HEALTH WEALTH CAREER

ACTIVE SMALL CAP EQUITIES AND THE VALUE OF LOCAL KNOWLEDGE

JANUARY 2019

Maintaining global exposure in aggregate remains important for diversification. This could be achieved by blending a handful of regional small cap mandates — at least some of which are active — as opposed to using one or more active global strategies.

Including an allocation to small cap equities as part of a broader equity portfolio provides diversification and is likely to be additive to returns. Consequently, Mercer's recommended approach to building equity portfolios includes a specific allocation to small cap. The rationale for this is set out in detail in our 2016 paper, "Small But Not Irrelevant: Small Caps Within a Global Equity Allocation."[1]

The small cap equity market, when compared with the broader market, is also considered to be generally less efficient (information flows less freely and evenly among market participants), which improves the theoretical case for active management. The empirical evidence appears supportive of this argument. Therefore, we encourage investors with the governance and fee budgets to accommodate some active management within their equity portfolio to make their small cap allocation one of the first areas they consider.

When considering an equity allocation, we also generally advocate allocating to the broadest possible universe. This allows for maximum diversification of stock, sector and market-specific risks. Within an actively managed allocation, this maximizes the opportunity set within which skilled investment managers can source attractive investment opportunities and build a diversified portfolio across sectors and regions. This typically means looking at global instead of regional mandates.

In the case of small cap equities, however, we believe that there may be potential for active regional specialists to add value when compared to a global approach. But there is considerable uncertainty inherent in any forecast of prospective active returns, and given the challenges involved in building out a portfolio of regional or country-level exposures (in terms of the scale and governance required), a global approach will remain appropriate for many.

Maintaining global exposure in aggregate remains important for diversification. This could be achieved by blending a handful of regional small cap mandates — at least some of which are active — as opposed to using one or more active global strategies.

[1] See also Mercer's "A Blueprint for Improving Institutional Equity Portfolios" (2010) and "Building Equity Portfolios with Style" (2014).

CHALLENGES FOR GLOBAL ACTIVE SMALL CAP STRATEGIES

Broadening the investment opportunity set for small cap equities remains intuitively appealing. Paradoxically, however, it may be the breadth of this universe that makes a global approach to small cap challenging for investment managers. The global small cap universe is far larger by number than its mid/large cap equivalent — of the c. 15,000 stocks listed stocks globally, c. 11,000 would be broadly defined as small cap. Maintaining broad, yet deep coverage of the universe is likely to be extremely onerous even for the most well-resourced asset managers.

Compounding the challenges that the global small cap universe's scale brings, these companies are often more domestically or regionally focused,[2] and managers therefore may require a greater understanding of the nuances of the local economy within which they operate. Traditional fundamental approaches rely on reasonably intensive bottom-up research (often with an on-the-ground presence), and it may prove impractical for a global manager to build up enough resources to cover the universe adequately.

There are capacity constraints associated with small cap investing, and the resources that a manager is willing to dedicate to such a strategy may therefore also be limited. The benefits of having a broad and borderless opportunity set may be outweighed by the practical difficulties in developing sufficient depth of coverage to add alpha.

2 Data from MSCI Economic Exposure Indexes show that across a number of regions the level of exposure to foreign revenues is lower within small cap indexes than in their large/mid cap equivalents.

ARGUMENTS FOR REGIONAL ACTIVE SPECIALISTS

The primary argument for adopting a regional approach within small cap: Active small cap management lends itself to highly experienced individuals or teams who know their regional market very well.

In focusing exclusively on their narrower domestic markets, regional small cap managers will often have developed extensive networks of local brokers, company contacts and peers from which to gain an informational edge. Having this familiarity with the local market does not guarantee success, but can help — especially since small cap markets generally have weaker sell-side coverage and are often overlooked by capacity-constrained larger cap managers, creating potential alpha opportunities for skilled managers/teams.

The arguments against using a mix of several regional strategies for allocating to small cap are that you may lose some element of oversight for the final portfolio as it becomes harder to monitor and manage the aggregate risk and style profile.

We would agree that the approach of combining regional managers does require a larger governance budget and may not be appropriate for all investors. But for investors with the appropriate governance resources, we believe that a composite portfolio made up of specialist active regional mandates has the potential to deliver higher levels of active returns.

It is also worth noting that although this rationale is most intuitive if applied to fairly narrow market definitions, it is likely that the benefits of local or regional expertise occur along a spectrum. This means that any moves to narrow investment manager focus from a global starting point may also have the potential to increase active returns.

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PAST PERFORMANCE

The charts below show the outperformance of the median manager within each universe. It demonstrates that even without taking successful fund selection into account,[3] there has been scope for significant outperformance from allocating to an active small cap strategy in most regions over most periods.

The global small cap universe is relatively new at around seven years old, meaning that our database has approximately seven years of comparable data. Given this relatively short sample period, we have to be cautious about how much weight we give to these results. However, it is noteworthy that the median manager in the global universe produced a lower additional return against its benchmark than the equivalent strategy for nearly every regional universe over the period shown.

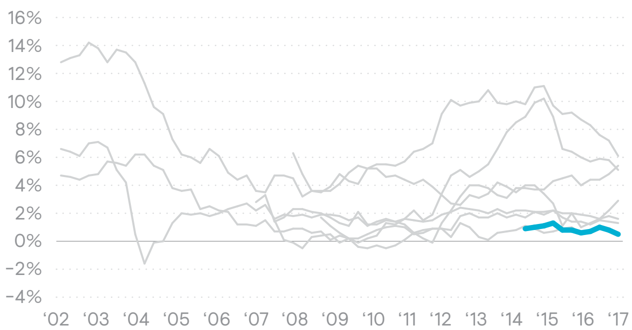
In the resource-oriented markets — Australia and Canada — the performance of active managers relative to the index has historically been very volatile (this is evident in both large cap and small cap universes). When resource stocks are outperforming, active managers have tended to struggle and vice versa. In both markets, active small cap managers have outperformed over longer time periods and this outperformance in Australia has been very large. We doubt this level of excess return is sustainable in the future.

[3] Performance comparisons of investment strategies highly rated by Mercer with the broader universes are calculated and published on a quarterly basis in our research value-add reports. For further information on these reports and their methodology, please contact your Mercer representative.

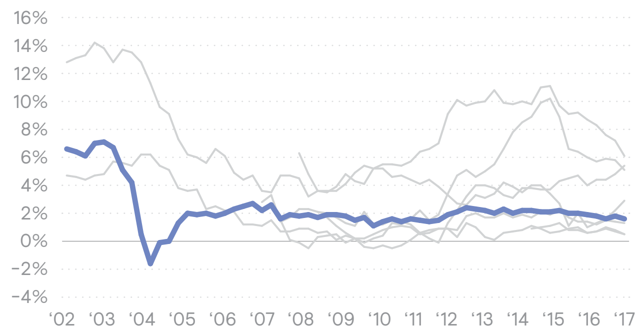
MEDIAN ACTIVE SMALL CAP MANAGER OUTPERFORMANCE BY REGION

Each chart shows the outperformance of the median manager for the same eight universes, with a different universe highlighted in each. Performance is annualized over rolling five-year periods.

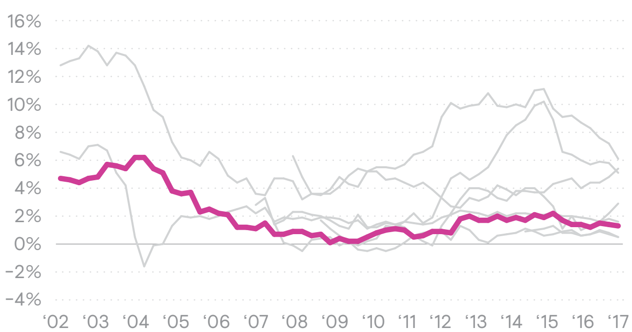
GLOBAL



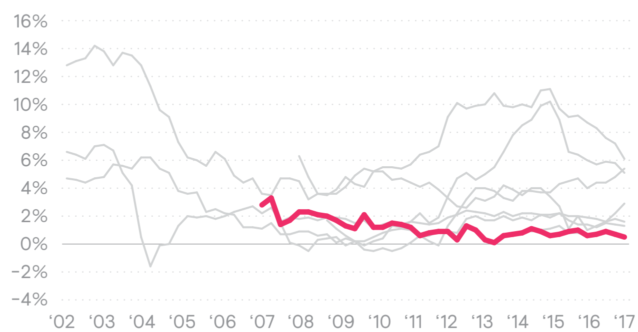
EUROPE, AFRICA AND FAR EAST (EAFE)



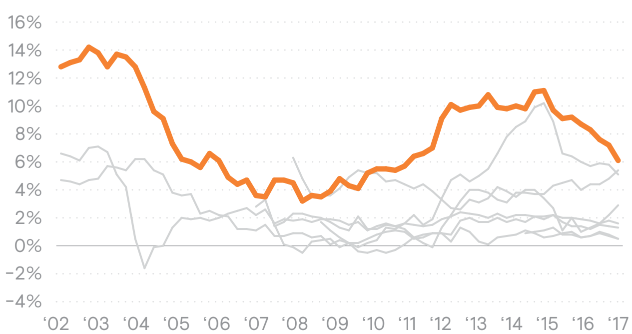
UNITED STATES (CORE)



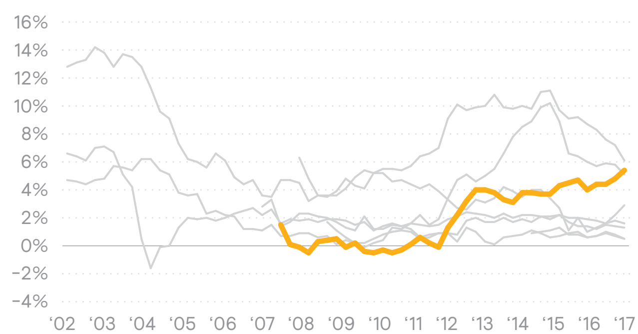
EUROPE (INCLUDING UK)



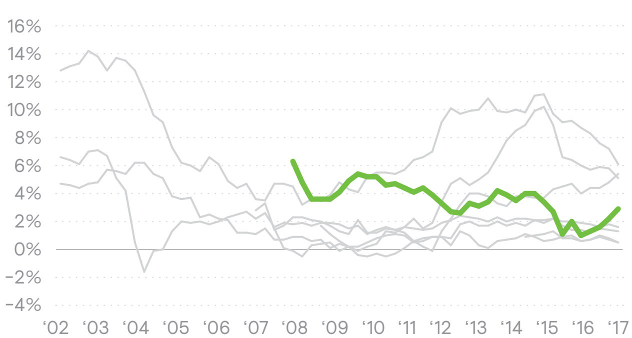
AUSTRALIA



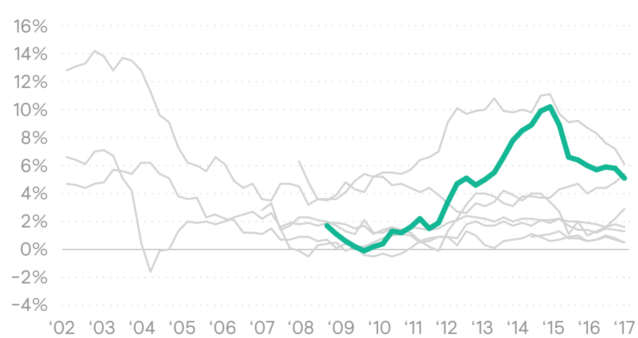
JAPAN



UNITED KINGDOM



CANADA



Source: MercerInsight, Thomson Reuters Datastream and Mercer estimates. Performance for the Asia (ex-Japan) region is excluded from the charts above due to insufficient performance history.

WHAT ABOUT INVESTING DOMESTICALLY?

If we accept the argument that regional specialists are able to deliver greater active returns than global small cap managers, then it may be reasonable for more constrained investors (those without the governance budget, or appetite, to commission multiple active strategies within their small cap portfolio) to ask whether allocating to a single, possibly domestic, regional active strategy is appropriate.

There may be merit in selectively allocating active mandates to regions believed to have higher potential active returns. However, this will mean a less diversified beta allocation as economic risk is concentrated in a given region or country. Furthermore, in the case of a local bias, this may present an additional challenge as the financial health of the dependent or contributing individual or organization (the defined contribution saver or sponsoring employer, for example) may be more closely correlated with investment outcomes.

Therefore, although we expect a portfolio of specialist regional managers to demonstrate higher active potential than an allocation to one or more global small cap strategies, we also, in turn, prefer a global approach to one with concentrated regional beta exposures, except where specific investor circumstances or beliefs warrant such a structure. For example, investors with shorter time horizons may have a specific concern about currency risk associated with foreign investments and may choose an overweight to their local region.

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CONCLUSION

There is no definitive right answer as to whether to adopt a global or regional approach to small cap investing on an active basis, and inevitably the decision will be driven by an individual investor's circumstances and beliefs. One circumstance that may be decisive for many investors is the very large scale of small cap assets required to make individual allocations to narrower markets, which may represent a small part of the overall portfolio.

We believe that the evidence points toward greater potential for alpha when using a regional approach, and we also highlight evidence that certain regions appear to have represented less fertile ground for active managers than others. However, forecasting prospective active returns is challenging and for those with limited governance budgets and/or those who are cognizant of relative country exposures, a global approach remains appropriate.

For those with sufficient scale and governance budgets wishing to combine specialist regional small cap managers, such an approach would need to take account of the aggregate style and risk characteristics, and build in appropriate diversification and rebalancing — a challenging, but surmountable, task in our view.

In the following sections, we provide an overview of the available strategies across a range of small cap universes and some more detailed comments on portfolio construction.

AVAILABLE STRATEGIES — GLOBAL VERSUS REGIONAL

In terms of universe shape, it is worth noting that the universe of global small cap managers, for which we collect quarterly performance data, is a relatively new universe consisting of 101 strategies (as at 30 June 2018). It is a universe, therefore, in which industry expertise may still be developing and where some strategies are, in effect, regional "bolt-togethers," where managers might have varying levels of skill in the different regions.

Such strategies tend to be run by large fund management firms that happen to have built up regional expertise in small cap strategies. On the face of it, this may sound like the perfect solution for a governance constrained small-cap investor — local teams combining in a coordinated manner.

However, in practice, we believe that the likelihood of a single investment house running best-in-class investment teams across multiple regions is low. Furthermore, the ability to centrally dictate changes on constituent portfolios in order to manage risks across the broader portfolio (a core benefit of a global approach) will be limited in reality as local strategies are typically also catering to local investors.

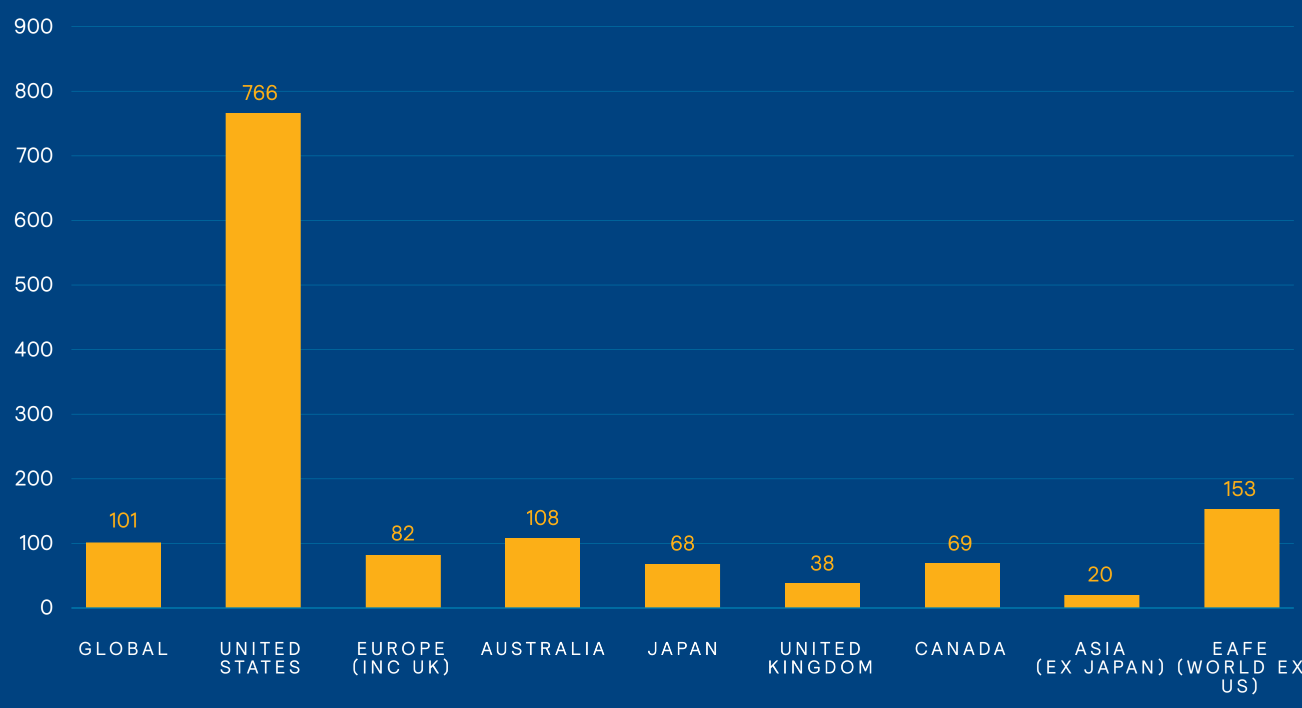
A third category of strategy within the global small cap universe, which we have not discussed in detail, is systematic (quantitatively managed) strategies. It is possible that such strategies are well placed, with respect to small cap strategies, to deliver broad, truly global investment coverage with coordinated risk management. They are also able to do so in a far less resource-intensive manner than their fundamental peers. However, there are currently a limited number of quant strategies in this space and those available typically have quite short track records.

The number of available active small cap strategies in the United States is vastly greater than in other countries or regions, where adoption of dedicated small cap managers has been less widespread or slower to take hold.

The chart below shows the size of each small cap universe for which Mercer collects quarterly performance data (and within which Mercer has active research coverage). It is clear that the opportunity set for most investors is not broadened by considering a global mandate rather than a portfolio of regional strategies.

However, it is also clear that the number of available active small cap strategies in the United States is vastly greater than in other countries or regions, where adoption of dedicated small cap managers has been less widespread or slower to take hold. As active US small cap equity investors have sought more global exposure, this has also facilitated the growth of the EAFE (Europe, Africa and Far East) universe.

GLOBAL AND REGIONAL SMALL CAP EQUITY STRATEGIES



Source: MercerInsight (data as at 30 June 2018).

PORTFOLIO CONSTRUCTION

REGIONAL BREAKDOWN

Among the first questions faced by investors interested in constructing a portfolio of specialist regional small cap equity managers is how much to allocate to each region.

We believe that the index is a reasonable starting point and, to the degree that performance will be judged against it, a rational one. In the following exhibits, we use indexes provided by MSCI as our reference, but it is worth noting that other indexes may differ materially in their construction methodologies, which results in different regional allocations. As a result, careful consideration should be given to the choice of index and how it is likely to complement the broader equity portfolio.

The chart below shows a recent breakdown of the MSCI All Countries World Small Cap index against an equivalent large cap index. It has remained broadly similar since 2008 (when the US allocation within the small cap index increased noticeably). We show the historical range (since 2011) for each region within the MSCI World Small Cap Index in the chart at the top of the following page.

We would suggest most investors constructing a small cap equity portfolio of regional strategies choose a starting point for their regional allocations that broadly reflects the historical ranges (shown in the chart at the bottom of the following page). This does not necessitate a separate allocation to each category shown, although in an unconstrained world, this would be our preference.

However, if investors can tolerate high short- to medium-term volatility, relative to a global index, then they may wish to consider overweight allocations to markets where investor beliefs in active management are strongest.

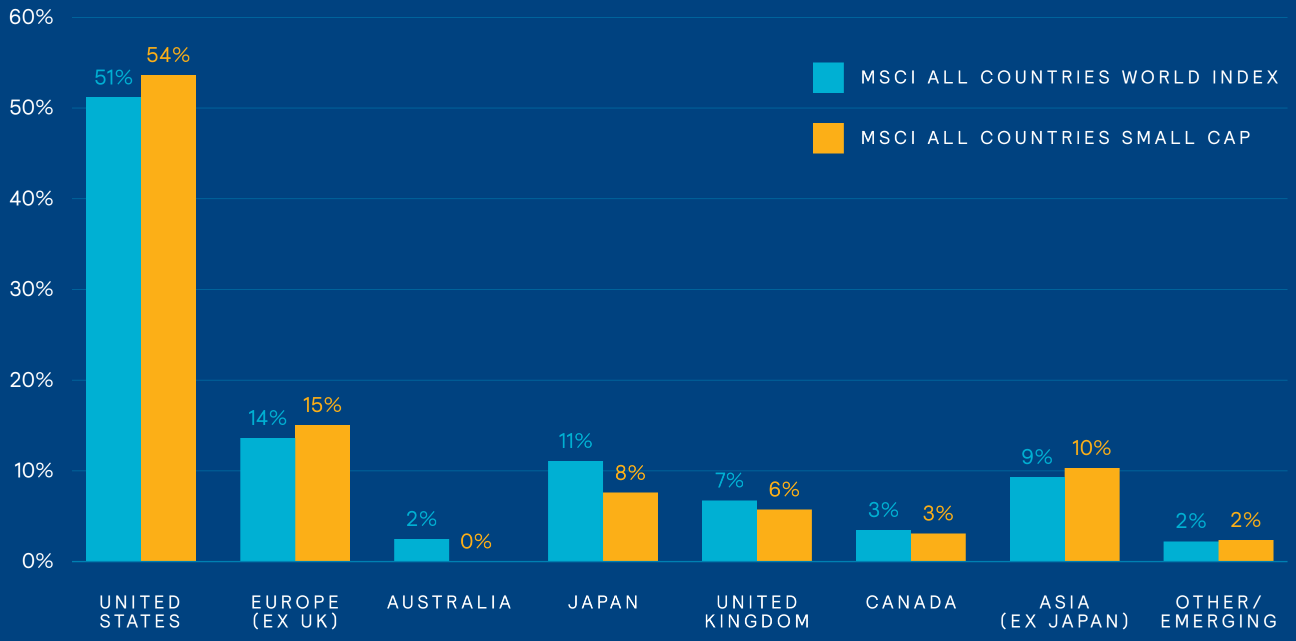
For a global mandate, we would generally advocate the inclusion of emerging markets as well as developed markets within the small cap portfolio to ensure maximum breadth within the portfolio.

However, an explicit allocation to emerging market small cap may not be necessary. Active managers in universes such as Asia and Europe are often managed to a benchmark that includes emerging markets, a market segment that may also be captured to some extent within an active emerging market allocation.

For those investors with more generous governance budgets, a specialist small cap emerging market allocation may be an attractive option within a portfolio of active regional small cap managers, or within a portfolio of emerging market equity strategies. But we would suggest that gaining exposure to this relatively small and less liquid portion of the market should not be a priority for most investors.

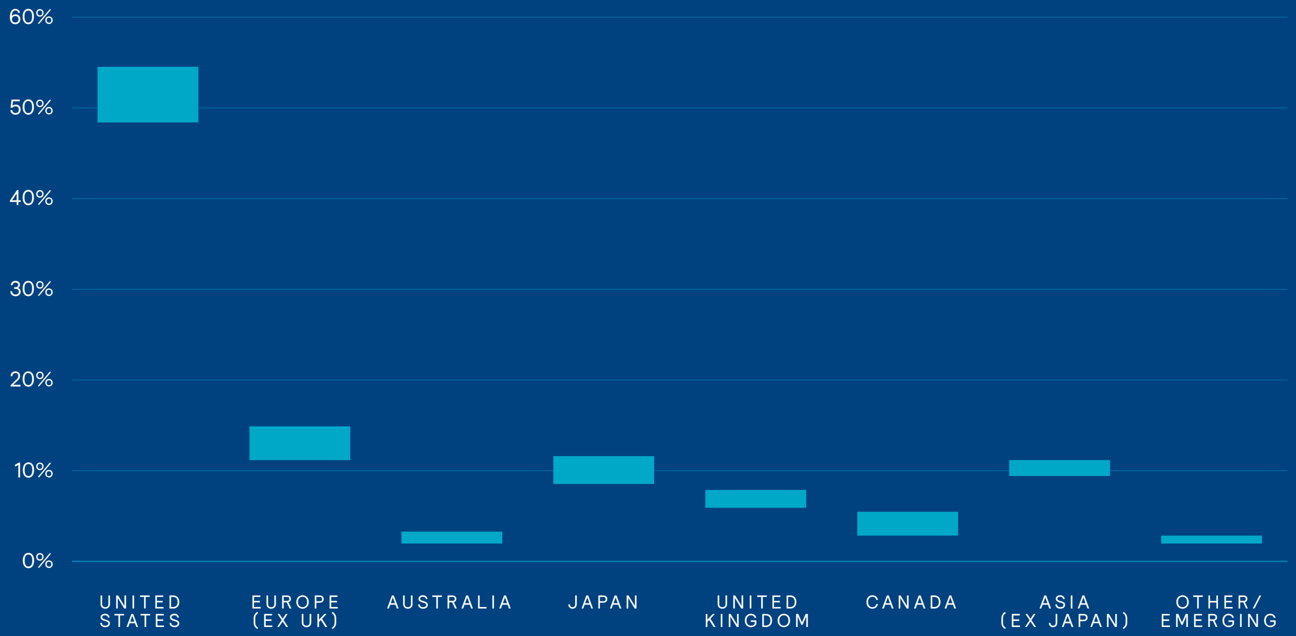
We deliberately avoid being overly prescriptive in the weightings to each market since we would expect these to vary according to investor circumstances. Some may choose to have a domestic bias that would serve to reduce currency risk, whereas those with a longer time horizon may be unconcerned by this risk. Over the longer term, we have no reason to believe that small cap return premiums would differ materially across markets.

REGIONAL WEIGHTINGS AS AT 30 JUNE 2018



Source: Thomson Reuters DataStream.

HISTORICAL RANGES FOR MSCI ALL COUNTRIES SMALL CAP REGIONAL WEIGHTINGS



Source: Thomson Reuters DataStream. The regional classifications shown are Mercer estimates and are intended to broadly align with Mercer's investment research universes and cover the period from 30 June 2011 to 30 June 2018.

ABOUT MERCER

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HOW MERCER CAN HELP

Wealth and investment require sophisticated solutions. We offer research and advice on how to assess risk and design investment strategies while keeping in mind the need to optimize throughout changing times. Along with more than 140 manager researcher with in-depth knowledge of the complexities and ever-changing factors that impact investment, Mercer's consultants can help you make effective decisions that align with your business needs and ensure more rewarding futures for your employees.

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