



# The case for small to mid-caps

If you research Australia's largest listed companies, you'll discover that some of them were much smaller stocks not that long ago. Small or medium companies can be overlooked, given they're often considered riskier than their large cap peers. Yet historically, investors have been rewarded for additional risk with superior long-term returns.

## What are small and mid-caps?

Mid-cap stocks are generally companies that sit between 51 and 100 on the Australian stock exchange by market cap (the number of shares on issue multiplied by the price of those shares). Similarly, small cap stocks are those that sit outside the top 100 companies.

Mid and small cap stocks you might be familiar with include Bluescope Steel, Cleanaway and Magellan Financial Group.

## Why invest in smaller stocks?

### 1 Hidden gems

Smaller stocks are less well known and analysed compared with larger companies, and information on them isn't always publicly available. This means skilled, active investors, with the right resources, have the potential to find quality stocks that may be under-appreciated and under-priced. These investors believe that over time other investors will recognise the qualities of these stocks and their share price will rise.

Another reason to invest is that smaller stocks can be takeover targets. Not only does a takeover offer propel the target's share prices to unexpected heights; the tendency for larger companies to invest in smaller ones often means that small and mid-caps trade above what they otherwise would.

## 2 Potential bumper returns

Smaller companies offer the potential to generate excess returns. This is because in a company's lifecycle the point that revenue and earnings are expanding at their fastest rate is often when it is a rising small or mid-cap stock. It's also at this point that its share price often takes its biggest leaps.

In short, small caps that become large caps can make a lot of money for investors along the way.

## 3 Smaller stocks help diversify a portfolio

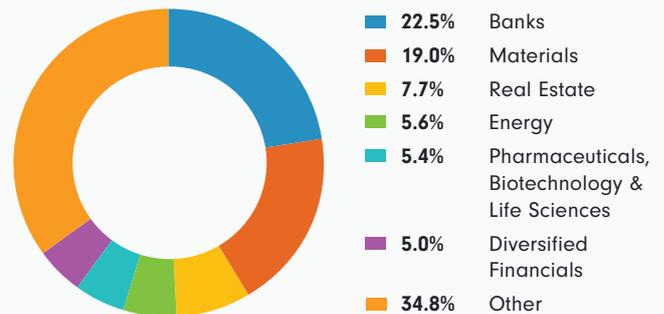
The larger end of the Australian stock market is highly concentrated by sector. If you invest in a standard Australian share fund or index you'll notice your investment is heavily skewed towards banks and resources. The big four banks, for example, make up 22.5% of the ASX 200 index.\* So if the majors take a tumble, so will your investments.

By comparison, mid and small caps are much more diversified. The top-10 stocks account for just 17% of the index with exposure across a wider range of sectors which is reflected across the entire index.

“ Investing in the sector is exciting because of the potential returns you can achieve – companies like Cochlear or CSL with share prices that have risen close to 100 times over 10 or 15 years. If you can manage the risk of the sector and find the future leaders and avoid the future blow ups – you can achieve great outcomes for your clients. ”

James Abela, Portfolio Manager  
Fidelity Future Leaders Fund

## Financials and materials dominate the S&P/ASX 200



Source: ISW/MDM as at 31/03/2019.

## 4 Interests are often more aligned

When you invest in a company you want to make sure that you invest in a company where management are focused on generating superior returns and are committed to acting in the interests of all shareholders.

With smaller stocks, it's common to find that management still own a chunk of the company, whereas CEOs of large companies might only own a tiny part of the conglomerates they run. Because of this, management at smaller companies are likely to act with shareholders in mind because they are significant shareholders.

## What sort of companies can you access?

Today the small to mid-cap market is home to many of Australia's future leaders. Let's look at a couple of examples:

### Market leadership through innovation



Cochlear designs and provides hearing solutions for hearing loss and hearing related issues. It is a global leader in the implantable hearing devices arena.

Founded in 1982, Dr Graeme Clark was inspired to develop the world's first electronic implantable hearing device after seeing the effects of hearing loss - his father was hearing impaired.

Cochlear has consistently focused on innovation and its investment into research and development (R&D) has yielded results. Since 1981, Cochlear sold more than 550,000 devices in over 100 countries - more than two-thirds of the hearing implant market globally. In 2018, Cochlear delivered annual revenue of AU\$1.4 billion and spent over AU\$160 million in R&D. It operates in 30 countries and employs over 3,500 people globally.

From its modest beginnings as a small-cap stock listed on the ASX in 1995, Cochlear today is among the top 50 ASX companies with a market cap of over AU\$10 billion.

Cochlear share price (AUD)  
December 1995 - May 2019



Source: Refinitiv DataStream, May 2019.

## On track to be a leader



Altium is a software company that provides PC-based electronics design software for engineers who design printed circuit boards.

The company was founded in Tasmania in 1985 by Nicholas Martin, who saw an opportunity to make the design of electronics product affordable, by marrying the techniques of electronics design to the PC platform.

Since then, Altium has been a pioneer in creating electronic design tools that help electronics designers harness the latest devices and technologies. By continuing to innovate, the company has won market share and been able to grow revenues and deliver strong returns on capital for investors.

Today the company has an annual revenue of AU\$200.3 million, employs 600 people and has regional headquarters in Australia, United States, China, Europe, and Japan, with resellers in all other major markets.

## Where there's reward, there is risk

Investing in smaller stocks may offer investors many benefits but there are risks too.

## Management is often inexperienced

A company's business model is often untested in all economic conditions because the company might not have been around long enough. Smaller stocks are often single businesses, which means that they offer one type of product or service. They are therefore more vulnerable to competition and thus stagnating or failing.

## Smaller stocks carry extra risk at an aggregate level

When investors are concerned about the economic outlook they may seek safe havens. Asset classes that are perceived as risky (such as mid- and small caps) can be sold down.

Even allowing for these risks, however, the potential extra return and diversification benefits of smaller stocks make them worthwhile considerations.

## The importance of active management

Given small to mid-caps are considered to be riskier, it's important to help mitigate risk by creating a diversified portfolio and select companies that are well positioned to generate returns through the ups and downs of market cycles.

At Fidelity, we believe an active investment approach offers crucial advantages for investors because we can thoroughly research and select opportunities from a much broader universe than those available in the Index.

The advantage to investors is greater diversification across sectors and companies, which helps reduce risk, and more opportunities to create meaningful value.

### Like to know more?

Fidelity Future Leaders Fund is a diverse and blended actively managed portfolio of 40 to 70 small to mid-cap Australian shares.

Testament to its unique and disciplined investment process, the Fund has been awarded the Morningstar 2019 Australian Fund Manager of the Year Award – Domestic Equities Small Cap Category\* for the second year running.

If you'd like to know more about the Fidelity Future Leaders Fund, visit our website or call or email our client services team:

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