Why FY25 could be the Year for ASX Small Caps

SALTER BROTHERS
EMERGING COMPANIES LIMITED

- **The relative valuation of Australian small cap equities versus Australian large cap equities is at 20-year lows, offering a unique time in the cycle to invest in the sector**
- **Small cap fundamentals well placed and green shoots are emerging**
- **Australian small caps have significantly underperformed over the last three years**
- **Underperformance of small caps part of a global trend**
- **Small caps forecast to benefit from an improving macroeconomic environment**
- **Small cap investment benefits from an active management approach**
- **SB2 offers a diversified portfolio of actively managed small caps trading at a discount to the underlying asset value**

There is currently a material disconnect between small cap fundamentals and their trading performance. Small cap indices, both in Australia and abroad, are trading at historic discounts to large caps following a divergence in trajectories which began in 2021. Balance sheet evaluation of small cap firms though, tells a story of strengthening in the decade since the Global Financial Crisis (GFC). Small cap balance sheets are now better placed than in previous periods of small cap underperformance from which they successfully rebounded.

Thus, small caps appear well placed to profit from an improving forecast macroeconomic environment in 2025. Prior to investing, it should be noted that investors have historically benefited from taking an active management approach to small caps, to avoid the pitfalls and find the treasures of the market.

Recent Event Spotlight

The first two weeks of July 2024 have seen encouraging small cap green shoots in global and domestic markets. Since July 1, the Russell 2000 US Small Cap Index has increased 7.7 per cent, while the S&P 100 – the 100 largest US firms – only increased 2.7%. Meanwhile, the S&P/ASX Small Ordinaries has increased 3.7% over this period, growth significantly above its average two-week return so far in 2024 of 0.35%.

About the Author of this Article

- Salter Brothers is a global fund manager with over $3.5B of group assets under management.
- Salter Brothers Emerging Companies Limited (ASX:SB2) is a listed investment company (LIC) dedicated to investing in small cap Australian companies with a market capitalisation of under $500M. It offers a professionally managed and diversified exposure to the Australian small cap sector.
- SB2 is managed by a large and proven investment team. Gregg Taylor is the Lead Portfolio Manager with over 25 years small cap investing experience.
- SB2 has a strong three-year track record of outperforming the small cap market.
- As at 30 June 2024 the current share price of SB2 trades at a ~40% discount to the underlying post tax NTA value.

State of Play

As shown in Figure 1, Australian small caps have endured a run of consistent underperformance relative to large caps since Q4 2021. The global picture, shown in Figure 2, is similar, with downturns in the US and the MSCI Global Small Cap Index tracing further back to Q2 2021. Such a disconnect has analysts both in Australia and abroad turning their attention to small caps, identifying value and studying the market signals to appropriately time their investments. However, as Morningstar noted in their recent report on the topic, obsession with timings can be a distraction: the more important point is that value exists.

Figure 1: Total Returns of the S&P/ASX Small Ordinaries and the S&P/ASX 100, 2019-2024(June), Index = Jan-2019. Source: S&P..

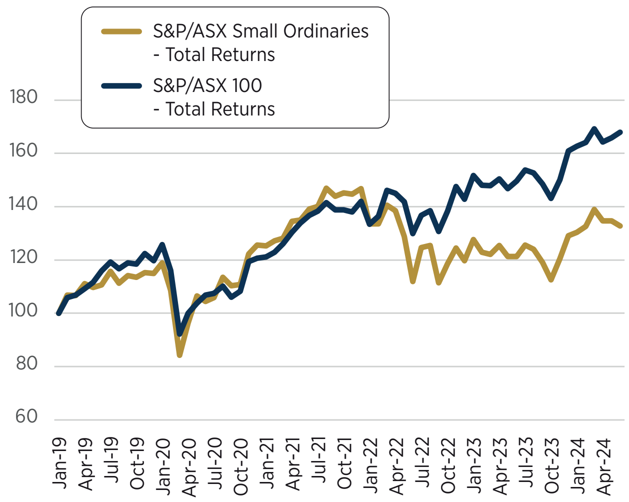
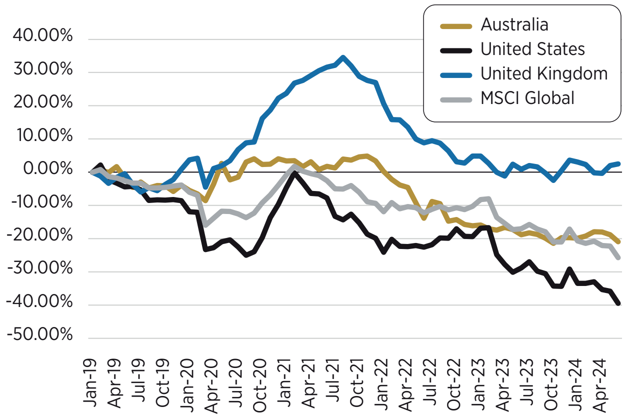


Figure 2: Relative return of the S&P/ASX Small Ordinaries to the S&P/ASX 100, the Russell 2000 to the S&P 100, the FTSE Small Cap Index to the FTSE 100, and MSCI Global Small Cap Index to the MSCI Global Large Cap Index, 2019 – 2024 (June), Index = 2019. Source: S&P.



As evidence of this value, consider Figure 3, which illustrates the time path of the Price to Book Value (P/BV) – a measure of the relationship between a company's trading price and the value of its assets – of the S&P/ASX Small Ordinaries and the S&P/ASX 100. Over the last decade, the P/BV of both indices has tended to move in harmony. Further, comparing this figure to Figure 4, which shows the time path of the relative return of the S&P/ASX Small Ordinaries over the same period, we notice an instructive relationship. Periods of small cap underperformance have tended to coincide with periods of the index trading at below average P/BV. Conversely, periods of small cap overperformance have tended to coincide with the opposite. Looking at the current period, small cap P/BV is notably below both large cap P/BV and its own long-run average.

Figure 3: P/BV of the S&P/ASX Small Ordinaries and the S&P/ASX 100, 2014-2023. Source: S&P.

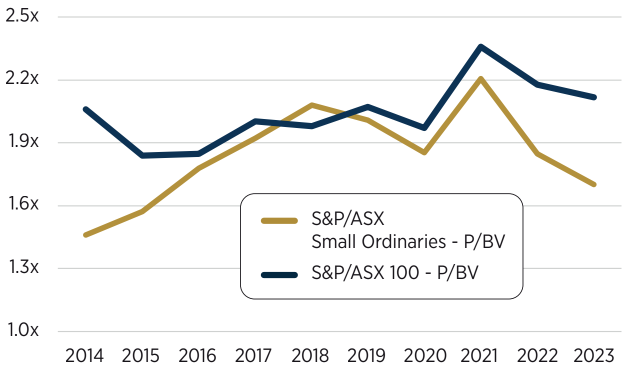
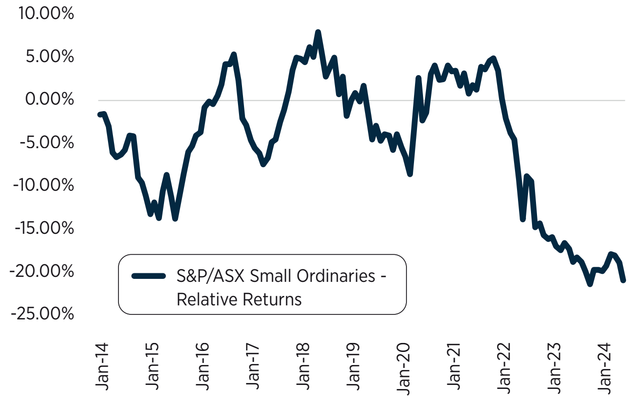


Figure 4: Relative return of the S&P/ASX Small Ordinaries compared to the S&P/ASX 100, 2014-2024 (June), Index = 2019. Source: S&P.



How Did We Get Here?

Macroeconomic Headwinds

Small caps have suffered from a highly unfavourable macroeconomic environment in recent years. In a 2020 research paper on the "Small-Cap Premium" – the historic outperformance of small caps over the long term, studied by researchers since its discovery in the 1980s – Lorne Switzer and Alan Picard showed that relative small cap performance was cyclical, outperforming during periods of economic expansion, and underperforming during periods of economic struggle. Assessing Australian GDP growth since 2019, as shown in Figure 5, we see mixed support for this as a deterministic factor in this case. However, this is largely due to the impact of the COVID-19 pandemic, with strong growth figures during the recovery period masking a weak economy. Looking at the trend, it is clear that growth has been on a downward trajectory since Q2 2021, and framing GDP in index terms, as in Figure 6, we see that economic growth has slowed considerably since Q4 2021 – the inflection point for small cap underperformance.

Figure 5: Australian GDP Growth (Year to Quarter), 2019Q1 – 2024Q1. Source: ABS.

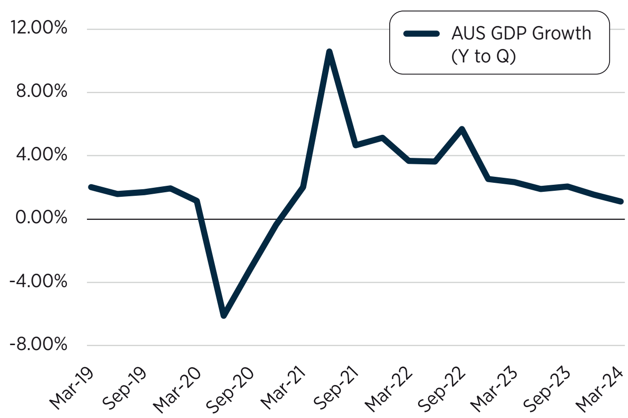
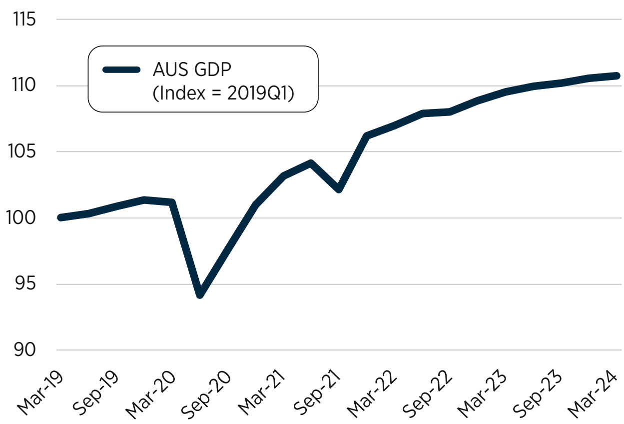


Figure 6: Australian Seasonally Adjusted Real GDP, 2019Q1 – 2024Q1, Index = 2019Q1. Source: ABS.



The impact of interest rate rises

Though not supported by Switzer and Picard's research, interest rates have also been frequently discussed as a source of variation in relative small cap performance due to the different lending environments faced by small and large cap firms. Given perceptions of a greater risk profile informed by their size, small caps tend to face shorter term loans with more variable rates, pushing up their interest rate burden during periods of high rates. Assessing both macroeconomic and company data, we do find evidence that this may be a contributing factor to current underperformance.

Beginning in Q2 2022, Figure 7 shows that interest rates have experienced a sharp incline, placing pressure on company balance sheets. This can then be seen in the declining EBITDA/ Interest Expense ratio of both small and large caps since 2021 – with small caps operating at a much lower multiple than large caps (Figure 8). However, two pieces of counter evidence should be noted. Firstly, the rise in interest rates did not occur until after the underperformance inflection point, with roughly half of the underperformance achieved prior to the first rate rise. Secondly, though the EBITDA/Interest Expense ratio for small caps did fall to 3.9x in 2023, that still placed it above the twenty year average of 3.7x, reflecting the strength of small cap balance sheets.

Figure 7: RBA Official Cash Rate, 2019Q1-2024Q1. Source: RBA.

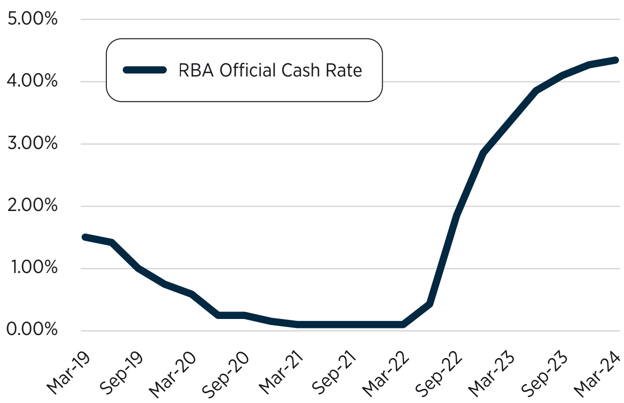
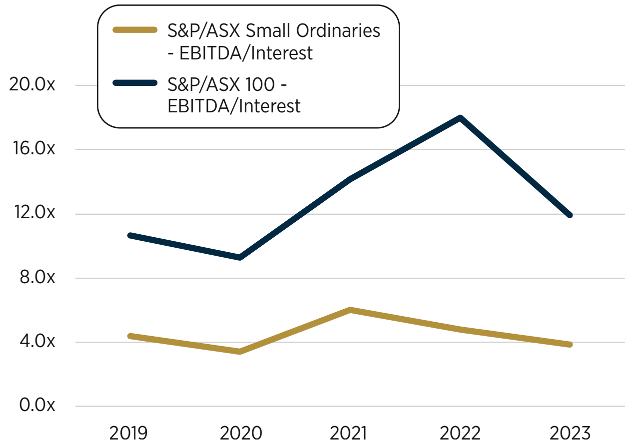
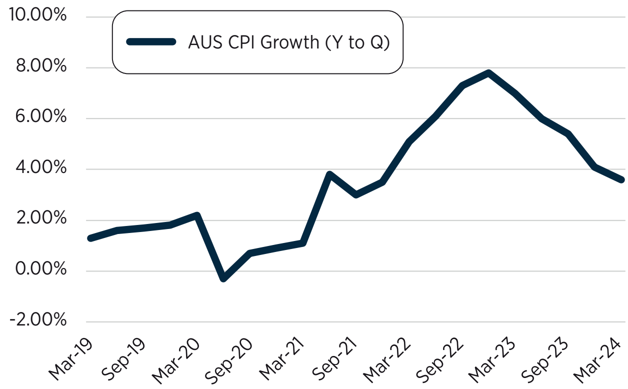


Figure 8: Ratio of Earnings Before Interest, Tax, Depreciation and Amortization to Interest Expense of companies listed on the S&P/ASX Small Ordinaries and the S&P/ASX 100, 2019 – 2023. Source: S&P.



A final macroeconomic headwind, which was identified by Switzer and Picard as the key correlate of small cap underperformance during economic downturns, is inflation. Given their smaller market power, small caps are often more susceptible to rising inflation as they lack the pricing power to pass on rising costs to consumers. Looking at the data in Figure 9, we do see a clear uptick in inflation in Q2 2021, remaining high over the underperformance period.

Figure 9: Year to Quarter Growth in Australian CPI, 2019Q1 – 2024Q1. Source: ABS



Leaders and Laggers

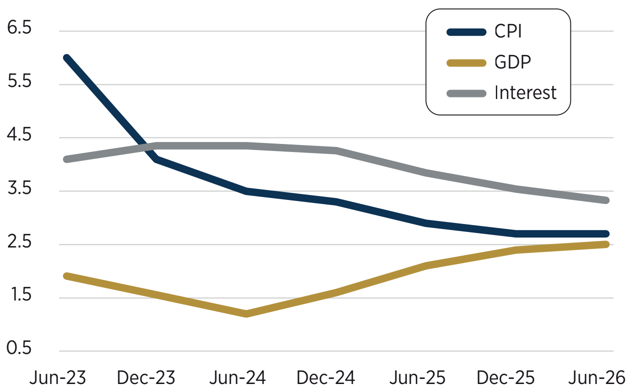
As correlates of relative small cap performance, it is interesting that both trend GDP growth and inflation, led the small cap downturn by two quarters while interest rates lagged by two quarters. Taken in terms of expectations, this puzzle makes sense. If we assume that interest rates are considered the more important predictor of relative small cap performance – a fact which the weight of coverage on the topic in investment spaces would seem to suggest – and we assume that savvy investors want to stay ahead of the curve, it seems logical that investment decisions would be made based off interest rate expectations as opposed to the rate decisions themselves. In that case, trend GDP growth and inflation, as two key determinants of interest rate expectations, would appear as useful leading indicators.

From Underperformance to Overperformance

An Improving Macroeconomic Environment

Although recent monthly inflation figures have been disappointing, the long term outlook for Australia's major economic indicators remains favourable. According to the RBA's May survey of market economist forecasts, 2025 should bring with it some encouraging small cap tailwinds, with rising GDP growth and falling inflation and interest rates (Figure 10).

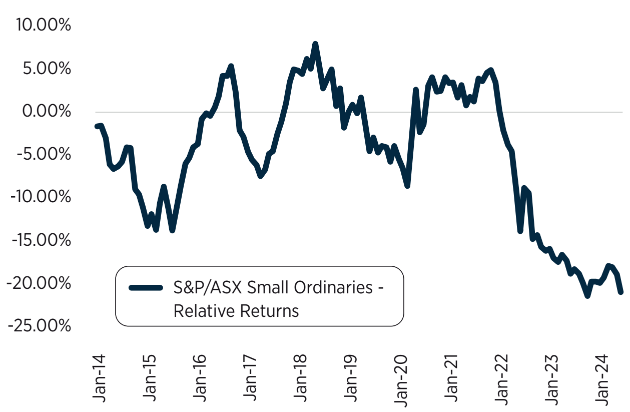
Figure 10: Average of market economist's forecasts, May 2024. Number of forecasters surveyed per measure: 27-39 (varied with time horizon). Source: RBA.



Historical Performance

As shown earlier in Figure 4, the relative performance of small caps has tended to be cyclical in nature, with periods of underperformance and outperformance following each other in turn. As such, while the current downturn is unusual with respect to its depth, it is not out of sync with the overall pattern, a pattern which would suggest a future return to a period of outperformance.

Figure 4: Relative return of the S&P/ASX Small Ordinaries compared to the S&P/ASX 100, 2014-2024 (June), Index = 2019. Source: S&P.



Small Cap Balance Sheets

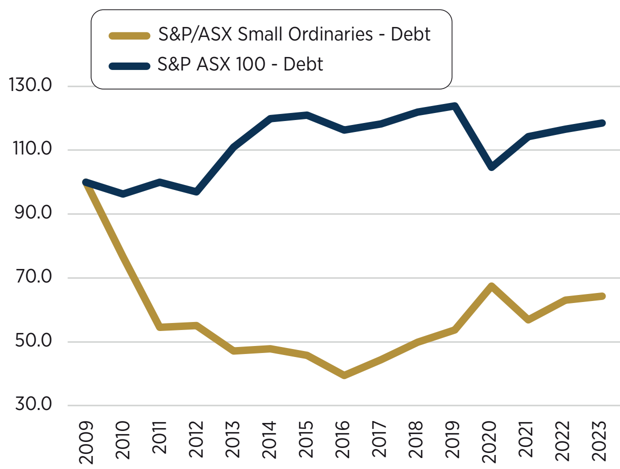
In the decade since the GFC and the ripples that followed, small caps have undergone a process of balance sheet strengthening to better insulate themselves from future financial crises. As evidence of this, consider the relative position of small cap balance sheets during the current underperformance event and the other large underperformance event captured in Figure 4: 2013-15.

As illustrated in Figure 11, in comparison to the 2013-15 underperformance event, which small caps successfully reversed, indicators of small cap health amidst the current event are almost universally equivalent or superior. The only notable exception to this is with respect to debt position. However, this is largely due to the flight from risk that followed the GFC. Lending to small caps decreased considerably in the years that followed the crisis and has only recently begun recovering. However, given that lending to large caps continued to grow over this period, the recent change in small cap debt profile could be taken as an endorsement of small cap strength (Figure 12).

Figure 11: Relative position of small cap balance sheets. Comparison of 3 year average for companies in the S&P/ASX Small Ordinaries. Green indicates clearly better performance, red clearly worse, and grey equivalent. Source: S&P Capital IQ.

	2013-15 Av	2021-2023 Av
Revenue Growth	Red	Green
Gross Profit Margin	Grey	Grey
EBITDA Margin	Grey	Grey
EPS	Red	Green
Operating Income	Red	Green
Cash	Red	Green
RoE	Red	Green
Debt/Equity	Green	Red
EBITDA/Interest Expense	Red	Green

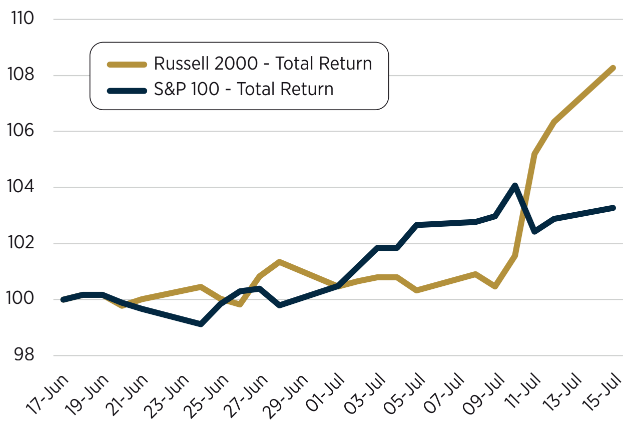
Figure 12: Index of long term debt (Index = 2009) for companies on the S&P/ASX Small Ordinaries and the S&P/ASX 100, 2009-2023. Source: S&P Capital IQ.



July 2024 Green Shoots

The first two weeks of July 2024 have brought encouraging signs of a small cap revival that some commentators are even suggesting could be a turning point. While it is still to early to tell if that is the case, recent data does seem to warrant a higher alert status for small cap investors. Turning to the data, Figure 13 depicts the month-to-date total returns performance of the Russell 2000 and S&P 100 indices, indexed to June 17. Given that relative performance in the US market has previously led results in the Australian market, the divergence in performance depicted here is certainly worth keeping an eye on.

Figure 13: Total Return of the Russell 2000 Index and the S&P 100 Index, June 17 – July 15 (Index = June 17). Source: S&P Capital IQ.



The Benefits of Active Management

Though the outlook for small caps looks promising, investors are still advised to proceed with caution in the small cap market. More so than other classes of securities, small caps require – and benefit from – an active management approach. Assessing the performance of small cap indices both in Australia and globally, there is evidence that the indices have been dragged down by compositional issues. Whereas large cap indices have benefited greatly from the boom in technology stocks, these benefits have not filtered through to small cap indices which tend to have higher exposure in other areas, such as the lower performing materials and mining sectors. Further, small cap indices also tend to have greater exposure to the consumer discretionary and real estate sectors, which tend to be more vulnerable to cyclicality. Combined with the lesser coverage of small caps, these factors necessitate a more deliberate approach.

As evidence of how even a rudimentary active management approach can significantly improve small cap investment performance, consider the relative performance of the S&P/ASX Small Ordinaries Select Index – launched in December 2018 – which employs a profitability screen to filter the larger S&P/ASX Small Ordinaries Index. To be eligible for inclusion, Small Ordinaries firms must have recorded positive earnings per share (EPS) over the previous 24 months. Continued inclusion then requires at least one of the last two 12 month periods have positive EPS.

Figure 14: Relative return of the S&P/ASX Small Ordinaries Select Index compared to the S&P/ASX Small Ordinaries Index, 2019-2024 (June), Index = 2019. Source: S&P.

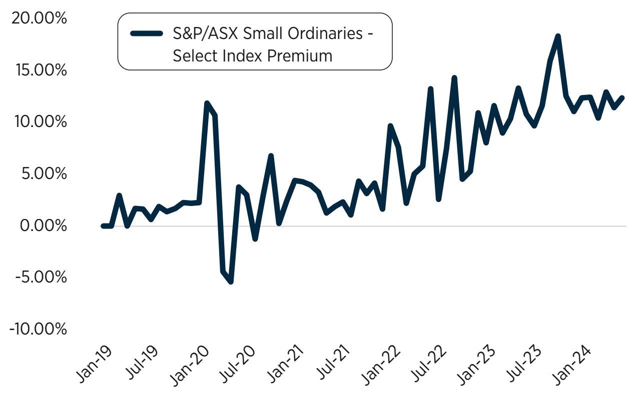
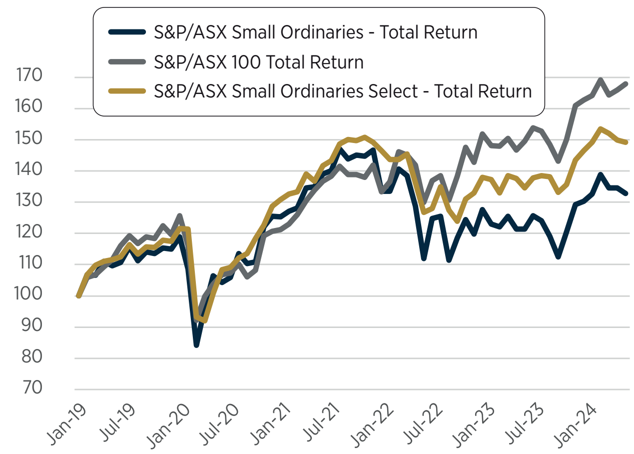


Figure 15: Total Return of the S&P/ASX Small Ordinaries Select Index, S&P/ASX Small Ordinaries Index, and the S&P/ASX 100, 2019-2024 (June), Index = 2019. Source: S&P.



Looking at the data in Figures 14 and 15, the S&P/ASX Small Ordinaries Select Index clearly outperformed the broader S&P/ASX Small Ordinaries Index, closing the gap significantly to the large cap S&P/ASX 100. As such, an active management approach offers opportunities not only to maximize returns during periods of small cap outperformance, but also minimize the impact of underperformance events.

Salter Brothers Emerging Companies Limited (SB2)

The success of the S&P/ASX Small Ordinaries Select Index speaks to the value of an active management approach in the small cap market. However, as a mechanism of active management the index does nothing more than employ a simple EPS filter. As a result, the index still contains a robust 131 companies (the full S&P/ASX Small Ordinaries Index contains 194). By contrast, SB2 is an actively managed, fundamentals driven fund of only 25-30 investments, curated and monitored by experienced industry experts. It therefore offers an exciting opportunity for investors looking to diversify their portfolios and increase their small cap exposure with a view to capitalising on current unrealised value in the market.

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Authorised for release by the Board of SB2.

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