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Global small and mid caps: The blue chips of the future

Global small and mid cap companies, known as SMIDs, include some of the most exciting growth opportunities in the global equity universe. We take a look at how this often overlooked asset class can fit in Australian investors' portfolios.

When investors think about global equities, the first companies to come to mind are often large cap names like Amazon, Apple, Facebook and Microsoft. But there are many smaller, lesser-known but highly investable small and mid caps (SMIDs) on offer. These stocks cover a diverse range of industries and many of them have the potential to grow into global giants. SMIDs have traditionally been overlooked by investors in global equity portfolios, which have tended to focus on large cap names.

The time is right for SMIDs

Compared with Australian small and mid cap companies, the global SMID cohort provides a wide range of much larger, more liquid and higher quality companies. And with the market concentration and profits of large cap stocks – especially the tech giants – appearing to be close to their peak, global SMIDs provide exposure to a different part of the global equity market that can provide future outperformance.

SMIDs focus on the segment of the global listed universe of companies with less than US\$20 billion in market capitalisation. Breaking it down, small cap companies are generally classified as having a market cap of between US\$300 million and US\$2 billion and are often categorised as growth stocks.

Mid cap stocks, on the other hand, usually have a market cap ranging from US\$2 billion up to US\$20 billion. They tend to be established companies in the process of expanding in industries that are expected to experience rapid growth. Indeed, mid cap companies are often considered the blue chip companies of the future due to their enormous growth potential.

Long runway of growth

SMIDs tend to have a capability for higher compounding returns when compared with large cap companies. Australian investors may be missing out on some of the highest growth investment opportunities from small and mid-sized global companies that are yet to reach their full potential.

The SMID segment of the global equity market includes many companies operating in a 'sweet spot' – mature and successful enough to begin employing professional management as they progress beyond the start-up phase, but still with enough room to grow.

The biggest opportunity exists where there is a compelling intersection between a SMID company's competitive strength and a significant growth runway ahead. By this stage, SMIDs have proven their business model and achieved some product and customer diversification.

These companies are often building a strong leadership position with an improving balance sheet and cash flows to support them, coupled with having plenty of growth opportunities available to capture and exploit.

Because smaller companies have more room to grow, there's potential for a longer run of compounding growth. Comparatively lower sell-side coverage means that there may be greater mispricing of SMIDs on an individual stock basis, thereby offering more opportunities to outperform.

The role of SMIDs in portfolios

Global SMIDs can complement an Australian share allocation by increasing portfolio diversification in innovative industry sectors that are not highly represented in the ASX300, such as Healthcare, IT and Industrials.

Furthermore, an allocation to SMIDs may broaden the maturity profile of companies in an investor's global equity portfolio, by introducing a larger proportion of younger companies with ample runway for growth, to complement the more mature companies represented in large cap equities.

And while smaller companies tend to be more volatile than larger stocks in isolation, a well-diversified portfolio of stocks including SMIDs will not necessarily be more volatile than a portfolio consisting solely of large caps.

Partnering with a global expert

The Artisan Global Discovery Fund, which is distributed to Australian investors by Copia Investment Partners on behalf of US-based Artisan Partners, provides exposure to high quality global SMIDs that are innovative and poised for further growth. Typically, these companies have franchise characteristics that benefit from an accelerating profit cycle, while also trading at a discount to private market valuations.

The Fund employs a growth investment style with an unconstrained approach relative to the MSCI All Country World SMID Cap Net Index weightings. As it aims to avoid exposure to the largest companies, it may offer portfolio diversification and complementary exposure when used alongside other large-cap, benchmark-aware global equity funds and Australian equity strategies.

Global SMIDs can form part of a well-diversified portfolio, giving investors exposure to strong growth characteristics that are often lacking in global large caps. Experienced asset managers like Artisan Partners are well placed to help Australian investors tap into this increasingly important asset class.

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