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The outlook for growth opportunities in small cap shares

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Rising interest rates hit smaller companies harder than their larger peers. Now it looks like the rate rise cycle could be coming to an end and some investors are starting to consider smaller Australian company shares again. We explain what this means for your investment portfolio.

What are small cap shares?

When investors talk about Australian small cap shares, they're referring to the 200 companies that are listed on the Australian Stock Exchange (ASX) and tracked by the ASX Small Ordinaries index. These companies operate in diverse industries – health care, consumer discretionary, energy, communication services, financials, materials and real estate. They're called small cap because their value, or market capitalisation, is smaller than many of the companies listed on the ASX. The average small cap company is valued at $1.5 billion. In contrast, the companies in the ASX 100 (the ASX's largest 100 companies) are more than 13 times larger: with an average value of $20.2 billion each.

Most of these smaller Australian companies are not household names and don't get a lot of attention from the media or market analysts. And because they're too small for many investors, they can be overlooked.

Yet there can be good investment opportunities among Australian small cap shares. This is because investors may be able to buy undervalued companies before their growth potential becomes known by the broader investment community. What's more, smaller companies are often nimbler and more innovative than their larger peers, which can mean they grow faster. Most larger companies were small once, and as small companies grow, so does the equity invested in them.

How rising interest rates hurt small cap shares

While most businesses find rising interest rates difficult, Australian smaller companies have had to navigate a confluence of challenges since May 2022, when rates started rising again:

- **Rising interest rates restrict a small company's access to funding.** When a small company is early in its growth phase, it may not produce much revenue and so needs to borrow money to fund its operations and strategic plans. When interest rates are rising, this funding is both harder to get and more expensive.
- **Consumers spend less when interest rates are high.** The ASX Small Ordinaries index has a larger exposure to consumer discretionary companies. These are companies in industries such as travel, lifestyle retail, home electronics and education – representing 17.4% of the ASX Small Ordinaries index versus 5.8% of the ASX 100. When consumers are under pressure, investors usually sell down their investments in consumer discretionary companies.
- **Investors generally prefer larger companies when investment markets are uncertain.** Given the effect of high interest rates on smaller companies, larger companies can be relatively more attractive to investors. In turn, it can be harder to sell the shares of smaller companies because there are fewer investors wanting to buy them, depressing smaller company prices.

So as the interest rate outlook improves, the profits of some small-cap companies could lift.

How a peaking interest rate cycle supports a growth outlook for small caps

Looking to the future, some central banks are indicating that interest rates could be reaching their peak. This means that funding and other interest rate challenges could lessen for smaller companies. In turn, investors are starting to become interested in small cap growth opportunities again.

The August 2023 reporting season showed the resilience of corporate Australia. Dividends remained strong and concerns about the impact of inflation, labour costs, freight costs and interest rates are resolving.

So as the interest rate outlook improves, the profits of some small-cap companies could lift. And with less uncertainty, more investors could find smaller companies a hunting ground again for growth, taking advantage of the lower prices for smaller companies versus larger companies.

What's more, because there's a broader range of industries represented in the ASX Small Ordinaries versus the ASX100, investors seeking diversification are also more likely to consider smaller companies.

Investment risks to consider

In addition to the risks of share market investing generally, some risks loom larger for smaller companies, such as:

- When inflation and interest rates increase, smaller companies are generally harder hit than larger companies.
- Weaker economic conditions can be more challenging for smaller companies as they often don't have the pricing power or brand strength of their larger competitors.
- While some smaller companies have robust operations that generate consistent profits, others carry quite a bit of capital and earnings risk for investors. For example, mining companies in the exploration or mine development phase may not deliver the returns the company envisaged.

Benefits of professional investment management and an active approach

Because the ASX Small Ordinaries Index includes a broad range of companies with very different risk profiles, a professional investment manager can sort the stronger companies from the weaker ones. They do this through deep research into each company. And because they understand the risks and opportunities that are unique to this sector, they can pick the best times to buy in and sell out of a company.

How we can help

If you'd like to discuss how an increased exposure to Australian smaller companies could bring diversification and growth opportunities to your investment portfolio, speak to us. We can advise you on your options after taking into account your overall financial goals.