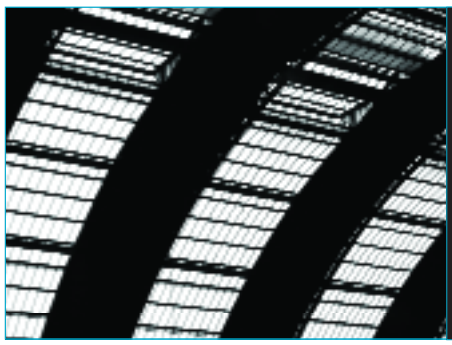

Fidelity Select Global Small Cap discipline

The catchphrase "strength in numbers" suits Fidelity International to a tee as it launches its tried-and-tested global small cap discipline in Australia, writes MICHELLE BALTAZAR.

The numbers are pretty compelling. Fidelity International is one of the Goliaths of the investment world with over $345 billion in assets on behalf of more than five million investors in more than 20 countries. Doing all the legwork for more than 1,000 funds are 4,500 people, approximately a fifth of whom are devoted to investment research.

Local institutional investors will be able to tap into this investment firepower after the group's local subsidiary, Fidelity Investments Australia, launched what it calls the Fidelity Select Global Small Cap discipline. As the name suggests, it is essentially a bespoke solution for super funds and large investors that want access to the group's top 200 global small cap picks.

Why invest in global small caps? Jason Ciccolallo, the Melbourne-based director and head of institutional sales, said it comes down to three key factors. "Small caps are semi-efficient, under-researched and under-owned." Because of these, you are more likely to find small caps that are heavily discounted to their fundamental value as future growth can be unrecognised or miscalculated. By contrast, large caps tend to be relatively more efficient, over-researched and in come cases, over-owned.

Proof on this is that according to Mercer, all eight of the fund managers in their global small cap survey have beaten their benchmark over the five years. If you also take the performance of international (or EAFE) small caps compared to international equity since 1995, the average rolling 5-year excess return for the median manager of international small caps is 3.35 per cent, or 130 basis points over the same returns of international equity.

Put another way, research from independent quantitative analysis consulting firm Inalytics has shown that the unintended bias of fund managers against small cap stocks cost investors 65 basis points per month in 2006 or a loss of over 7 per cent (700 bps) for the year.

Of course global small caps have beaten global large caps and vice versa, depending on the time period. But Ciccolallo argues that while global small caps will suffer disproportionately during periods of market volatility, their outperformance over the long term will more than compensate for that.

To differentiate themselves from other global small cap specialists, Ciccolallo highlights the size of their investment universe and the resources Fidelity is allocating to research it.

The Fidelity Select Global Small Cap discipline is managed by Boston-based Rob Feldman, the portfolio manager who is also a member of the Fidelity-owned Pyramis Global Advisors' Select team of five professionals headed by Cesar Hernandez. The Select team manages over US$22 billion in assets, of which around US$1 billion are in small caps (no capacity issues).

Feldman and his team are supported by the Fidelity-owned network of around 400 equity analysts based in key cities around the world. The team then uses risk models to build a style-neutral portfolio of the best 200 or so global small cap opportunities analysed by this network.

"Last year, our analysts rated more than 5,100 companies worldwide, equivalent to about 95 per cent of the world's stocks by market capitalisation. About 3,500 of these stocks are small caps – those with a market capitalisation of between US$100 million and US$5 billion."

"As fewer analysts cover global small caps, there are correspondingly greater opportunities for Fidelity's own extensive company research to uncover investment opportunities that are undiscovered by the market."

He added, "It's not just the size aspect, it's the fact that Australia just doesn't offer investors some of the investment exposures they need. Aerospace, motor car manufacturing, defence, big IT and telecommunications suppliers, big pharmaceutical companies – they need to go overseas to get those exposures."

JASON CICCOLALLO

Investment strategy

To build the portfolio, Fidelity's research team translates visits to shopfronts, factory floors and satellite offices into bottom-up fundamental research, stock selection and portfolio construction.

"Our process aims to identify companies with strong management teams, strong top and bottom-line growth potential and the potential to gain market share, to name a few, " said Ciccolallo.

"Our portfolio construction parameters also limit our sector exposures to plus or minus three per cent to ensure that the portfolio remains focused on stock selection."

It is also the group's people skills that will give investors the necessary alpha at a time when the sub-prime crisis is generating winners and losers. "Fidelity's contingent of well informed analysts provides us a competitive advantage versus other managers who may rely solely on quantitative models," he said.

"Fundamental analysis is central to our investment process. Many of the things that we look for in an investment are difficult or impossible to quantify. These could be the strength of the management team and its ability to execute, the market potential of new product offerings or the prospects for a successful corporate restructuring."

He stressed, "It is primarily these intangible factors that enter into the decision to buy or sell a stock, but also the level of conviction in the investment thesis which results in the size of the investment in the portfolio."

Admittedly there are risks. "Foreign investments, especially those in emerging markets, involve greater risk and may offer greater potential returns than US investments. These risks include the political and economic uncertainties of some foreign countries and currency fluctuations. There are additional risks associated with those funds that concentrate in one geographic location."

But as the saying goes: no pain, no gain. In Fidelity's case, it is through painstaking research in the less transparent and more volatile world of small caps that they aim to deliver returns. "Because of the inherent inefficiencies in the sector, there exists strong potential for alpha generation and that makes it an attractive sector to invest in."

In short, a Goliath in the investment world takes on the Davids of the global stockmarkets and it's a win-win situation for them and for their clients. ∎

Statistics

Portfolio manager	Rob Feldman
Benchmark	S&P/Citigroup EMI World
Objective	To outperform its benchmark by 3% pa on a rolling three-year basis
Ex-ante tracking error	Generally between 4% and 6%
Portfolio constraints	Stocks: Generally +/– 2% from benchmark Sectors: Generally +/– 3% from benchmark* Country: Generally +/– 3% from benchmark* Region: Neutral
Number of stocks	Between 175 and 225

* Country and industry allocations are a result of stock selections. These ranges are guidelines only.

S&P/Citi EMI Global Index

Return in global small companies from Nov-02 to Oct-07 – S&P/Citi EMI Global Index (before tax and before fees)