THE CASE FOR SMLL

BetaShares Australian Small Companies Select Fund (managed fund) (ASX: SMLL)

BetaShares
Exchange Traded Funds
www.betashares.com.au

MAY 2017

Sorting the Wheat from the Chaff: The Case for Smarter Australian Small Cap Investing

Due to the top-heavy nature of the Australian equity market, investors often seek exposure to small-cap stocks so as to provide added return potential and diversification to their portfolios. Yet investors seeking such exposure through passive investments in established small-cap investment indices have generally been poorly served, as these indices have historically not provided extra return for their added risk.

Part of the problem is that the benchmark S&P/ASX Small Ordinaries Index (the "Index") has a number of deficiencies, including containing a number of speculative companies which may have high gearing or no earnings - such as small mining exploration companies – the collective performance of which has tended to be underwhelming. Indeed, the small cap sector is one of the few investment markets in which most active managers have been able to consistently beat the index over the long term.

The fact that smaller cap stocks tend to be less well covered by the professional investment community suggests market pricing is less efficient than the large cap space and hence there may be greater scope to generate excess returns above the benchmark index. This suggests that a carefully constructed investment strategy – which screens out stocks with unfavourable investment characteristics such as high gearing and non-profitable business models along with other potentially value destroying metrics can lead to a basket of higher quality stocks which aims to eliminate the performance drag from these more speculative companies over the long run.

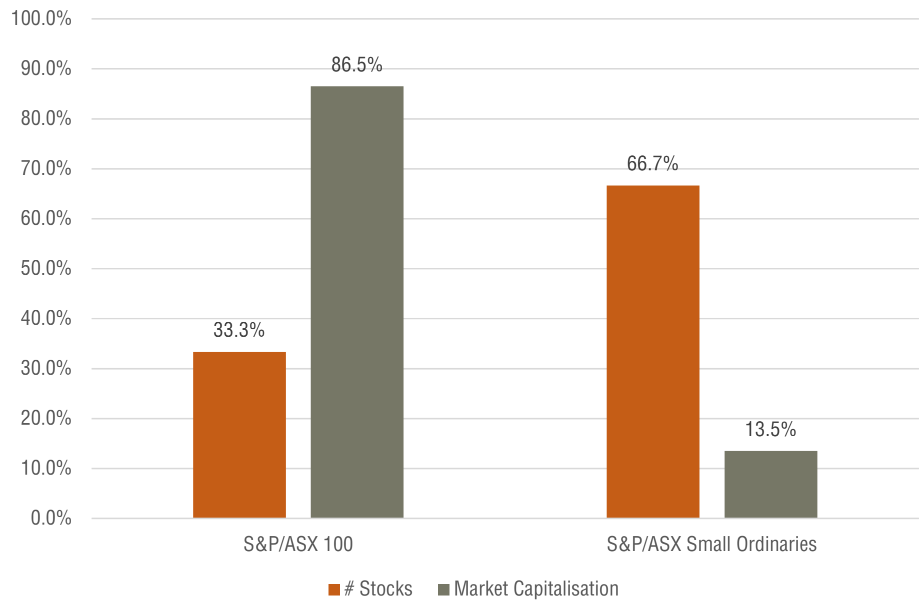
With that in mind, the **BetaShares Australian Small Companies Select Fund (managed fund) (ASX: SMLL)** uses a screening methodology to select a portfolio of small company shares listed on the ASX that aims to outperform (after fees and expenses) the Index over the medium to long term – and at a lower management fee than that typically charged by many traditional active fund managers in the small companies space.

Australian investors are highly exposed to large cap stocks

Australia's pre-eminent equity benchmarks – against which most active and passive investment funds used by investors compare themselves - have very top-heavy exposure to large-cap stocks.

As seen in the chart overleaf, while accounting for only one third of the 300 stocks in the S&P/ASX 300 Index, the top 100 "mid/large cap" stocks accounted for 86.5% of that index's market capitalisation as at 31 January 2017. By contrast, the bottom 200 stocks of the S&P/ASX 300 Index, which comprise the most well-known small-cap investment benchmark, the S&P/ASX Small Ordinaries Index, accounted for only 13.5% of the S&P/ASX 300 Index's market capitalisation.

SHARE OF S&P/ASX 100 AND S&P/ASX SMALL ORDINARIES IN S&P/ASX 300 INDEX (BY NUMBER OF STOCKS AND MARKET CAPITALISATION) – 31 JANUARY 2017



Source: Bloomberg

Those investors who invest directly in the market also have relatively concentrated shareholdings. According to the latest (2008) ASX Share Ownership Study, direct investors held on average only around 7 stocks in their portfolio – and this average level of holdings had not changed much over previous years.

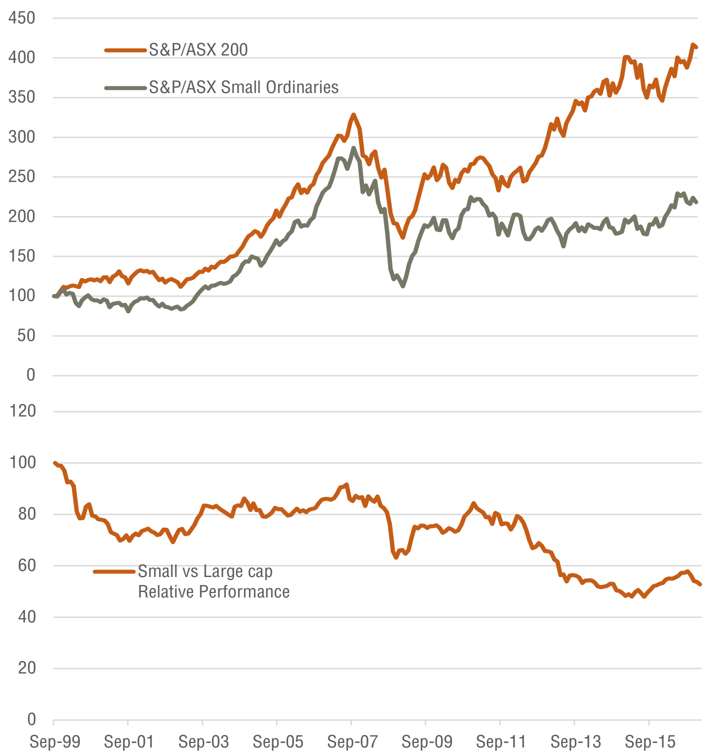
All this suggests that investors may be missing the diversification benefits and return potential that could be available by increasing exposure to small-cap stocks. Indeed, as small-cap stocks tend to be more volatile and "risky", finance theory suggests they should offer stronger long-run returns than large-cap stocks.

There's been no Australian "growth premium" in passive small-cap investing

It's an old investment truism that higher returns generally go to those prepared to take on more risk. In the case of equity markets, this risk-return trade-off is most evident when considering stocks by their market-capitalisation. As the price performance of large cap stocks is generally less volatile or "risky" than that of small cap stocks, the latter are usually expected to provide higher longer-run returns.

Yet, at least in the case of Australian equities in recent decades, this small-cap return premium for added risk has not generally been evident. As seen in the chart below, the benchmark S&P/ASX Small Ordinaries Index has generally underperformed the more large-cap dominated S&P/ASX 200 Index.

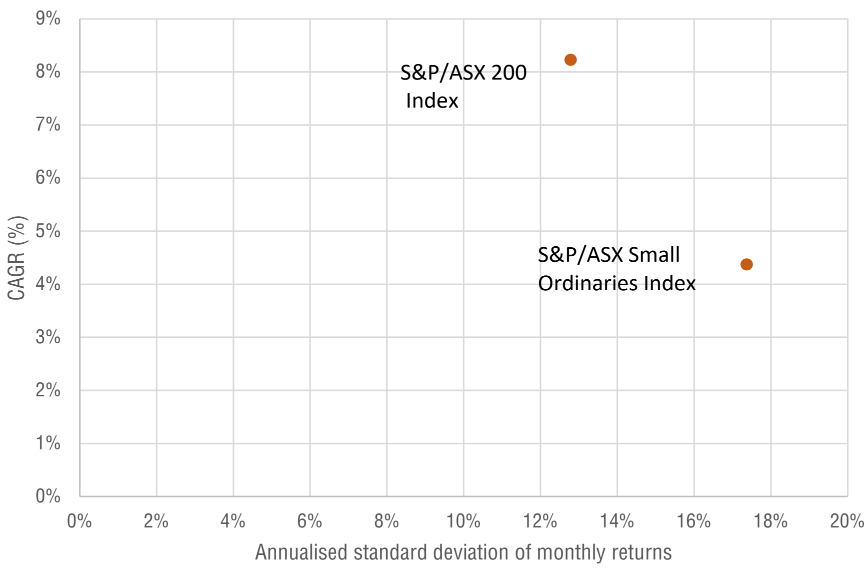
RETURNS OF THE S&P/ASX 200 ACCUMULATION INDEX AND S&P/ASX SMALL ORDINARIES ACCUMULATION INDEX: OCTOBER 1999 TO MARCH 2017



Source: Bloomberg. Past performance is not an indicator of future performance.

This lower return performance by the small cap index, moreover, has come at the expense of somewhat higher return volatility. Risk-adjusted returns from the S&P/ASX Small Ordinaries Index are even worse when compared to the larger-cap dominated S&P/ASX 200 Index.

RETURN AND VOLATILITY OF OF THE S&P/ASX 200 ACCUMULATION INDEX AND S&P/ASX SMALL ORDINARIES ACCUMULATION INDEX: OCTOBER 1999 TO MARCH 2017



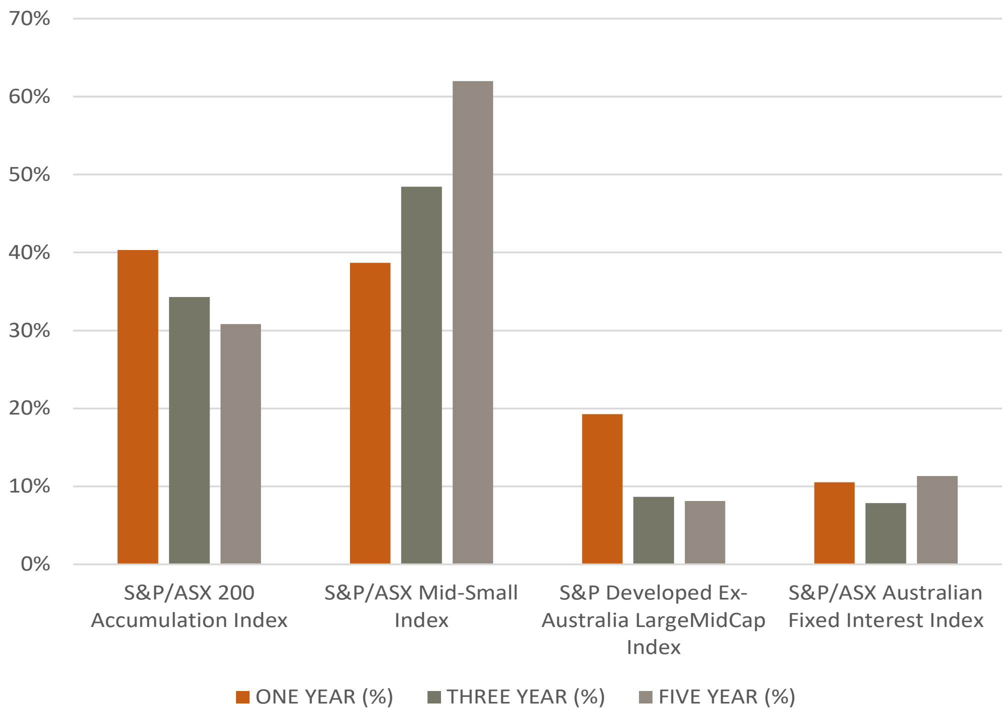
Source: Bloomberg. Past performance is not an indicator of future performance.

Good discretionary small cap managers are expensive and hard to find

Part of the challenge for the traditional small cap index is that is contains a number of speculative companies which may have high gearing or no earnings, the collective of performance of which has tended to be underwhelming. By merely avoiding such stocks, active managers often find they can deliver outperformance. What's more, the fact that smaller cap stocks tend to be less well covered by the professional investment community suggests market pricing is less efficient than in the large-cap space – so there is perhaps greater scope to generate "alpha" returns from diligent investment research.

As a result of these factors, surveys suggest that the small-cap sector is one of the few areas of the investment landscape in which most active managers have tended to beat their established benchmark over the long term.

% OF ACTIVE MANAGERS THAT OUTPERFORM THEIR BENCHMARK INDEX: 1, 3 AND 5 YEARS TO 31 DECEMBER 2016



Source: S&P, December 2016. Past performance is not indicative of future performance.

That said, gaining access to the best small cap active managers is not straightforward, as scale limitations mean many of the most successful funds often need to close their doors to new investors. What's more, fund investments in this area often come with a substantial cost: according to Morningstar data, the average investment fee charged by small cap managers is around 1.8% p.a[1], and this is before taking into account any performance fees charged!

1.Based on Morningstar data as at February 2017.

SMLL: A competitively priced 'screen-based' approach to small-cap investing

Given the clear limitations of the traditional Index, and extensive research on various factors which have shown to improve stock performance, BetaShares considered whether it may indeed be possible to generate cost-effective, alpha generating small-cap performance through adoption of a carefully constructed investment strategy drawing upon carefully selected stock "screens."

For example, our screens draw on extensive evidence[2] which suggests that past price performance or "momentum" is an important indicator of a stock's relative returns over the near to medium term. This research also suggests "value" stocks – or those that tend to be relatively less expensive on traditional price-to-earnings or a price-to-book value basis - also tend to find it easier to outperform more expensively valued "growth" stocks over time. Overly speculative or unproven small cap stocks can also be avoided by only considering those companies which are profitable and those with a strong ability to service debt.

The end result of this research has been development - from the ground up - of a tailor-made investment strategy specifically designed for the particular characteristics of the Australian small-cap market, and which aims to provide exposure to a portfolio of higher-quality, profitable small companies by screening out stocks with relatively poorer return potential over the long run.

The BetaShares Australian Small Companies Select Fund (managed fund) – ASX: SMLL

Drawing on the research above, the BetaShares Australian Small Companies Select Fund (ASX Code: SMLL) aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term (after fees and expenses). The stocks which SMLL invests in are generally within the 91-350 largest by market capitalisation. The portfolio will typically consist of 50-100 stocks.

The strategy of the Fund is to use a series of screens that aim to identify only those companies with positive earnings and strong ability to service debt – thereby eliminating from selection highly speculative stocks that may be a drag on the overall performance of the Index over the long term. Relative valuation metrics, price momentum and stock liquidity are also evaluated as part of the stock selection process.

What's more, the Fund is able to adopt this investment strategy while still charging fees estimated at only 0.39% p.a. In addition, a performance fee is also applicable, equal to 15.5% of the Fund's performance above the performance of the Index in a calendar quarter[3].

2.See, for example, Factor Efficacy Down Under, Morgan Stanley Research, January 24, 2017.

3. Note any underperformance by the Fund relative to its benchmark (measured in percentage terms) must be made up before a performance fee is payable, provided that negative performance in a quarter will be carried forward for up to four quarters.

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Conclusion

Given the top-heavy nature of Australia's equity market, added return potential and diversification benefits might be afforded to investors by seeking out more exposure to the small-cap stocks.

That said, passive exposure to the small cap sector through funds that track the Index would not have delivered good risk-adjusted returns in recent decades.

Yet while many active small cap managers have been able to beat the Index over time, their performance has not been without cost – with the average fee presently around 1.8% p.a.

By contrast, the BetaShares Australian Small Companies Select Fund aims to beat the Index over time through use of a carefully constructed investment strategy that allows the Fund to charge a significantly lower investment cost of only ~0.39% p.a., not including performance fees.

Trading Information

BetaShares Funds can be bought or sold during the trading day on the ASX, and trade like shares.

EXCHANGE	ASX
ASX CODE	SMLL
INAV ASX CODE	YSMLL
CURRENCY	AUD
TRADING HOURS	10:00-16:00 (AEST)
BLOOMBERG CODE	SMLL AU
IRESS CODE	SMLL.AXW

Fund Information

DISTRIBUTIONS	SEMI-ANNUAL
MANAGEMENT FEE	0.32% P.A
EXPENSES	ESTIMATED AT 0.07% P.A
PERFORMANCE FEE	15.5% OF PERFORMANCE ABOVE THE S&P/ASX SMALL ORD.ACC.INDEX
FUND INCEPTION	7 APRIL 2017
BENCHMARK	S&P/ASX SMALL ORDINARIES ACCUMULATION INDEX

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There are risks associated with an investment in the Fund, including investment objective risk, market risk and small companies risk. For more information on risks and other features of the Fund please see the Product Disclosure Statement.