

Transcript

The Ideas Exchange  
Episode 5: Making the most of Australian small caps

June 2021

**Voiceover** [00:00:01] Welcome to the Monthly Ideas Exchange podcast brought to you by ASX, The Heart of Australia's financial markets. Each month we'll connect you to a range of leading industry experts who'll give you a look into the finance industry and deliver valuable insights, hear about important market events, industry research, tips for your own market research, as well as innovative products to help you diversify your investment portfolio.

**Martin Dinh** [00:00:34] Hi everyone and welcome to the Ideas Exchange podcast by ASX. I'm your host, Martin Dinh, and in today's episode, we'll learn about one of the best performing sectors over the last 12 months, namely the Australian small cap sector. Today I'll be joined by Emilie O'Neill, ESG and Equities Investment Analyst for Perennial Value Management, as we chat about some of the benefits and risks of the small cap sector and take a deep dive into the eInvest Better Future Fund, which is an active ETF that focuses on socially responsible Australian and New Zealand listed small and mid-cap companies. So come join us as we learn more about the Australian small cap sector.

**Martin Dinh** [00:01:18] Hi Emilie. Welcome to the Ideas Exchange podcast. It's great to have you here today.

**Emilie O'Neill** [00:01:22] Hi, Martin. Thanks so much for having me on.

**Martin Dinh** [00:01:25] So in today's episode, we're looking to cover the small cap sector, which is often an area that is overlooked by investors when assessing investment opportunities. For example, as at 31 March 2021 domestic and global small cap ETFs represented less than two per cent of the entire ETF market. That being said, the small cap sector is a sector that can offer breadth, opportunity and diversification for those investors willing to accept the additional risk that comes with investing in a small cap portfolio. So before we go into more detail about some of the benefits and risks of investing in the small cap sector, I was wondering, Emilie, as an ESG and equities investment analyst for the eInvest Better Future Fund, an ASX active ETF that invests in a portfolio of socially responsible Australian and New Zealand listed small and mid-cap companies, how do you define a small cap company?

**Emilie O'Neill** [00:02:18] Great introduction and I concur with everything that you've said. You know, the small cap market offers a great opportunity for

investors for a whole bunch of reasons, which hopefully will touch on a little bit later. But when we're talking about small caps, what that means to us is that it's companies listed on the Australian Stock Exchange that fall outside of the ASX 100. Now, what is the ASX 100? Well, that's the 100 largest companies that are listed on the stock exchange. And actually they make up about three quarters of Australia's market capitalisation. So what we do is we look outside of those top 100 companies for really interesting opportunities that we say are contributing to a better future.

**Martin Dinh** [00:02:55] So now we know that the small cap sector comprises of companies on the lower spectrum in terms of market cap, in your opinion, what are some of the benefits of investing in the small cap sector?

**Emilie O'Neill** [00:03:05] So what we find with smaller companies is they tend to be higher return, but also a lot higher growth as well, because there's a lot more potential. These are companies that might be earlier in their business cycle and haven't really established their dominant position in the market. So there is a lot more potential for upside here and that in return relates to shareholders as well. So the great thing about smaller companies is that the Small Ordinaries Index or outside of the top 100, there's actually a lot more diversification. So in the larger companies, we tend to be quite skewed on the ASX with the banks and the miners. But if you look outside of that, the small caps offers a really interesting sector diversification there. And there's not as high of a concentration in one sector, which is great. And they also, because they're smaller, tend to be more pure play exposure. They don't have really diverse revenue streams. You're getting the pure exposure to a certain theme or to a certain business line. There's lots of innovation as well and technology that's happening in the space, which is really exciting for Australia. We've got these amazing companies that we can access through the ASX. They don't have those big legacy issues that you might find with some of the large companies that have been around for ages. And they tend to have you know, they're burdened by their technology or their compliance. Because they're a little bit smaller, they can be more nimble. And the other great thing about small caps at the moment is they're a lot more leverage to the Australian market. And in an environment where the Australian economy is doing really well, that's definitely a positive for investors.

**Martin Dinh** [00:04:29] Emilie, you've outlined some great benefits of investing in the small cap sector, you know, such as the small cap sector offering diversification, I guess also outside of large cap companies, but also that also creates opportunities for you to buy companies with potentially offering great growth opportunities, but are also leveraged to the Australian market. But on the flipside, what are some of the main risks of investing in the small cap sector?

**Emilie O'Neill** [00:04:52] Yes, of course, as you might hear, people say high risk and high return. So where we see high returns, there also tends to be high risk as well. And investors should really be aware of those risks before deciding to invest in smaller companies. So one of the biggest things that we see in a small cap market is high volatility. Now, what that means is the share prices

can go up and down a lot more rapidly than larger companies. And what that really means for investors is you need to have a longer investment horizon so that you can overcome those big cyclical movements in the share prices. The other issue that we have in the small caps market is illiquidity. And what that means is that there's not as many buyers and sellers in the market for a certain company, which means that if you're looking to buy or sell a position, it might be a little bit more difficult than if you were buying a large cap company that has lots of traders in and out every day. And I mentioned this is a positive, but this could also be a negative as well. They do have concentrated business revenue streams, which means that they don't really have that protection if that revenue stream is unsuccessful or there's, you know, maybe covid has really impacted that particular segment of the market, they don't have the diversification of some of the larger companies to move away from that revenue and get revenue from other sources. They also tend to not pay dividends. And that's because they're high growth, so they're not established businesses with stable revenue streams in the most part. So you're not getting those high dividends that you might be looking for in the large cap market. And there's, of course, a risk that the business model isn't actually going to work. And so they basically stop trading. That's another risk that you have to consider in the small caps as well. But what's crucially important in smaller companies is the management teams, because they're going to drive the business to success or basically to stop trading. So we're really making sure that when we're looking to invest, that we're looking for competent, skilled management and executive teams that can bring it forward. And because typically they might have lower salaries, that there's less skilled managers who are attracted to smaller companies. So that's something we're really watching.

**Martin Dinh** [00:06:48] So in summary, it appears the small cap sector is generally more riskier than large caps. You've mentioned some of the reasons, limited revenue streams, lower liquidity, higher volatility, just to name a few. But for those investors who are willing to accept that additional risk, there still appears to be a real breadth of opportunity and diversification in that small cap sector. Out of curiosity, how has the small cap sector performed since covid?

**Emilie O'Neill** [00:07:12] Yeah, that's a great question. And I think one of the things that investors should remember as well with the small cap space is that they tend to be under researched as well. So that means that we can find opportunities that have a lot more upside as the market starts to realise their potential and become aware of them. And over covid what tends to happen in environments where there's more of a downturn or the economy outlook doesn't look as positive, is small cap companies, as you mentioned, they're more volatile, so they'll fall more than the large cap companies. So we know that the Small Ordinaries Index or basically the ASX 200 to 300. So that's the two hundred and first company to the three hundredth company by market cap listed on the stock exchange. That will actually, that index fell a lot more than the ASX 100, and that's because they have more risk of these, you know, revenue streams or that they're more concentrated business. They don't have the diversification. So we saw those fall a lot faster than the broader market. But in a recovery, smaller companies tend to do a lot better. And so we've

actually seen since the fall in March last year, we've seen smaller companies recover a lot quicker. And as I mentioned, one of the key reasons for that is because they have really strong exposure to the Australian market, which is obviously doing well at the moment. And they also have leverage to the Australian dollar. And because that's been rising, that supported these smaller companies as well.

**Martin Dinh** [00:08:30] So in summary, it does appear that small caps, they did experience a bigger draw down during the peak of the sell off than large caps. But on the flip side, they rebounded a lot stronger than large caps as the Australian economy has recovered, as you mentioned. So now that we've covered some of the basics of small caps, I thought a great segue to this conversation is to ask some questions about an active ETF that you have listed on ASX that invest in socially responsible Australian and New Zealand listed small and mid-cap companies, namely the eInvest Better Future Fund under the ASX ticker IMPQ. Now out of curiosity, why did you choose to take an active management as opposed to tracking an index that covers the small cap sector such as the S&P ASX Small Ordinaries Index?

**Emilie O'Neill** [00:09:16] Yeah, great question. I guess following on from that, I guess taking a step back, what is active management? And that's basically stock-picking. So that's where you choose companies that you think are going to outperform the market. What that means is that our team, including myself as an investment analyst, we go out and we research stocks that we believe are most likely to generate a good return for our investors. And so we go back and we model the company's profit and loss statement. We come up with a valuation. We basically meet with management on many occasions to get comfortable with the team and the outlook for the business. We look at industry trends and competitors and the market opportunity, and that allows us to form a view on whether a company is going to outperform. That is really important in small caps, basically, because there's a lot that can go wrong for a smaller company. And so we want to make sure we're picking those that are going to do great things and have the best opportunity to succeed. And that's why active management is really important in the small cap space. And you don't really, you might not necessarily want, particularly in this environment, to hold everything that the index might offer because they're going to be some losers. So the whole premise is to try and select those that have the greatest opportunity to do you well for your returns. And the other great thing about active management is we can participate in capital raisings. That means that when companies go to raise money from shareholders, we can participate in those raises, sometimes at discounts, and that allows us to continue to generate good returns as well. What we love is that there's so many great, interesting companies coming onto the ASX, particularly with a focus on a better future. So having strong environmental or social performance, and that's why we're able to find these great opportunities right here in the Australian market. What we're finding is that companies from overseas, so from the US market that are a little bit too small to list on the Nasdaq are actually coming in listing on the ASX, which provides us with such a great exposure to great growing innovative companies that are doing fantastic things for society and for environment.

**Martin Dinh** [00:11:09] In summary, it looks like active management can be useful in the small cap sector. And this is, you know, given the diverse nature of small cap companies. And also you've mentioned a good point that I didn't know about being able to participate in capital raisings. And I think, you know, small cap sector being such a diverse area. I think because of that, that requires deep due diligence and analysis as well. And for me, that makes a strong case for active management in the small cap sector. Interestingly, I've also read in some studies, such as the SPIVA Report by S&P, that active management in the small cap sector has been more successful in outperforming their benchmarks relative to other asset classes. So now that we've talked about why investors should consider active management in the small cap sector, I wanted to ask why IMPQ takes an environmental, social and governance, short for ESG approach, when selecting small and mid-cap companies, given this is something we don't see much in the listed space at all. So in your opinion, by taking an ESG first approach to small and mid-cap companies, what benefit does this bring?

**Emilie O'Neill** [00:12:12] Yes, I'm sure you guys have had a lot more about ESG and sustainability investing because it is really a hot topic right now. Lots more money is flowing into the sector. And actually at a global level, 55 billion per month is going into ESG investments across the world. That really just shows the changing view that sustainability is important for investors and it actually helps generate returns. So we take a truly ESG first approach, and that's because we believe that companies that are contributing to a better future are likely to experience business tailwinds or what we call positive catalysts, which allow them to outperform and generate strong, consistent returns. And we believe that we can generate those strong and consistent returns while also helping society become better and helping the environment and helping to tackle environmental issues. So there's lots of research out there that supports the case for sustainable investing or ESG investing, and it actually really makes general sense when you think about it. So companies that are focussed on ESG and sustainability tend to have fewer ESG related controversies. So we've seen a number of issues on the stock market where there's been cultural concerns of an organisation where they may have done some environmental damage, which has caused an impact to their share price. So if they have less ESG related controversies, they're probably going to perform better because they don't have that downside impact when they have issues. And following on from that, they're going to experience less regulatory attention. So the regulator is not going to be as focussed or crack down or increase regulation, which is burdensome for companies. And another thing that we're seeing is really strong demand from consumers who actually want to actively buy from companies that are doing good things. And they're prepared to pay a premium for that, which is great for businesses that are focussed on that area. And as I mentioned, the flow of money into these funds means that investors are also looking for these more sustainable companies. We also find that they tend to have a low cost of capital, which is basically a fancy word for that they can raise money at cheaper prices, which provides them with a higher valuation and they tend to be lower risk. And what's my favourite is that they have better staff outcomes. So staff that work for these companies really care about

what the company is doing. And they feel more connected to a business that is focussed on the environment and focussed on society and is focussed on making sure people feel happy at work. And that leads to better engagement, lower turnover, so less people are leaving or want to leave. And it's creating a great sense of productivity within the business because continuously rotating staff is costly, that's a business expense. So if they can maintain their staff and keep them actively engaged at work, that's going to lead to positive outcomes. And so they're just a few of the things that research finds why ESG tends to outperform.

**Martin Dinh** [00:14:50] Those are some great points. I mean, by taking an ESG first approach, it seems that you can find companies that can manage their risk better, but also at the same time deliver strong performance, which is, you know, quite a topical area over the last couple of years. And there's a lot of logic, like you mentioned, given these companies tend to have higher staff retention, less legal and regulatory risk, a lower chance of bankruptcy, and also a lower cost of capital, just to name a few. So to me, when I when I hear you talk about ESG, it seems like you're a big advocate in this area and you're extremely passionate about this area. So why do you think it's so important to consider ESG when investing in general?

**Emilie O'Neill** [00:15:28] You're really right. I'm very passionate about it for a number of reasons. The first is, I think it does support a case for generating returns, which is what we're here to do. We're here to generate strong, sustainable returns for our investors because that's why we're in business. But at the same time, it allows us to direct money into companies doing good things and direct it away from companies that are not doing good things. And for me, that's really important because I want to have a future that I want to live in and I want to use my capital to generate positive outcomes for the world and not be investing in things that are going to lead to detriment for years to come. So I think that the myths around ESG and returns has really diminished in the last few years, and that's just proven by the weight of money going into these sustainable products. And I think that there's more and more recognition that companies that are managing their ESG risk well are better at managing all of the risks in their business, which means that they're going to be better companies. So you should really be thinking about investing in ESG or sustainability because it's going to help your portfolio. So that's just a no brainer for me. But it's also really important for those investors who want to invest in line with their values. I have so many friends that live a really sustainable life. You know, they constantly use their KeepCup. They're removing plastic from when they're shopping, they're donating to charity. They're doing all of these great things because they're passionate about being a good person and doing the right thing for the world. But then they don't know where their super is invested. They don't know what type of companies are held in their investment portfolio. And that's a real concern because they could be investing in companies that they wouldn't dream about ever buying a product from. So I think that it's really important to make sure that your investments are aligned with what you believe. And the best way to do that is go in and look at your holdings. Is that a company that you would expect to see in a fund that you're investing in? Yes or no? And if it's not, then don't put your

money there, because that's just giving the company greater funds to continue operating.

**Martin Dinh** [00:17:19] I think those are some great points that I can relate to as well. You mentioned investing in something that aligns with your values, but at the same time investing in companies that can also deliver strong performance as well. So almost like having a feel good story that you can make money on. I think that's a great point to take away when making a decision whether you should incorporate ESG into your portfolio. So I wanted to dive a little bit deeper into the portfolio construction of IMPQ. I was interested in knowing how you find value when selecting which companies go into the portfolio.

**Emilie O'Neill** [00:17:53] Yes, great question. So in the Better Future Fund or IMPQ, we have a really big investment team. So we have about nine dedicated small cap analysts, which is a very large team to go out and find opportunities. And there's a number of criteria that we look at or that the companies have to meet in order for us to put our money there. And those include valuation multiples. So we're looking at a factor called price to earnings. We're also looking at dividend yield, what we call price to free cash flow or EPS growth, which is earnings per share growth. And we're really focussed on the industry outlook as well. So is the segment growing or can the company take greater share, because that's going to lead to profits down the line. We also want to see really strong margins, which means they generate a profit on their business operations. And their pricing power, so if they have increased costs on their supply side, can they pass that on to consumers? Do they have ability to price up or down? And also, we go out and we talk to customers. We talk to suppliers about the business to make sure that everything's operating as we would expect. And we take all of this on a two to three year view. So we're not investing for the short day trade. We're really taking a view on the sustainability of the business over a two to three year time horizon, because, as I mentioned, small caps can be volatile. So you need to be able to withhold any short term volatility and focus on the underlying value of the investment.

**Martin Dinh** [00:19:14] So I guess in summary, it sounds like the secret source for IMPQ is a mix of focussing on small and mid-cap companies with, I guess, strong balance sheets. You've mentioned some of the factors such as PE ratio, minimal debts, large cash balances, but you also focus on companies with positive ESG outcomes as well that contribute to a sustainable future. Is that correct?

**Emilie O'Neill** [00:19:34] Yeah, that's exactly right. So not only are we looking at the valuation criteria in the business opportunity, we're also making sure the company has a strong ESG performance as well. So we have our internal scoring mechanism, which looks at the company's environmental, social and governance performance, but also their ability to engage or discuss ESG with investors, with the market. And how competent are management at discussing how important sustainability is for their business? And that's a really great indicator to look through what sustainability means to them and how sustainable the business is. So we also go out and actively seek companies in

certain sectors that we believe are going to generate good returns, but also in the sectors that are helping the world. So things like health care, renewable energy, low carbon technology, employment, well-being, these are sectors that we're focussed on, safety is another one. So we're going out and finding really great companies that have great growth opportunities, but also really strong ESG credentials.

**Martin Dinh** [00:20:35] Turning to your crystal ball, Emilie, what's your outlook for the Australian small cap market?

**Emilie O'Neill** [00:20:39] We're really positive on the Australian market at the moment and the outlook for smaller companies. So if you've been following the Australian dollar, you've seen that it's been very strong. And as I mentioned, this is a benefit to a lot of small cap companies that are exposed to a higher AUD. And also smaller companies have more domestic exposure. And given that the Australian economy is really strong, we've had jobs growth. We've had a strong housing market, as I'm sure many of you have been reading about, sentiment has improved. We've got balance sheets of the consumer that are really good health. So people have savings, people have excess funds. And so all of that leads to what we think is a really strong outlook for Australian small cap companies. And as I touched on a little bit earlier, we're seeing a lot of deals or listings from the US market, which means onto the ASX because they're too small for the Nasdaq. And that's just constantly providing us with a flow of new companies to the market that we're able to invest in. And the outlook is really strong. We're really positive. And we think that small caps can continue to outperform in the near term. And we're going out there and looking for those companies that we think are being undervalued by the market.

**Martin Dinh** [00:21:45] I mean, it looks like a very positive outlook, like you mentioned, for the Australian small cap sector. And I think you mentioned some great points because the small cap sector is so closely linked to the strong tailwinds of the Australian economy, you know, such as Australia's success in combating covid, the ongoing government fiscal stimulus, RBAs accommodative monetary policy. But also you mentioned another interesting point that I didn't know about some US companies actually moving their listing to the ASX because of their size. But, yeah, I'm definitely looking forward to seeing the small cap sector in action in 2021 and onwards. Where can we find more information if we wanted to learn more about the eInvest Better Future Fund or maybe some information about ESG or the small cap sector?

**Emilie O'Neill** [00:22:31] Yeah, great. So on the eInvest website, which is [www.einvest.com.au/ASX](http://www.einvest.com.au/ASX), we'll have a lot more information about this podcast, links to further ESG information, where to access the fund. But because it's a quoted product on the ASX, you buy it like you would buy any other share on the market. So you just type in the code, which is IMPQ, and you can purchase it like that. So that's why we love active ETFs, because it's just such a great way for consumers to access active management, active



professional management on the market. And it's the way I invest and that I encourage my friends to invest as well.

**Martin Dinh** [00:23:07] Me too. Well, that wraps up this month's episode on the small cap sector. I wanted to thank you, Emilie, so much for taking time out of your day to shed some light into the often overlooked small cap sector. I really enjoyed our conversation and I look forward to having you down the road.

**Emilie O'Neill** [00:23:23] Thanks, Martin. It was awesome. And I really appreciate your great questions.

**Martin Dinh** [00:23:26] Well, that concludes our episode on the Australian small cap sector. It was great learning about some of the benefits and risks of the Australian small cap sector, Perennial's investment approach when it comes to the Australian small cap sector and why it pays to include environmental, social and governance factors into a portfolio. In next month's episode, I'll be joined by Graham O'Brien, Senior Manager of Equity Derivatives at ASX, as we talk about some of the trading activity trends that we have seen since covid and dispel some common trading myths. Until then, thank you for listening and we look forward to you joining us next month.

Are you keen to learn more, why not visit the ASX Blog [asx.com.au/blog](http://asx.com.au/blog) for a wide range of articles, videos and insights from ASX experts, listed companies and investment professionals.

**Voiceover** [00:24:11] ASX Ltd, ABN nine eight double zero eight six two four six nine one and its related bodies, corporate ASX makes content available for podcast content and the content may be downloaded on these conditions. ASX grants and nonexclusive licence to download the content for private and non-commercial use only. You may not use the content for any other purpose, including without limitation distribution to a third party or implying a connection between you or any third party and ASX its officers, employees or contractors. The views, opinions or recommendations of the author or speaker in the content are solely those of the author or speaker and do not in any way reflect the views, opinions, recommendations of ASX. The content is provided for educational purposes only and is not intended to include or constitute financial product advice. You should obtain independent advice from an Australian financial services licensee before making any investment decisions. ASX does not give any representation or warranty with respect to the accuracy, reliability, completeness or currency of the content to the extent permitted by law. ASX and its employees, officers and contractors are not liable for any loss or damage arising in any way, including by way of negligence from or in connection with any information provided or omitted or from anyone acting or refraining to act in reliance on this information.