PERSPECTIVE

Small Stars Can Shine Bright

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When markets are volatile and uncertain, many equity investors often gravitate toward the larger companies they perceive to be the most stable—in the form of large-cap stocks. Within the emerging-markets universe, we see a number of small-cap stocks with shining potential that we think shouldn't be ignored.

Big Misconceptions about Small-Cap Stocks

We have found that as an asset class, emerging-market small cap is one of the most widely misunderstood and underutilized among investors. It is often perceived to be a place to avoid in times of uncertainty, but we see things differently. Many small companies are driven by local market dynamics and are therefore less dependent on global market trends. The small-cap emerging-market universe is anything but small—there are thousands of small-cap stocks available to invest in today, and the investment universe continues to expand due to the gradual liberalization of equity markets to foreign investors and the continued expansion of equity markets through initial public offerings, secondary offerings and privatizations.

KEY DISTINCTIONS VS. LARGER COMPANIES

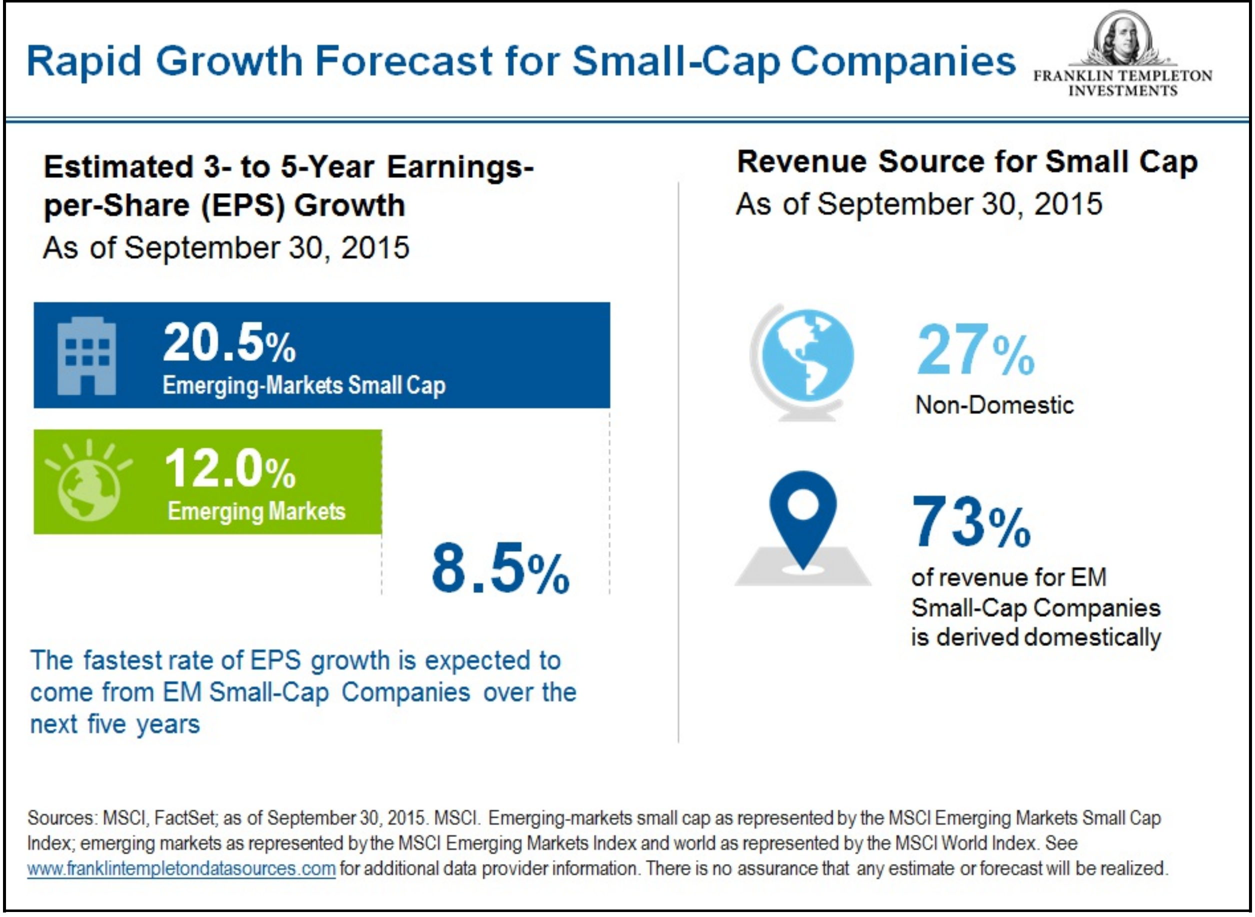
- Smaller companies in emerging markets are generally privately owned and competitively operated, and are often larger players in smaller industries.
- Small caps are particularly notable in the consumer area, in which we can access small but fast-growing and profitable consumer companies to reach burgeoning consumer markets.
- Small caps generally have low foreign ownership levels and are often under-researched, overlooked and mispriced. The lack of coverage and transparency creates potential risks and opportunities.
- Based on our analysis, many small-cap companies with attractive fundamentals and long-term growth prospects are trading at deep discounts due to the lack of sell-side coverage and liquidity.
- As we seek out growth opportunities at bargain prices, we prefer companies with prudent financial policies and strong balance sheets that have generally abstained from taking significant financial leverage risk.

Why Consider Small Caps?

Among the many reasons to consider investing in small-cap stocks, smaller companies in emerging markets are generally privately owned, competitively operated, more local and are often larger players in smaller industries. Aside from relatively high organic growth compared with most larger companies, industry consolidation and acquisitions by larger companies as well as increased investor attention are additional potential sources of growth which can be independent of the broader macroeconomic environment. Many of the stocks in this space are under-researched or unloved, giving us the opportunity to uncover interesting opportunities others may have overlooked. We see that as the essence of what investing in emerging markets generally is about—discovering undervalued stocks in burgeoning markets that could rise to become tomorrow’s stars.

The Asian small-cap space is of particular interest to us, and we have been using recent market volatility to search for opportunities. We believe reforms taking place in many emerging markets in the region could prove to be beneficial for smaller companies. Additionally, since domestic demand is typically the main revenue driver for small-cap companies, the combination of good economic growth, a growing middle class and lower oil prices—which can help check inflation and support a lower-interest rate environment—could be an added benefit to smaller companies in the region, freeing up consumer dollars to purchase their products. Within the small-cap space in emerging Asia, we currently favor consumer-oriented companies given the growth opportunities we see across many markets, as well as health care, pharmaceuticals and biotechnology companies.

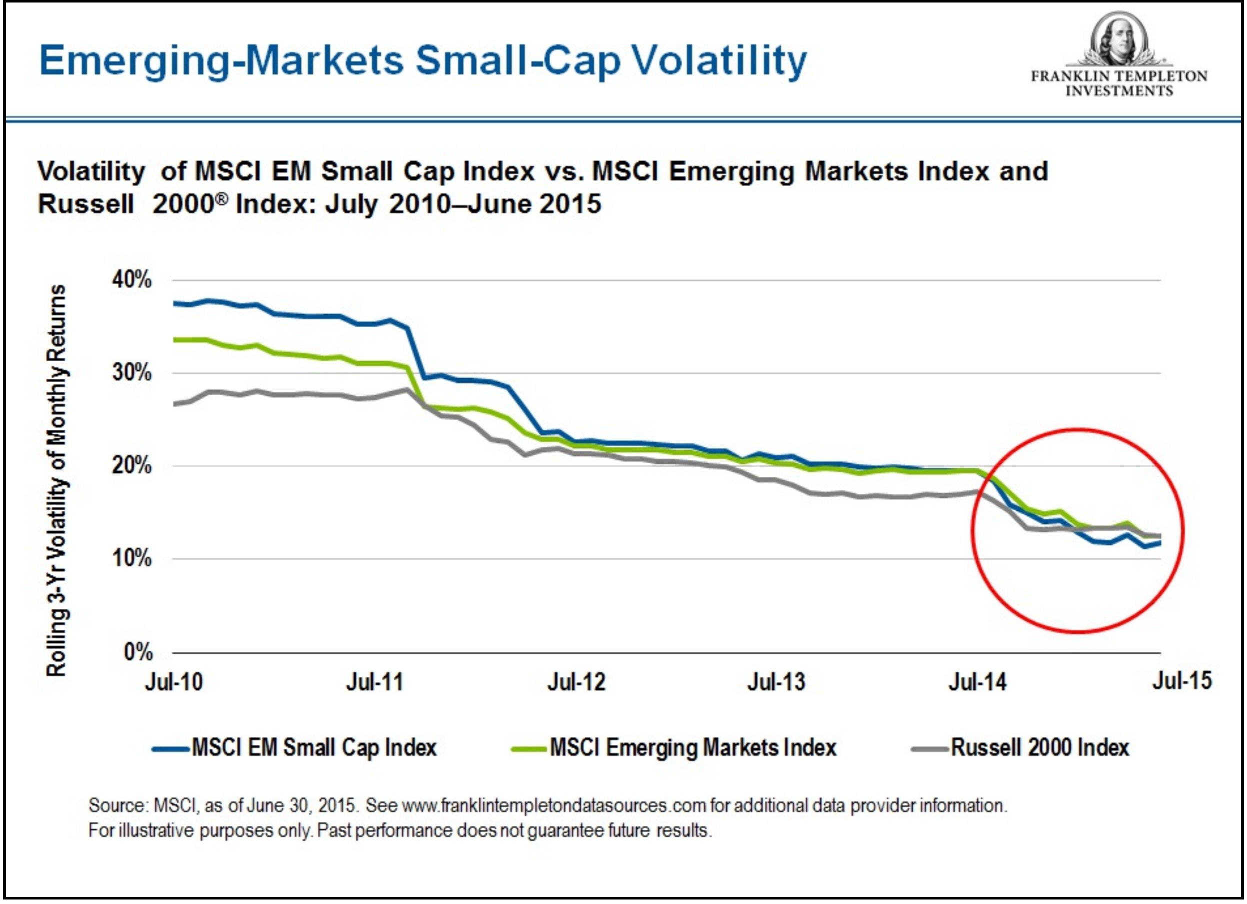
Of course, that doesn’t mean these companies are all well managed or worthy of investment. Therefore, purchasing small-cap stocks through a passive (index-based) strategy may produce unintended consequences. Stocks with poor growth prospects, poor corporate governance or other such factors may be components of a small-cap benchmark index, but they might not be desirable to invest in over the long term. Additionally, regular index rebalancing can generate significant portfolio turnover for passive investors. We strive to generate alpha[1] through our bottom-up stock selection process, looking for companies that we think can increase their market cap by a multiple over a five-year time horizon, and we strive for only modest yearly turnover.



Risk and Small-Cap Investing

Risk is certainly an important part of a discussion about small-cap investing. I've never met a client who complains about upside risk. What worries clients is downside risk, and this is where we think we add value as active investors. Our team maintains an unrelenting focus on quality, seeking fundamentals that are on almost every measure superior to a benchmark index, including higher return on equity (ROE), profit margins and earnings-per share (EPS) growth, lower debt, better dividend yield, and most importantly for us at Templeton, cheaper valuations in terms of price-earnings ratios.

Contrary to many investor assumptions, the emerging-market small-cap benchmark index, as measured by the MSCI Emerging Markets Small Cap Index, at times has been less volatile than the broader index, the MSCI Emerging Markets Index, as well as the Russell 2000® Index, a US small-cap benchmark.[2] To us, that makes sense because small-cap companies are less correlated with each other, and less integrated into global markets than large caps generally speaking.



There are also numerous inefficiencies in small-cap markets, offering potential for alpha. In the United States, small-cap stocks generally trade at a premium to large caps in terms of price-earnings, due to the higher growth they can provide. When you look at emerging markets, sometimes the opposite may be true. In India, for example, small caps are generally trading at a discount to large caps. Much of this investment money is what we'd call "lazy money," or passive investment money, concentrated in large-cap index stocks that are not only more expensive but also subject to the volatility generated by rapid inflows and outflows of such foreign investments. Accordingly, we have found many undiscovered opportunities in Indian small caps.

Small-cap stocks have the potential to offer what is becoming ever-more rare in a slowing global economy—growth—and not only in India. Many emerging markets offer this strong growth potential—with many small-cap stocks available to potentially take advantage of it.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

Smaller, mid-sized and relatively new or unseasoned companies can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies. Historically, these securities have exhibited greater price volatility than large company stocks, particularly over the short term.

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1. Alpha is a risk-adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.

2. Sources: MSCI, Russell 2000®, as of June 2015. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged, and one cannot directly invest in an index. Past performance is no guarantee of future results.