Willis Towers Watson

The mid- and small-cap dilemma in Australian equity portfolios

There has been a gradual shift in mentality on active management and portfolio construction in order to increase the return potential in Australian equity portfolios. Part of this has involved gravitating towards more unconstrained managers which typically run more concentrated, higher risk and higher active share portfolios. While we believe that this change is beneficial for net-of-fee return outcomes, it also comes with important portfolio construction implications.

Traditional equity portfolios

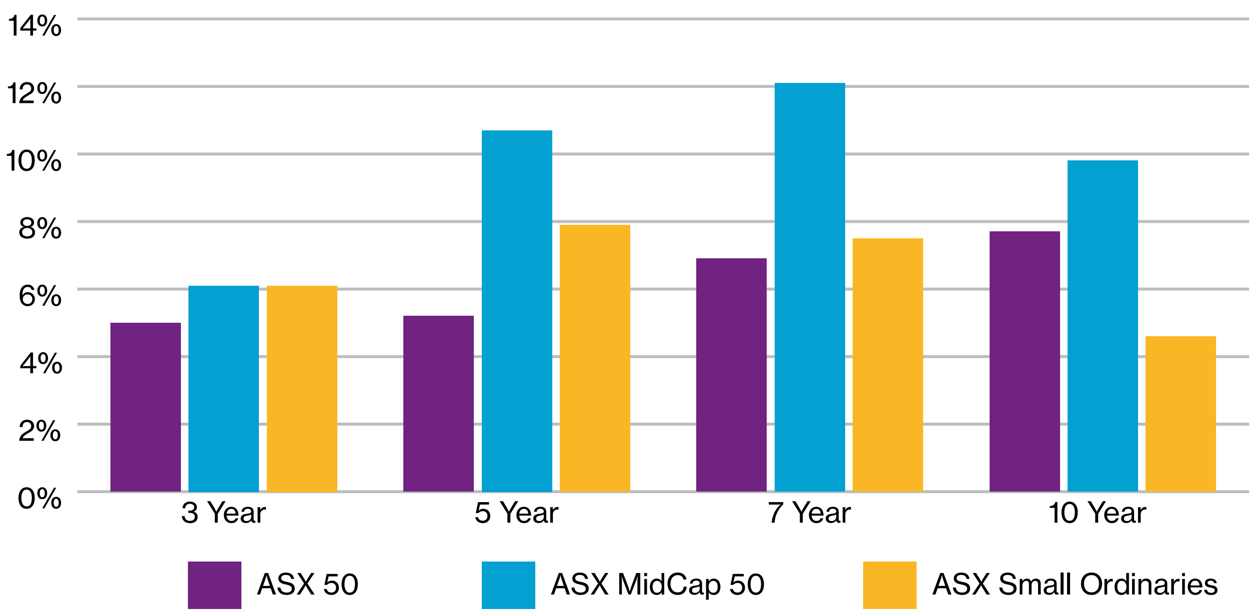
Traditionally, portfolio construction of active Australian equity portfolios involved the use of relatively diversified, benchmark-aware investment strategies, typically managed within tight stock and sector constraints. In a market like Australia, which has high degrees of stock and sector concentration at the large-cap end of the market, it is impossible for these managers to take meaningfully large deviations in positions in many stocks. Such constraints mean that investors tend to obtain restricted mid- and small-cap exposure via these strategies. Instead, for investors desiring a more meaningful mid- or small-cap exposure above the index weight, the traditional approach has generally required making a strategic decision on whether to hire mid- and small-cap specialists to sit alongside core managers.

Mid- and small-caps have historically represented a meaningful allocation of many investors' portfolios, despite limited evidence to support the existence of a small-cap beta premium in the Australian market (Figure 1). That said, we have always seen merit in having a moderate overweight to mid- and small-cap stocks via active management from a total return perspective. This part of the market offers a number of benefits over a market-cap neutral portfolio, some of which include:

- Reducing stock and sector concentration risks associated with market-cap neutral portfolios
- Improving the economic diversity of portfolios
- Access to companies with greater potential earnings growth than larger companies
- Inefficient pricing and wider choice offering greater potential for value-add from active management.

These considerations can create complexities for investment committees and risk adding to what is, in many cases, a heavy governance burden to select, manage and be accountable for such strategic exposures.

Figure 1: Performance by market cap (as at June 2020)



Source: Thomson Reuters

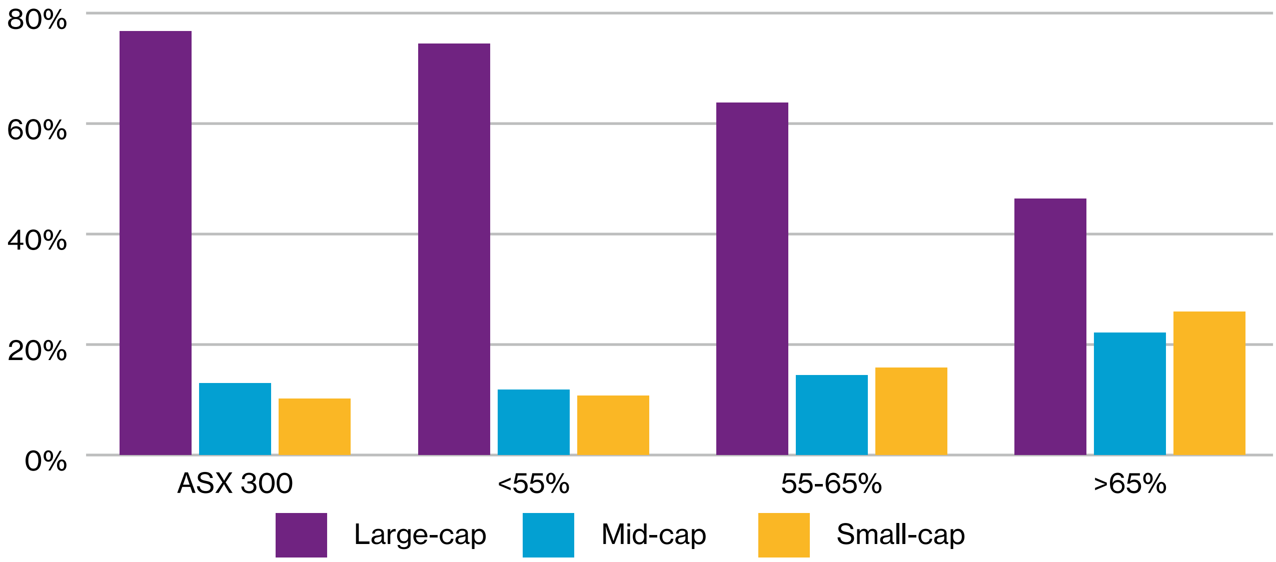
Better equity portfolios

With the shift of focus towards unconstrained, high conviction managers, this has naturally led to very different outcomes in portfolio structure which deserves careful consideration to ensure that all unintended risks are sensibly managed. One such consideration is in relation to mid- and small-cap exposures and requires a reassessment of the use of specialist market-cap specific strategies or, more specifically, whether a separate mid- and/or small-cap strategy is required.

Removing constraints from broad-cap Australian equity managers obviously provides greater flexibility in being able to ignore lower conviction stocks and prioritise focus on higher conviction ideas. This has led to a tendency for portfolios to exhibit significantly larger underweight positions in some of the larger-cap names that traditional benchmark-aware managers hold for risk purposes. Managers running unconstrained portfolios have instead invested a greater allocation further down the market cap spectrum towards mid- and smaller-cap names where they see better opportunities to generate alpha.

Figure 2 shows the universe of broad cap Australian equity strategies grouped based on approximate levels of active share. Portfolio holdings for strategies within each group are disaggregated across different market cap buckets. Unsurprisingly, it serves to highlight that the greater the extent of active management being employed (i.e. the higher the active share) in an investor's portfolio, the larger the likely overweight will tend to be to mid- and small-caps.

Figure 2: Impact of active management on mid- or small-cap exposure



Source: eVestment, WTW calculation
Portfolio holdings and active share taken from 77 ASX200 or ASX300 benchmarked strategies as at September 2019. Where holdings or active share details were unavailable for this date, the nearest date was used. Analysis excludes cash.
Market cap buckets are classified as following: large-cap: top 50; mid-cap 51-100; small-cap: 101 and below

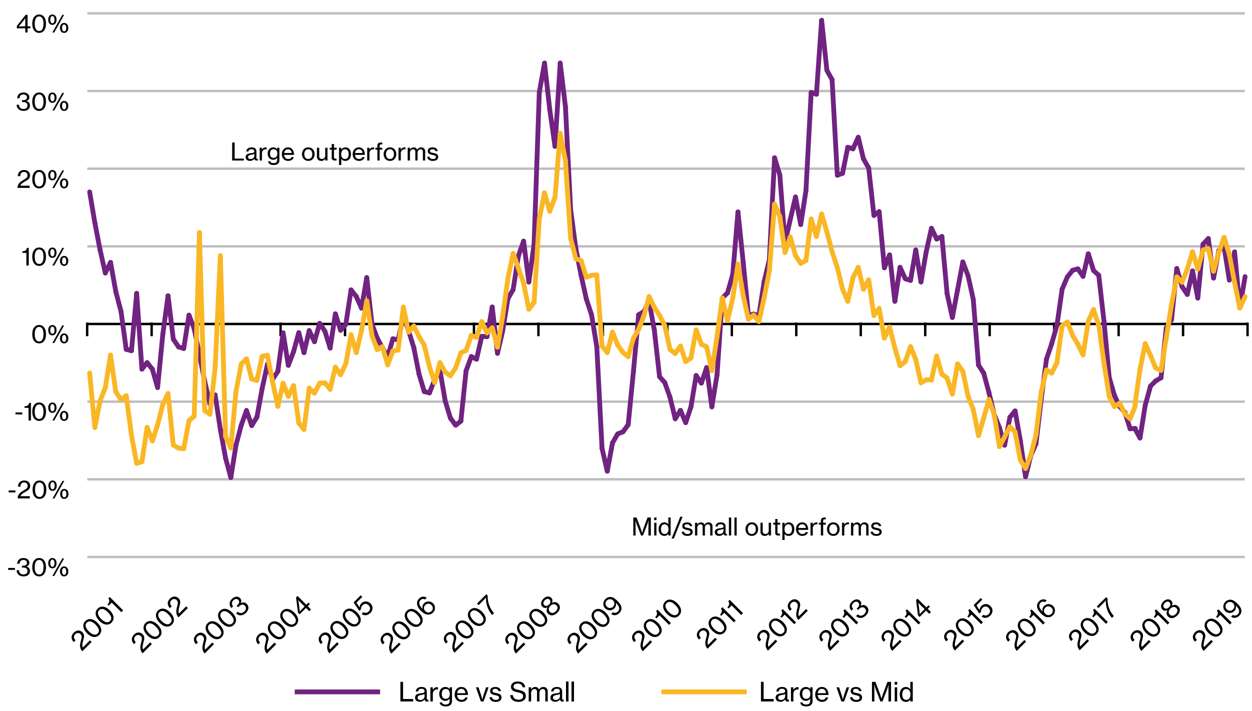
Implications

As we've highlighted, incorporating unconstrained strategies with increasingly high levels of active share will naturally result in an aggregate portfolio structure with a more pronounced mid- and/or small-cap bias than what is generally achieved using a more traditional approach. This outcome potentially reduces or removes the need for dedicated mid- and small-cap managers in the portfolio.

We believe this approach to portfolio construction and accessing the mid- and small-cap end of the market is a more efficient way of managing an equities portfolio and can result in a number of benefits to portfolio outcomes, some of which include:

- **Reduced fees:** Unconstrained broad-cap managers typically have a greater ability to charge lower fees than mid- and small-cap specialists. Allocating to these strategies can help maintain a meaningful exposure to mid- and small-caps while reducing fees at the aggregate portfolio level.
- **Improved flexibility:** The performance differential across the market cap spectrum is highly cyclical and can be very large at times (Figure 3). Most investors lack the tools or ability to dynamically manage portfolio exposures. Skilled unconstrained managers with the ability to invest across the market-cap spectrum as opportunities arise are often better placed to take advantage of these dislocations.
- **More efficient diversification:** A well-constructed equity portfolio is diversified by investment style and approach across the entire market-cap spectrum. Traditionally, many investors have tended to only employ a single mid- or small-cap specialist in their portfolios which in turn drives most of the risk in this area. Prolonged underperformance from this manager can lead to performance drag on the portfolio with no other managers to offset this. Obtaining mid- or small-cap exposure via multiple unconstrained broad cap managers provides a better way to manage or mitigate this risk and improves the overall durability of the portfolio.
- **Governance benefits:** Given small-cap specialists have tended to make up only 5-10% of an investor's total Australian equity portfolio, investors are increasingly finding that the time required to research, select and monitor these managers outweighs the relative impact this decision ultimately has on portfolio returns. Being able to spend less time here can free up opportunities to focus on more value-additive areas of the portfolio.
- **Manager stability:** Fragility of asset managers is often an overlooked area. Mid- and small-cap managers tend to have greater capacity restrictions, and as a result, higher levels of client concentration. This can make them more prone to business stability issues arising from prolonged periods of underperformance or capital withdrawal from larger clients. Given the historical trend towards passive management and the consolidation of the superannuation fund industry and internalisation of many investment functions, these pressures do not appear to be receding. Exposure to higher capacity, broader-cap managers can reduce these business stability risks.

Figure 3: One-year rolling return difference



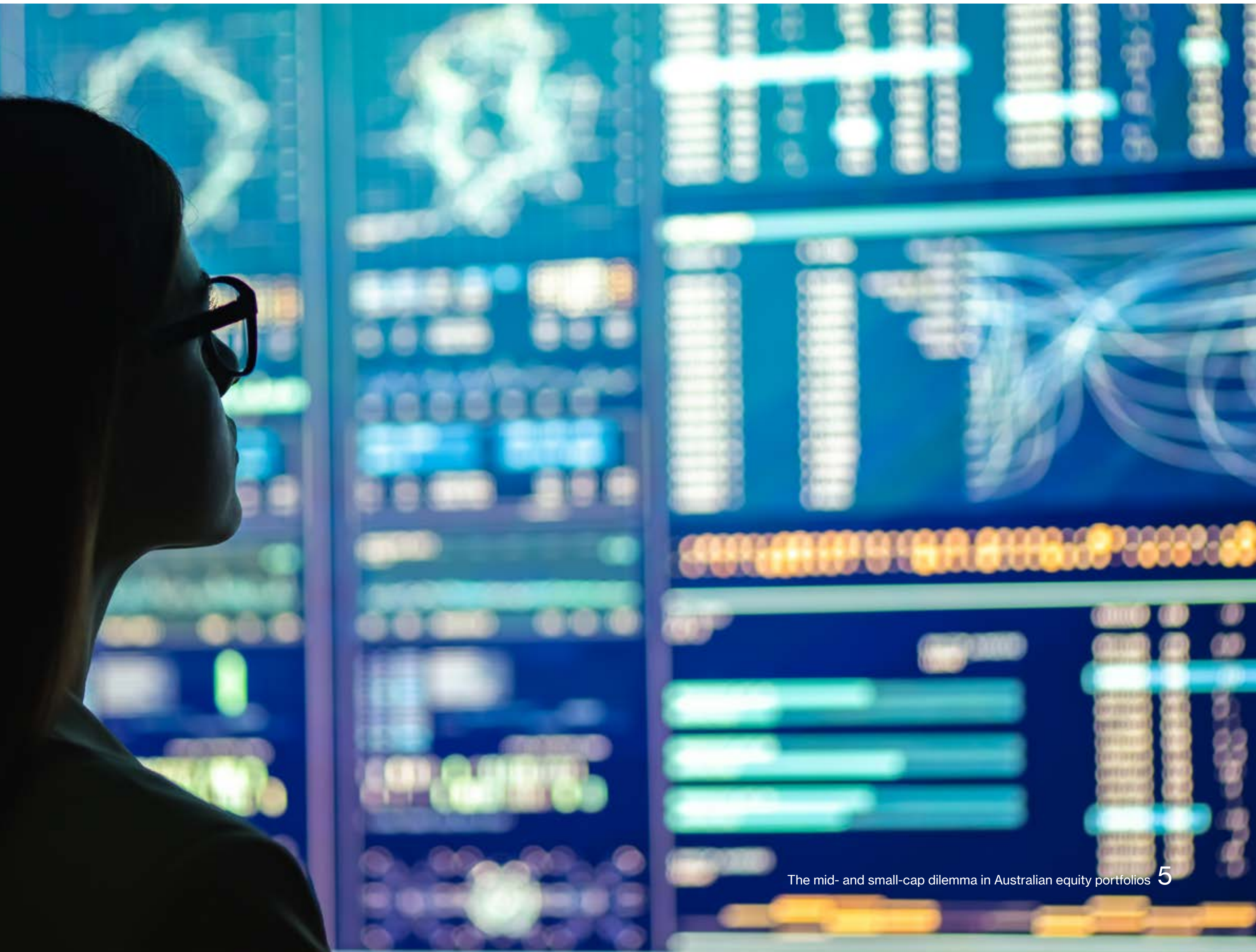
Source: Thomson Reuters

Summary

The shift in thinking over time and the heightened focus on using benchmark agnostic investment strategies in equity portfolios has amplified the need to rethink many investors' approach to portfolio construction. In Australian equities, this has led to consideration of the use of unconstrained broad-cap strategies as a way of accessing managers' highest conviction ideas in the mid- and smaller-cap part of the market.

Ultimately, we conclude that:

- Allocating to broad-cap, unconstrained strategies can help improve performance outcomes of a portfolio while reducing fees and significantly lowering the governance burden for investment teams.
- Unconstrained active strategies typically have a larger exposure to the mid- and small-cap end of the market, potentially reducing or removing the need for specialist strategies in a portfolio.
- Given the performance variability across the market cap spectrum, having a static mid- or small-cap allocation can result in significant headwinds at times. Skilled managers with broad-cap capabilities are often better positioned to dynamically manage portfolio exposures across the market cap spectrum, removing this accountability from asset owners.
- Unconstrained strategies offer a more efficient way of balancing risk exposures across the market cap spectrum for a portfolio, allowing investors to significantly improve the durability of their overall portfolios.



For more information, please contact your Willis Towers Watson contact or:

Michael Slaven, CFA
Investment Consultant, Equity Research
E: michael.slaven@willistowerswatson.com

Leslie Mao, CFA
Head of Equity Research, Australia
E: leslie.mao@willistowerswatson.com

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