Small caps in emerging markets can diversify and balance a portfolio

Manraj S. Sekhon, CFA,
Chief Investment Officer, Franklin Templeton Emerging Markets Equity

Investing in small companies in emerging markets offers exposure to many of the fastest-growing businesses in rapidly growing economies. The market is vast and varied, made up of some 20,280 companies boasting a total market capitalisation of more than US$5.2 trillion and daily turnover of more than US$38 billion[1]. As a result, this under-researched and often misunderstood asset class can help to diversify an institutional investor's emerging markets portfolio.

Developing markets have outperformed most other asset classes in the last decade, and the International Monetary Fund expects frontier markets' gross domestic product to grow by 4.9% in 2018, ahead of the 2.3% GDP growth forecast for developed economies.[2] Within the emerging-markets asset class, the largest and most successful companies are often organisations which export globally and make a substantial portion of their revenues from developed economies; by contrast, small caps are generally more locally focused and so offer exposure to factors which make emerging markets appealing, such as young populations and rising incomes.

In contrast to some perceptions, liquidity within small-cap stocks is comparable to that of large companies in the emerging-market world. At the same time, because the market is under-researched, small caps tend to be thinly covered by analysts and provide abundant opportunities to uncover mispriced assets.

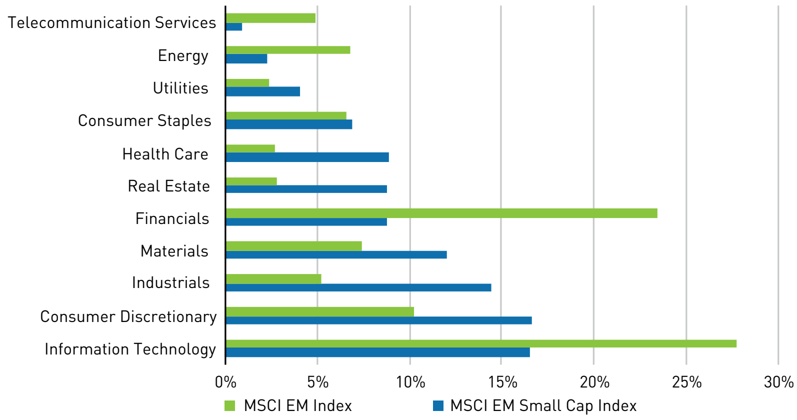
A chance to diversify

Small caps are often represented, among other sectors, by electronics and auto-parts manufacturing, consumer goods and services, and healthcare. They are usually moored to conditions in the local economy, exposed to domestic demand, favourable demographics, local reform initiatives and innovative niche products. This means the sectors to which small-cap investors are exposed can differ from those of larger-cap stocks, as Exhibit 1 shows.

Of the large-cap stocks hosted on the MSCI Emerging Markets Index, most are disproportionately dominated by exposure to information technology and financials and are therefore sensitive to global or country-level economic trends. State-owned enterprises, another prominent large-cap constituent, are too often managed by parties whose interests – control of some protected markets for example, or top-heavy payrolls – are not always aligned with those of minority investors.

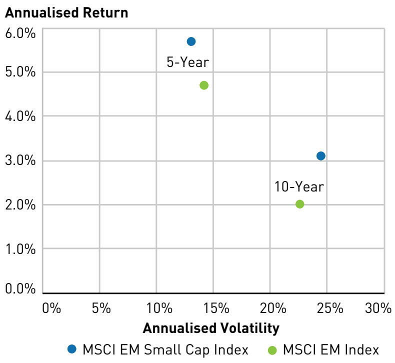
Accordingly, diversifying into small caps can provide exposures that may complement an existing larger-cap-oriented emerging market allocation. Simply put, small caps generally offer the types of exposure that drew institutional investors to emerging markets in the first place.

Exhibit 1: Side-by-Side Sector Comparison of Small- and Large-Cap EM Indexes
As at 31 December 2017



Source: FactSet. For illustrative and discussion purposes only.

Exhibit 2: Superior Returns, Lower Risk of EM Small Caps and Emerging Markets
Five- and 10-Year Risk/Return Trade Off
As at 31 December 2017



Source: Morningstar. For illustrative purposes only. Volatility measured by standard deviation over the noted time periods. **Past performance does not guarantee future results.**

More liquid, less volatile, still under-researched

Small-cap stocks in emerging markets are typically owned by local retail investors, who often trade more frequently than foreign institutional investors and operate on a shorter investment horizon, so boosting liquidity. In India, for example, investors have a huge number of smaller companies to choose from and ownership is skewed toward local parties.

It is a misconception that small-cap company stocks are more volatile than their larger-cap counterparts. Over various time periods, the standard deviation of emerging market small-cap returns has been broadly comparable to that of the larger-cap index. At Franklin Templeton Emerging Markets Equity, we believe this is due in part to the diversity of businesses in the small-cap class: a Korean television and online shopping stock is not necessarily exposed to the same factors as an Indian cement maker, for example.

It is also important to remember that the potential returns of the small-cap asset class compensate for the corresponding level of risk. Exhibit 2 highlights that over a five-year period, small caps demonstrate lower volatility for higher returns when compared with their large-cap counterparts.

Small caps are notably under-researched by brokers – a consequence of the vast number of companies to cover as well as the relative lack of information available. As a result, the average number of stock research recommendations for small caps is much lower than for larger-cap stocks and many small-cap stocks have little or no research coverage.

Here, an active manager could realise a critical advantage by directly researching such companies. In this way, he or she can increase the odds of finding a relatively unknown, off-index – and mispriced – small-cap stock. This is more difficult to achieve among large companies followed by many analysts who constantly update their recommendations.

Uncovering success

The role of an active manager is to identify which companies will succeed over the long term and with minimum downside risk and maximum risk-adjusted returns. We believe small companies are fertile ground for active managers who can focus on risk management and long-term growth drivers for the asset class.

Our small-cap research is driven by an extensive on-the-ground team of more than 80 portfolio managers and analysts in 20 offices globally. This allows us to have regular face-to-face meetings with prospective investments and the companies in our portfolios. We also have strong research efforts, with a focus on corporate governance and risk management, and the aim of delivering on the structural reasons for small-cap investing: finding companies best positioned to benefit from the demographics and rising wealth of consumers, with sustainable and defendable business models. Price is crucial to our approach and the focus of our team is to identify stocks trading at a discount to their intrinsic long-term value.

FOOTNOTES
1 Bloomberg, MSCI, December 2017
2 International Monetary Fund, World Economic Outlook, January 2018

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