

# Fish where the fish are

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The first rule of fishing is ‘fish where the fish are,’ and the second rule of fishing is ‘don’t forget rule number one’. And in investing it’s the same thing. Some places have lots of fish, and you don’t have to be that good a fisherman to do pretty well. Other places are so heavily fished that no matter how good a fisherman you are, you aren’t going to do very well.

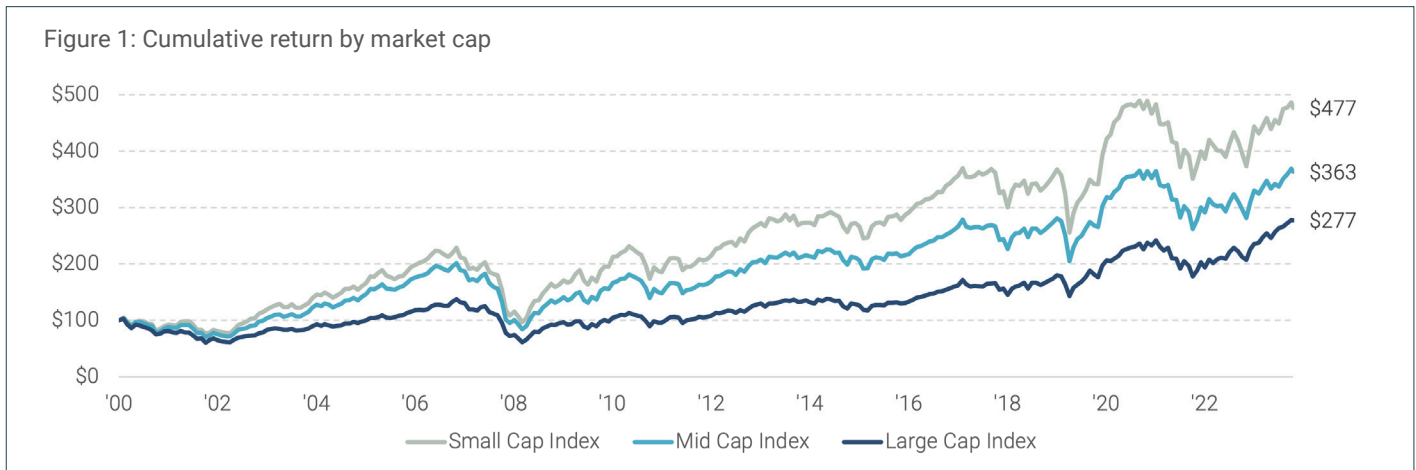
*Charlie Munger, Daily Journal 2018 Shareholder Meeting*

When Canopy Investors was founded, we started with a blank sheet of paper and asked ourselves a fundamental question: where can we best apply our expertise to generate exceptional investing outcomes for clients?

Guided by the wisdom of Charlie Munger, we decided to focus solely on global small and mid (SMID) cap companies. This often-overlooked segment of the market, in this context representing the bottom ~30% of total market capitalisation within each country, has historically outperformed and offers a rich opportunity set for active investors.

## Historical outperformance of smaller companies

Smaller companies have historically outperformed their larger counterparts. The chart below shows the cumulative performance of the MSCI World Small, Mid and Large Cap indices from January 2001 through September 2024. A \$100 investment in the small and mid-cap indices at the beginning of this period would now be worth \$477 and \$363, respectively, versus \$277 for the large cap index. In addition to higher cumulative returns, both the small cap and mid cap indices demonstrated superior risk-adjusted performance over this period, with Sharpe ratios<sup>1</sup> of 0.35 and 0.30 respectively, compared to 0.23 for the large cap index.



	Sharpe ratio (2001-2024)
Small Cap Index	0.35
Mid Cap Index	0.30
Large Cap Index	0.23

Source: Canopy Investors, MSCI, Factset.

<sup>1</sup> Sharpe ratio is a measure of risk-adjusted return, calculated by subtracting the risk-free rate from the investment’s average return, then dividing by the standard deviation of the investment’s returns.

The outperformance of smaller companies is not a recent phenomenon; Banz (1981) empirically demonstrated small-cap outperformance using a dataset going back to the 1920s. More importantly, small-cap outperformance has been found to persist even on a risk-adjusted basis. In their seminal paper, Fama and French (1992) incorporated size into their three-factor model alongside market beta and the value factor (book-to-market ratio) and found that the small-cap premium remained significant, even after controlling for these factors.

More recently, Asness et al. (2018) found that the size effect was stronger when controlling for “quality” or “junk” characteristics (defined by a combination of metrics describing profitability, growth, leverage, and the ability to payout earnings). They showed that small quality stocks significantly outperformed large quality stocks.

In our view, the historical outperformance of smaller companies is intuitive, and potentially attributable to several factors:

### Higher growth and longer runways

Unlike larger companies constrained by the “law of large numbers,” smaller firms can sustain higher growth rates for longer periods. Furthermore, their size allows them to capitalise on niche opportunities and untapped markets that larger companies might overlook or find difficult to pursue.

### Greater potential for takeovers

Small companies frequently become acquisition targets for larger firms seeking to diversify, enter new markets, or acquire innovative technologies. This takeover potential can create substantial upside for investors, as acquisitions often come with a premium over market value (Andrade et al., 2001).

### Founder-driven focus

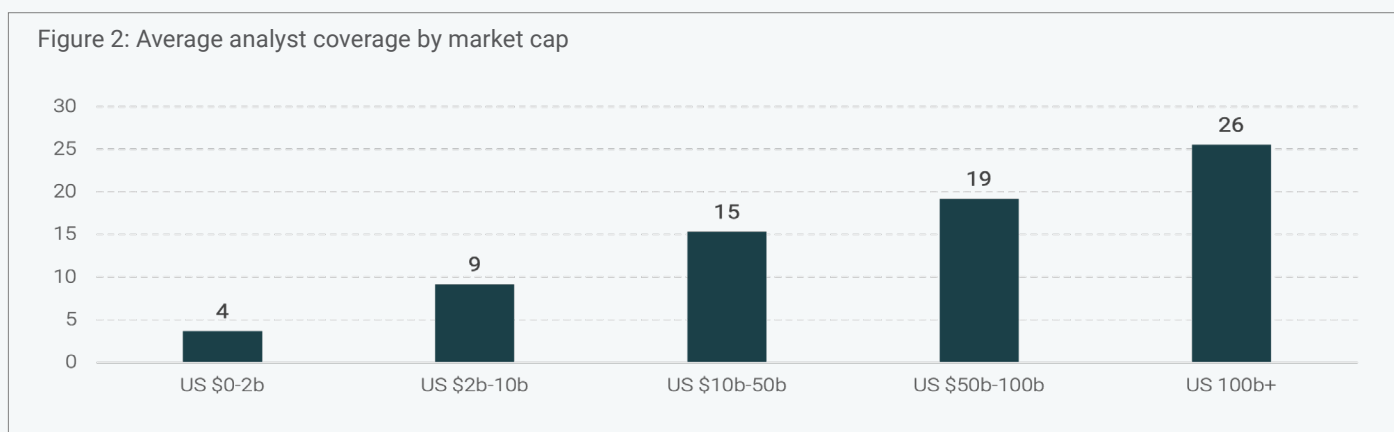
Many small companies are still led by their founders, who often have a strong vision and personal stake in the company’s success. This can drive innovation and long-term strategic thinking that may be less prevalent in larger, more established corporations.

## A rich opportunity for active investors

What’s more, the global SMID investment universe exhibits structural characteristics that create opportunities for active managers to generate further outperformance.

### Limited analyst coverage

Smaller companies typically receive less attention from sell-side analysts and institutional investors, resulting in a greater dispersion of expectations and potential mispricings, providing opportunities for diligent investors.



Source: Canopy Investors, FactSet, 2024

## Larger, more diverse investment universe

The SMID segment offers a vast and diverse set of investment opportunities across various geographies, sectors and business models, providing opportunities for manager differentiation. The charts following illustrate the contrast between market capitalisation and the number of companies in the large-cap versus SMID segments. Large cap stocks account for ~70% of the ~US\$91tn global developed markets market cap, with increasing concentration in large-cap indices in recent years, while SMID stocks comprise the majority of listed companies.



Source: Canopy Investors, S&P Developed Large and MidSmall Indices, 2024.

As highlighted in the chart below, there is some evidence that these factors have contributed to more persistent outperformance by small-cap active managers.



Source: Canopy Investors, eVestment data as at August 2024. Excess return calculated as annualized gross return of the median manager within each peer group, minus the appropriate benchmark (MSCI ACWI Small and Large Cap indices).

## An enduring opportunity

In sum, smaller companies have a track record of delivering strong returns, particularly when coupled with a quality overlay. There are structural reasons to suggest that these results are persistent. By focusing on this often-overlooked market segment, our aim is to deliver exceptional outcomes for clients, staying true to the principle of “fishing where the fish are.”

For more information, visit [canopyinvestors.com](https://canopyinvestors.com) or call 1800 895 388 (AU) or 0800 442 304 (NZ).

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