Market Update - Why favour small and micro caps

June 2025

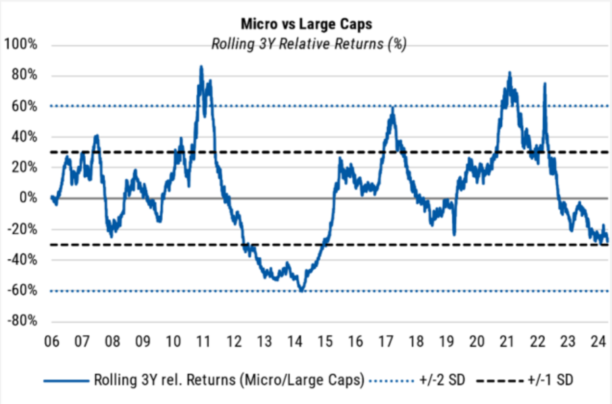
Currently we favour small companies over large caps in both international and Australian shares, while micro caps are viewed even more favourably over small caps within Australian equities. This bias is driven by the relatively attractive valuations found within small and microcap companies relative to large cap companies.

As central bank rates rose in 2022 through to the first half of 2023, large cap equity performance was relatively flat while small caps lagged considerably over this period. However, as rates stabilised, liquidity levels within equity markets picked up, and large caps were first to see some stellar returns delivered within both global and Australian large caps.

The run up in large cap valuations has led to their valuations being somewhat stretched, leaving small caps with more favourable valuations, and further so within Australian micro-cap valuations.

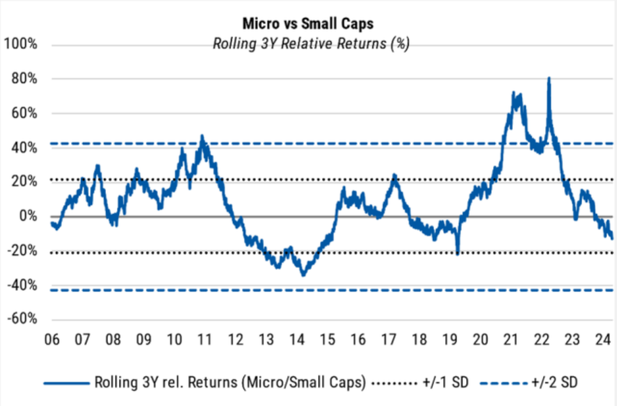
Large cap companies are more reliant upon solid economic growth to drive their growth, and the global economic outlook is uncertain, with the risk of recession in the US a possibility, although not a given. Small companies on the other hand, be they domestic or global small companies, can grow earnings through taking market share. This is often the result of them rolling out new technology or new processes to more efficiently deliver the same or superior products and services. Therefore, small companies and microcap companies, are not entirely reliant upon economic growth to drive profit growth.

The following chart highlights the three-year return differential between Australian large cap companies and microcap companies. There is close to a 30% difference between microcaps return versus large caps at this point in time, where large cap valuations are arguably fully priced.



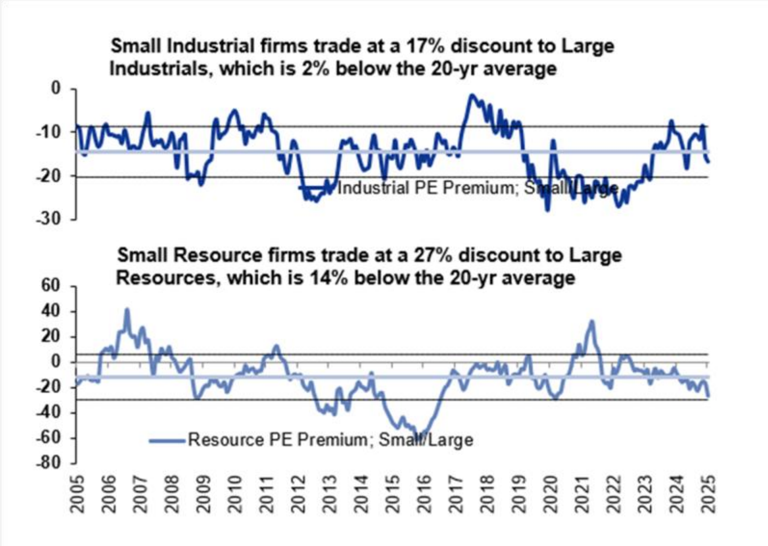
Source: Yarra Capital Management

Similarly, in the chart below we see three-year microcaps return lower relative to small caps by about 10%, supporting our overweight positioning to both small caps and microcaps.



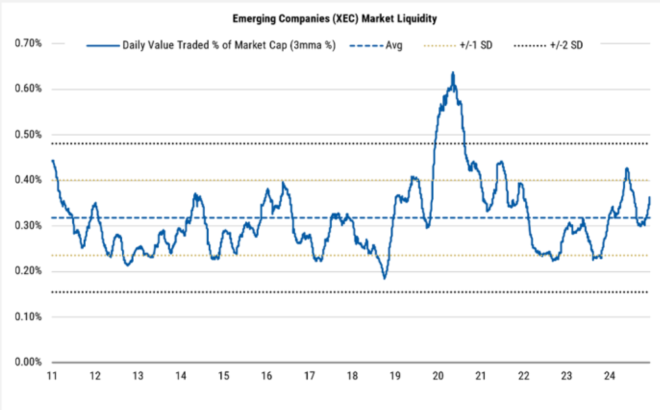
Source: Yarra Capital Management

The next chart further supports our contention that small caps are well priced relative to large caps, with small industrials showing a 17% discount to large caps, which in turn sits below the 20-year average. The case for small resources is even more compelling, although global economic uncertainty will influence the outcome for resources, going forward.



Source: Yarra Capital Management

We also believe further justification for our overweight to microcaps can be seen within the chart below, which shows market liquidity improving within Australian emerging companies. Market liquidity is important in driving repricing in share prices, with a lack of liquidity leading to discounts. The increasing liquidity showing up now should help towards rectifying the discounts back to 'normal' levels.



Source: Yarra Capital Management

Exploiting such mispricing opportunities allows us to deliver long term outperforming portfolios for our clients. We also like to use active managers within small companies as lower levels of research and coverage within the space tends to lead to a lower level of understanding of smaller companies by the market, providing greater opportunities for active managers to exploit and add value through their company research.