Asian Small Cap stocks: about to rise like a Phoenix?

Summary

- Asian small cap stocks are **unloved and ignored**. We believe this could be about to change.
- We find that **the Chinese yield curve has historically been one of the most prominent drivers of the (out)performance** by Asian small caps.
- As small cap companies largely serve domestic markets, they will be among the **greatest beneficiaries of an imminent monetary impulse in Emerging Markets**, such as China.
- **Lower correlation to developed markets and attractive valuations** versus large cap stocks result in a compelling investment proposition.

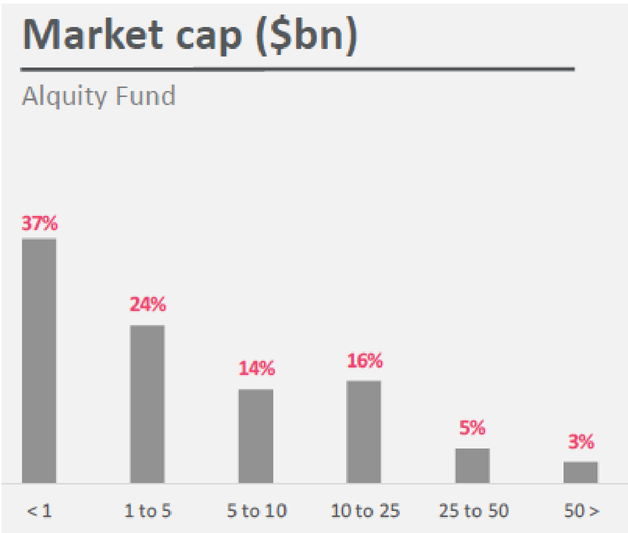
Introduction

In this article, we examine the investment case for Asian small cap stocks which have recently been out of favour with investors. We start with an analysis of the key drivers that resulted in **small cap Asian stocks delivering stronger returns than large caps at various points in time after the Global Financial Crisis** (GFC). We use the FTSE Asia Pacific ex Japan ex Australia ex New Zealand All Cap and Small Cap indices for the analysis.

We find that the Chinese yield curve has been one of the most prominent drivers of the (out)performance by small caps. There is a strong parallel with the current environment, where **we expect that central banks will continue to shift to an increasingly accommodative monetary policy stance**, which will contribute to the strength of domestic economies and in turn benefit small caps once again. This is combined with compelling valuations and increasing signs of deglobalisation, further strengthening the arguments for investing in Asian small caps.

The Alquity Asia Fund

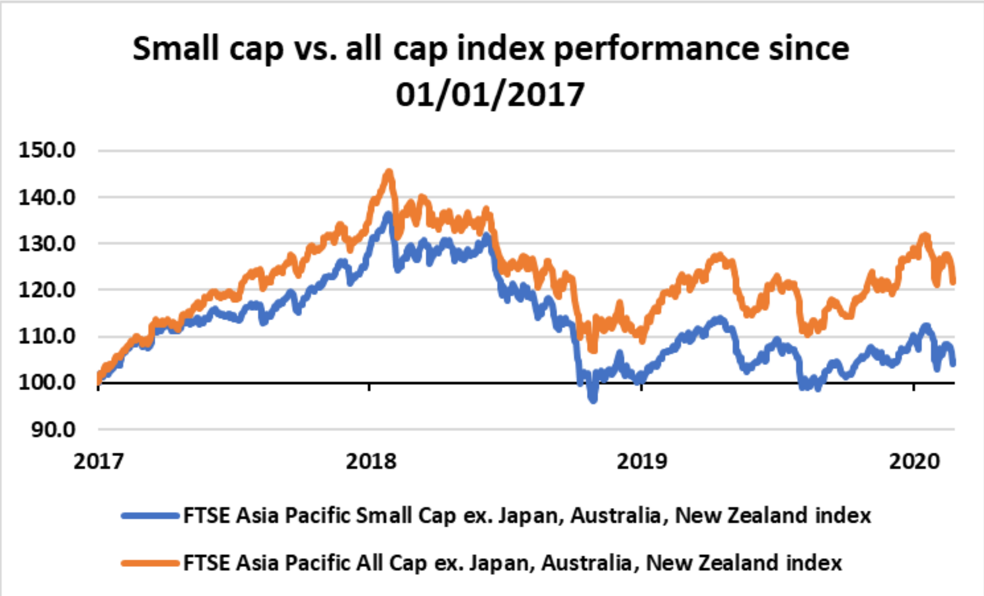
The Alquity Asia Fund has an unconstrained approach to investing in Emerging and Frontier Markets. **The Fund consists of well-run, sustainably sound, quality companies focusing on long term structural themes, which are predominantly domestically driven.** As shown below, we typically find the best opportunities in the small- and mid-cap space, which accounts for 75% of the portfolio. **The median market cap of our top 10 holdings is just USD 2.1bn versus USD 118.0bn for the top 10 holdings in the large cap Asia Pacific ex Japan ETF.** Thus, our findings relating to the outlook for small cap Asian stocks have a direct relevance to the Fund.



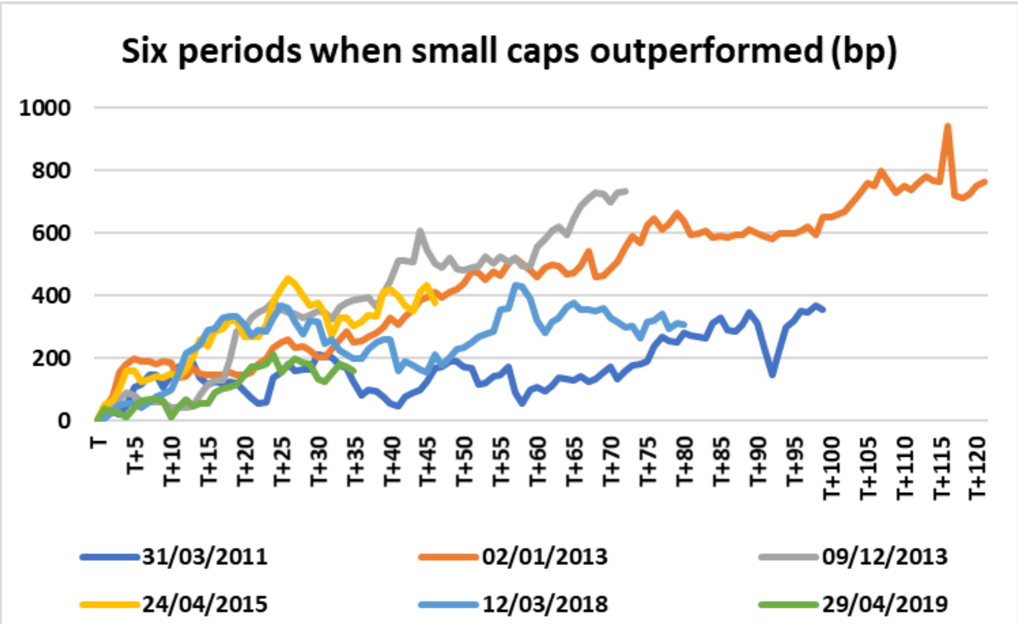
Source: Alquity, December 2019

Learning from History: Periods when small caps outperformed large caps

Since 2017, small cap Asian stocks have lagged large caps (see chart below) and increasingly so over the latter part of the period. But, there were sustained periods in the past when small caps delivered stronger returns than large caps. **We believe the performance gap over the last 3 years could narrow**, and sustainably reverse going forward.



Source: Bloomberg, Alquity calculations



Note: time *T* at the beginning of the x axis represents the first trading day when small caps' outperformance started (all six start dates are in the legend of the chart)
Source: Bloomberg, Alquity calculations

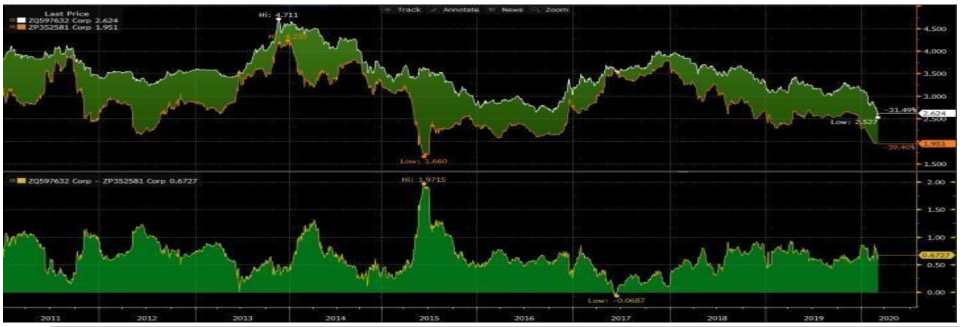
Start	End	Number of trading days	Outperformance of SC index (bp)
31/03/2011	17/08/2011	99	355.4
02/01/2013	20/06/2013	121	762.0
09/12/2013	19/03/2014	72	735.2
24/04/2015	29/06/2015	46	377.2
12/03/2018	02/07/2018	80	307.9
29/04/2019	17/06/2019	35	160.5

Source: Bloomberg, Alquity calculations

One common driver of small caps' outperformance is the shifts in the shape of the Chinese yield curve. The yield curve captures the risk-free component of companies' cost of funding as well as the changes in the amount of liquidity available in the domestic market. We identified two factors, which determine whether the evolution of the yield curve benefits small caps:

1. The change in the level of the 1-year Chinese government bond yield
2. The change in term premium implied by the Chinese sovereign yield curve (i.e. the spread of the 10-year Chinese government bond yield over the 1-year)

Historical term premium: spread between the 1Y and 10Y Chinese government bond yields since 2011



Source: Bloomberg

The mechanisms are the following:

- **Small caps outperformed their peers in periods when the 1-year Chinese government bond yield was decreasing** (such as the periods starting 09/12/2013, 24/04/2015 and 29/04/2019)
- However, **a rising 1-year yield does not automatically mean that small caps would face headwinds.** In periods when the 1-year was rising, whilst the Chinese yield curve was flattening (i.e. the term premium compressing), small caps outperformed (such as the periods starting 31/03/2011, 02/01/2013 and partly 12/03/2018)

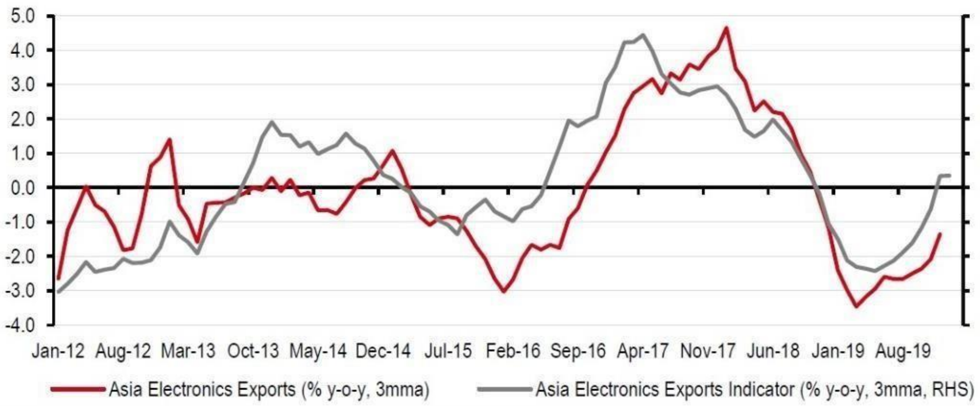
We believe that the monetary transmission stimulates domestic economies in particular and thus significantly benefitting companies who rely on domestic demand. As small cap companies largely serve domestic markets (as opposed to for example large cap export behemoths) with their products and services, they will be among the greatest beneficiaries of an incoming monetary impulse.

We also assessed if there was a consistent correlation between small cap (out)performance and commodity prices (using the Bloomberg Commodity index) or dollar strength (utilising the trade-weighted Asian DXY dollar index). According to our findings, **small caps can deliver stronger returns than mid and large caps despite an environment where the dollar strengthens and/or commodity prices increase, as long as the Chinese yield curve shifts favourably**.

Our macro expectations

At the very end of 2019, we formulated our macro view where we expected a cyclical recovery of the global economy in 2020. **Despite the disruption brought about by the coronavirus, there were still firm signs of a global economic recovery** (e.g. a recovery in Asian electronics exports at the beginning of 2020; see the graph below). Although in the short term the underlying recovery may stall due to the coronavirus, **we believe the economic weakness will prove to be a temporary phenomenon.**

Asia electronics exports and Asia electronics exports lead indicator



Source: HSBC

Central banks and governments have already started to step up their game and provide monetary stimulus (through lowering interest rates and injecting liquidity) as well as fiscal incentives (for example tax reliefs for corporates and households). We have already seen central banks in China, India, Indonesia, the Philippines, Thailand, etc. take a more dovish approach and we expect them to carry on with the easing of domestic financial conditions by further reducing interest rates. The Chinese central bank's pro-active measures, such as the reduction in borrowing costs (especially for small and medium-sized enterprises), is already well reflected in the downward shift of the whole Chinese sovereign yield curve and has started exert its positive effect on the domestic economy. We hold the view that after the normalisation of economic activity post-virus, central banks and governments will not be in a rush to withdraw stimulus to make sure the viability of the recovery.

As a consequence of the stimulus measures**, domestic fundamentals will be particularly bolstered favouring those companies which rely on domestic drivers – namely small caps**. Although the visibility on the short-term economic trajectory is limited at the time of writing (11th March), **we still maintain our view that a sustained cyclical recovery is likely to prevail after the shock by the virus abated.** This is particularly the case in India (driven by a rural recovery) and China (driven by the ongoing structural shift towards a more services-based economy fostered by the government). The Chinese and Indian markets account for 29.9% and 24.2% of the Alquity Asia Fund as at 11th March, respectively.

Is globalisation over?

Over a longer time horizon, we believe the investment case for small caps – from a top-down point of view – is also much stronger than in the past due to the overarching and consistently intensifying theme of deglobalisation. Thus, the expected upcoming period of outperformance of small caps is likely to be more sustained than in recent years. **Emerging markets will need to focus on developing their domestic economies, since they cannot rely on dynamically growing exports as the rate of global trade growth slows**. The latest example for a reversal in globalisation and global trade is the trade wars between the US and China, which remains unresolved – despite the fact that tensions stopped escalating at the very end of 2019. The disruptive economic effect of the coronavirus also highlighted the deep-rooted vulnerabilities of supply chains overarching multiple countries and continents. In our opinion, companies will consider re-optimising the supply chains in the future, which will also contribute to de-globalisation over time.

Do small cap stocks benefit from better ESG?

Many large cap companies are unfortunately state-owned entities (e.g. China Construction Bank, China Mobile, etc.). We have a concern that these companies operate in the interests of their national governments, whereas this is not the case for (private sector) small caps. Elsewhere, **Korean Chaebol** (which are large caps), such as Samsung Electronics, also **do not meet our ESG standards**, as these conglomerates (in our view) are typically run in the interests of the founding families rather than minorities. This has led to numerous bribery cases filed against the chaebol, and concerted government actions (largely unsuccessful) to reduce their influence.

Furthermore, we engage with company managements on Environmental, Social and Governance (ESG) issues on an ongoing basis. **We are able to achieve a much greater impact on the smaller companies than the large-cap names.** Many of the former are actually following high standards of ESG, but do not realise that they should publicise the data. Others are **very willing to learn and improve their policies by adopting best practices** (such as Vmart, an Indian retailer), but have limited experience given their domestic focus and small size. **We are able to share best practice from around the region to help them on their improvement journey.** This results in a much greater impact and improvement in ESG for the portfolio than could be achieved with the dominant large-capcompanies.

Correlation

A further advantage of a small cap strategy is the lower correlation to developed market indices. We compared the monthly returns of the Alquity Asia Fund Y Class vs the Lyxor Asia Pacific ex Japan ETF (large cap) as well as relevant developed market indices (see the matrix below). Over the last 5 years, between February 2015 and February 2020, the Alquity Asia Fund's correlation with major developed indices is lower than the Lyxor ETF's. One of the key reasons for the lower correlation between the Alquity Asia Fund is the fact that the Fund is focused on companies that are predominantly driven by domestic growth, which tend be smallercompanies.

We believe that this is important for investors who are seeking diversification across equity classes. Asia large cap indices are highly correlated to the S&P or FTSE, whereas our predominantly small cap strategy is significantly less linked, over a 5-year period.

Correlation matrix

Correlation of monthly USD returns between 02/2015 and 02/2020	S&P 500	FTSE 100	Euro Stoxx 50	Lyxor Asia Pacific ex Japan ETF	Alquity Asia Fund Y class
Alquity Asia Fund Y class	0.56	0.60	0.24	0.80	
Lyxor Asia Pacific ex Japan ETF	0.76	0.76	0.28		0.80

Source: Bloomberg, Alquity calculations

Valuation

Finally, **in addition to the favourable backdrop for small cap stocks and their lower correlation to developed markets, the Alquity Asia Fund is also meaningfully more attractively valued than the Lyxor Asia Pacific ex. Japan ETF** (large cap), whilst offering a higher return on equity and lower balance sheet gearing (see matrices below). Small cap strategies have been out of favour with investors for some time, although we expect that to change, and thus **valuations are low**. Our focus on high quality companies through our ESG process is demonstrated in the stronger ROE than the large cap ETF.

Valuation and profitability matrices

	Forward P/E FY2020	Forward P/E FY2021	Forward P/E FY2022
Alquity Asia Fund Y class	17.5	14.7	13.3
Lyxor Asia Pacific ex Japan ETF	21.0	18.4	16.1

	ROE FY2020	ROE FY2021	ROE FY2022
Alquity Asia Fund Y class	21.9%	21.8%	21.8%
Lyxor Asia Pacific ex Japan ETF	15.9%	16.3%	16.8%

	Alquity Asia Fund Y class	Lyxor Asia Pacific ex Japan ETF
Net debt to EBITDA	0.31	0.55

Source: Bloomberg, Alquity calculations

Conclusion

Our historic analysis of the drivers that result in small caps delivering stronger returns than large caps highlights that the Chinese yield curve is key. In the current environment, EM central banks will continue to shift to an increasingly accommodative monetary policy stance, which will strengthen domestic economies and in turn benefit small cap companies. Therefore, we believe that the historic conditions, which supported the outperformance of small caps are re-appearing. The shift towards de-globalisation also favours domestic, small cap companies over the longer term and thus we would expect the outperformance to be more long-lasting than in the recent past. Furthermore, Asian small caps currently offer better diversification benefits than large caps, as well as attractive valuations, lower gearing and a higher ROE.
Therefore, **we do not expect this out of favour asset class to remain so for long**.

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