



## FROM THE DESK OF

**Ian Hardacre**, MBA, CFA

SVP and Chief Investment  
Officer, Empire Life

Chief Investment Officer,  
Empire Life Investments Inc.

# THINKING “SMALL” – THE IMPORTANCE OF MARKET CAP DIVERSIFICATION

June, 2020

As investors, one of the first lessons we learn is the importance of diversification – that is, not putting all of your eggs in one basket. This is an important way to mitigate risk in a portfolio over most investment timeframes. We often hear of home-bias, meaning tending to a higher proportion of domestic investments. Depending on the risk-return profile of an investor, this can lead to them being over-exposed to economic and sector risks specific to a particular region. One of the easiest ways for investors to diversify a portfolio of Canadian investments is by allocating a portion of their assets into foreign stocks and bonds.

Taking it one step further, when looking overseas and even south of the border for potential investments, investors should note key differences between large-cap and small-cap stocks that can potentially improve diversification and long-term performance.

So, why invest in small cap companies? You may have heard of the “size effect”. The theory behind this is that smaller companies are inherently more risky but as such they are expected to outperform over time to compensate investors for this added risk. While the increased focus on US tech darlings, including FAANG stocks (Facebook, Amazon, Apple, Netflix, Alphabet (Google)) has made small caps laggards of late, many investors may be surprised to learn that small cap stocks have outperformed large caps over a 20-year time period.

Investment Name	Cumulative Return	Annualized Return
S&P 500 TR USD	196.41%	5.58%
Russell 2000 TR USD	238.73%	6.29%

Source: Morningstar. 20-year return as at April 30, 2020

Now, past performance does not predict the future but it is also worth noting that in the twelve months following the trough of the financial crisis (March 9, 2009), the Russell 2000 Index returned approximately 93%, outpacing the approximately 70% return of the S&P 500 Index. Could we see something similar as we recover from the current COVID-19 situation? Time will tell.

Another differentiating factor is that many global small cap companies sell the bulk of their goods and services to customers in their local markets. On the surface, having a less diversified revenue stream may seem like a disadvantage but the fact that these firms have closer ties to their local economies make them an excellent diversification tool when building a broad-based portfolio. Plus, the added diversification at the currency level can also lead to lower correlations with multinational firms that have significant exposure to the US dollar.

You also get vastly different economic exposures when you broaden your investment universe to include global small cap stocks. As you can see from this chart below, when including small cap stocks from the U.S. and international markets, you can reduce the cyclical nature of a portfolio, while also increasing the defensive characteristics, boding well for a longer term balancing between risk and reward.

Name	Cyclicals %	Defensive %	Sensitive %
MSCI Canada Small Cap	52.76	13.62	33.62
MSCI EAFE Small Cap	42.64	18.82	38.11
MSCI USA Small Cap	39.20	23.64	37.16

\*Based on Morningstar Super Sector weights – as at March 31, 2020

Finally, global small cap companies are an overlooked asset class, often under-covered by the analyst community and underinvested by both institutional and retail investors. This creates opportunities for active managers such as Empire Life, to seek out pricing inefficiencies and find companies that have strong management teams, competitive advantages and a sustainable business model to capitalize on future growth.

At Empire Life, we have been managing the Empire Life's Global Smaller Companies Fund (class A) since October 2005, giving advisors and investors the opportunity to add exposure to this particular asset class. It is rated 4-stars by Morningstar Rating™\* and we recently added this mandate to our GIF lineup in May 2018. In addition, we invest in global small cap stocks on both a strategic and tactical basis within the Emblem Global Portfolios, offering investors an expanded opportunity set.

Thank you for your continued support.

\*© 2020 Morningstar Research Inc. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete, or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. Overall star rating out of 90 Global Small/Mid Cap Equity Insurance Funds Category as of April 30, 2020

This document reflects the views of Empire Life as of the date published and is subject to change without notice. The information in this presentation is for general information purposes only and is not to be construed as providing legal, tax, financial or professional advice.

The Empire Life Insurance Company and its affiliates assume no responsibility for any reliance on or misuse or omissions of the information contained in this document. Information obtained from and based on third party sources are believed to be reliable, but accuracy cannot be guaranteed. Please seek professional advice before making any decisions. Empire Life Investments Inc. is the Manager of the Empire Life Mutual Funds (the "Funds") and the Portfolio Manager of the Empire Life Segregated Funds and is a wholly owned subsidiary of The Empire Life Insurance Company. The units of the Funds are available only in those jurisdictions where they may be lawfully offered for sale and therein only by persons permitted to sell such units.

A description of the key features of the individual variable insurance contract is contained in the Information Folder for the product being considered. **Any amount that is allocated to a Segregated Fund is invested at the risk of the contract owner and may increase or decrease in value. Policies are issued by The Empire Life Insurance Company.**

Policies are issued by The Empire Life Insurance Company.®/™ Registered Trademark of **The Empire Life Insurance Company**

### The Empire Life Insurance Company

259 King Street East, Kingston, ON K7L 3A8

Insurance & Investments – Simple. Fast. Easy.®

empire.ca info@empire.ca 1 877 548-1881

INV-2297-EN-06/20

