can allow investors to make a choice. Instead, if they wanted to focus on larger mid caps or they also want to add small caps. So, when the investors are feeling that maybe the outlook is more positive, as at the moment, they'd be looking to expand their investment horizon and investment universe, in looking at small caps as a way to diversify their portfolios. What we've seen in our research is that small caps tend to be less correlated with larger and mid caps who can, providing some diversifications benefits there, And also, research has shown, that over the long term, small caps tend to outperform larger caps in the equity market.

Jenna:

Raina, according to you, what are some of the implications of this increased interest for different industries in sectors?

Raina:

Yeah, absolutely. Small caps represent a very different industry composition, and companies, when you compare them to their larger cap counterparts. Now, generally speaking, sectors and industries that have large economies of scale, will be under-represented in small caps. For example, consumer staples, communication services. Moreover, within sectors, I think there are important industry-level differences. Now, let's take healthcare for instance. Pharmaceutical companies, generally, have tilted towards large caps, while biotech companies have generally tilted towards small caps. If you take banks for example, again, they've generally tilted towards large caps, while real estate firms have generally tilted towards smaller cap companies or smaller cap exposure. Now, small caps also tend to be overweight, sicklical sectors, such as consumer discretionary, industrials, materials, and underweight defensive, such as healthcare, communication services, consumer staples. And these tilts can have significant return implications during different phases of the business cycle. So, you know, small caps, as you've probably seen, generally tend to get hit harder during a recession, as they tend to be more sensitive to changes in the economy. However, I think, on the other hand, they also tend to recover quicker as they tend to more nimble, and they can respond to changes in the business environment a lot quicker than some of their larger cap counterparts. Now, this behavior definitely has implications for sectors and industries where small caps are over-represented. Now, for example, as the economies started opening up late last year, we saw consumer discretionary make a big come back, which helped small caps as well. Another point to note is that, you know, sector biases can also vary substantially across regions. For instance, in Europe, I would say there is a much less difference in the exposure to banks and financial service, between large caps and small caps. Especially when you compare them to the US. And small caps in Europe, traditionally, have represented a very different part of the economy, focusing on export-oriented consumer and capital goods. Now, this is quite a contrast from US small caps which have been traditionally concentrated in financials. Especially when you compare them to the weight of small caps in European financials.

Jenna:

Let's take a step back here, Raina, last year COVID-19 impacted economies worldwide, and global trade started showing signs of slowing down, what are some of the reverberations that we're seeing in developed and emerging market small cap indexes as a result of COVID-19?

Raina:

Yeah, you know, I think this, all this has transpired so quickly, but yet it's been such a long time for all of us. You know, when the world realized that COVID-19 was real, early last year, small caps felt the impact almost immediately. And it's really interesting to know how instant the effect was. So, small caps in Asian countries dipped much earlier than the rest of the world. And this was because the virus had already spread in many parts of Asia, but was yet to spread in Europe and the US. Now, when COVID-19 became a reality in the West, we saw Global X Asia small caps plummet. And, an interesting point to note here is that, even though small caps were plummeting across the board, there was a clear difference between those that were considered poor quality and those that were considered higher quality. So, clearly, investors favored small caps that were larger, profitable, and didn't need to refinance in choppy credit markets. Now, you know, as I'd mentioned earlier, while small caps can get hit the hardest when the economy is shaky, they could also tend to recover quite quickly when things stabilize, and we actually saw that happen. Many Asian economies reported low number of confirmed COVID cases, or rather had lower case growth since March 15, 2020, compared to some other major economies. And what we found there is that, small cap companies in Asian markets, which were initially beaten down, actually partially recovered, compared to their larger cap counterparts, over the following 4 weeks. And that scenario definitely did not play out in the Global X Asian markets, which was just being hit by COVID. Now, as the pandemic progressed, we saw an even clear trigger later in the year, for small cap recovery. And that was the vaccine announcement on November 9, 2020. So, while small caps have shown some recovery in anticipation, you know, of this announcement, the announcement that now we have vaccines that are more than 90% effective in preventing COVID-19, was a clear trigger for small cap indexes to rally following that.

Jenna:

Finally, Ana, as we continue to see increased concentration in small caps, what are some of the key takeaways for investors now that the economic recovery is underway?

Ana:

Yeah, so we have seen small cap indexes become a little bit more concentrated, coming from what Raina said, in terms of seeing that performance that we've seen in recent times, but by no means they are as concentrated as their kind of large and mid cap counterparts. So, for example, for something like the MSCI Wold small cap, the top 25 holdings, they represent less than 5% of the total index. While in the MSCI World which represents and looks at all the larger and mid cap companies worldwide, those top 25 companies is almost like 25% of the index. So, there is concentration in small caps, but by no means, at the same extent that we see in larger and mid cap indexes. Investors do worry about concentrations. Because that means that the performance of the industries or the portfolios that they look at, might be driven by a smaller set of companies, and the risk as well might be driven by those companies, and by company-specific news. So, again, from a small cap perspective, there is less of a concern. And as the economy recovery kind of takes hold, then again we can see that the various government's support and subsidy to smaller business to domestic businesses, is really helping those smaller businesses, the small caps, to bounce back. And, if we're going to continue in this kind of recovery environment, if we're going to continue to see that support from governments that help to the domestic economy, we should be able to see again further tailwinds for small caps. Because, what we've seen before in our research is that, smaller caps tend to be more domestically focused, can again be more exposed to the dynamics of the local and domestic economies, and that's where we are seeing a lot of the recovery take place. So, as time progresses and that recovery takes even stronger hols of the economies around the world, that could be, potentially, kind of, next, kind of, further support for the small caps. The other thing that has happened and has been happening for a while that could also provide some support to small caps is that companies have been rethinking their global supply chains, and maybe making them less global and more domestic. Again, shifting corporations around the world and having a bit more control of their supply chains locally. So, that again is a benefit for the smaller and kind of local, domestic businesses. So, again, from a kind of outlook perspective, the economy recovery index changing shift in global supply chain could still prove to be positive for the smaller businesses.

Jenna:

Well, Ana, Raina, great to have you both with us to help break down what's driving this increased interest in small caps.

Ana:

Thank you.

Raina:

Thank you.

Jenna:

And thank you for watching. I was Joined by Ana Harris, Executive Director, MSCI Index Product, and Raina Oberoi, Managing Director, MSCI Research. I'm Jenna Dagenhart with Asset TV.

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