

Investing in Australian Small Caps

SMALL CAPS AS AN INVESTMENT THEME

Market capitalisation is a measurement of the size of a company. It is the current share price times the number of outstanding shares. Small caps – or small market capitalisation companies – refer to a sub-set of the investment universe that has relatively lower market value. There is no universal definition for “small capitalisation” and it differs from market to market. For Australian equities, “small caps” usually refers to stocks in the S&P/ASX Small Ordinaries index which have a market value between \$54M and \$2.2B¹. Small caps may exhibit the following characteristics:

- new or young companies with shorter operating track record than their large-cap counterparts,
- companies that offer new products or services, using new business models, distributing through new channels or owning reserves that can be converted into profitable projects,
- companies with a simple operation and usually within a single geographical location,
- a lack of analyst coverage which can increase the likelihood of information asymmetry,
- securities that are thinly traded and hence investors demand a higher return to hold these stocks should they need to liquidate their investment quickly.

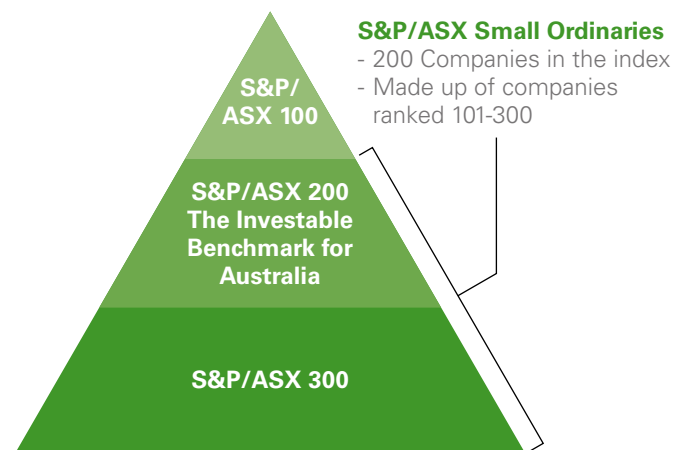
One compelling reason for investing in small caps is the growth potential that small companies offer – most of today’s large and successful companies started small. Fortescue Metal Group is a good example. Since formation in 2003 the company has transformed from a mineral resources explorer to become the world’s fourth largest producer and exporter of iron ore today. The company produced and shipped 39 million tons of iron ore in 2010 financial year and currently is one of the top 50 companies (in terms of market capitalisation) listed on the Australian Securities Exchange². While it’s true that a small cap will not necessarily produce spectacular growth just because it’s small, it’s also true that it’s easier for a junior miner to double sales or earnings than a global giant like BHP or Rio Tinto. Other reasons for investing in small caps include easy to understand business models and financial reports. Operating in a single jurisdiction or having only a few products or services makes it easier for investors to understand individual companies without the need to have sophisticated business or financial backgrounds.

Due to the associated risks and characteristics, small caps aren’t necessarily an investment choice for every investor, but they do offer some appealing attributes such as the ability to grow rapidly. Factors such as high business risks, thinly traded or lack of analyst coverage can be viewed as a disadvantage, but for some investors, these factors can actually present an opportunity.

S&P/ASX SMALL ORDINARIES INDEX

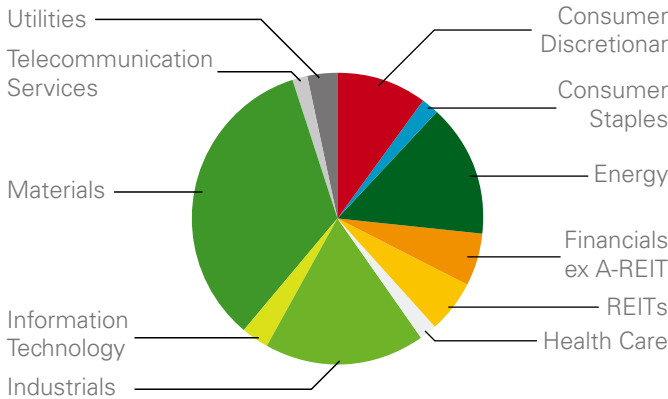
The S&P/ASX Small Ordinaries Index is a key benchmark for small-cap investment in the Australian equity market. It is a subset of the S&P/ASX 300 Index comprising shares included in the S&P/ASX 300 Index but not included in the S&P/ASX 100 Index (See Figure 1). The Index covers approximately 6% of the Australian equity market by capitalisation. Further information on the Index, including its past performance, is available on the S&P website at www.indices.standardandpoors.com. Figure 2 provides a GICS sector breakdown of the index.

FIGURE 1: MAP OF S&P/ASX INDICES



Source: S&P/ASX

FIGURE 2: BREAKDOWN OF S&P/ASX SMALL ORDINARIES INDEX BY GICS SECTOR

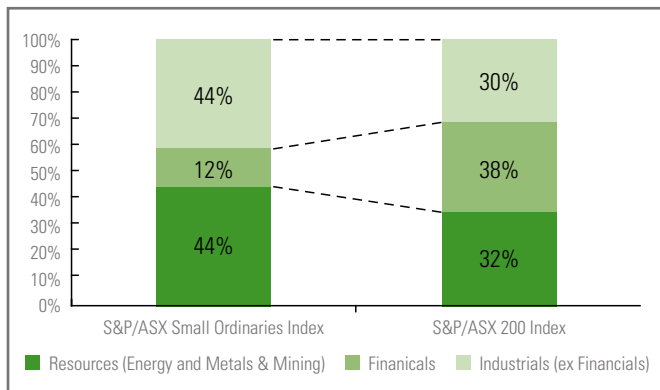


Source: S&P/ASX as at 31 January 2011

HIGHER EXPOSURE TO SMALLER RESOURCE COMPANIES

Unlike the broader market index like the S&P/ASX 200 which is dominated by the financials sector; the small-cap index is dominated by small resource and industrial companies with financials accounting for less than 15% of the market capitalisation (See Figure 3). As a result, the risk and return characteristics of the S&P/ASX Small Ordinaries Index is driven by the small resource and industrial companies.

FIGURE 3: S&P/ASX SMALL ORDINARIES INDEX COMPARED

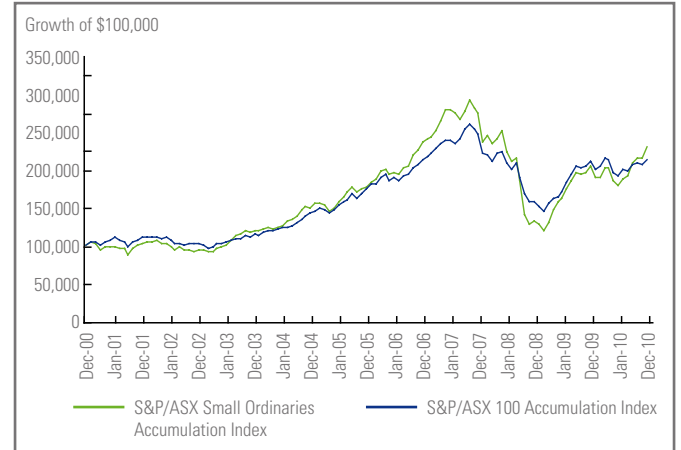


Source: S&P/ASX as at 31 January 2011

HISTORICAL PERFORMANCE

Academic research and practitioners both recognise a role that a small-cap investment can play in an investor's portfolio. Due to their different characteristics and risk profiles, one can expect small caps to perform differently from their large-cap counterparts. Historical performance of the Australian equity market supports this argument. There have been periods where the S&P/ASX Small Ordinaries outperformed the large caps significantly and there have been periods where large caps provided superior returns (Figure 4). Historical performance is not an indication of future performance which could substantially differ.

FIGURE 4: HISTORICAL PERFORMANCE, DECEMBER 2000 – DECEMBER 2010

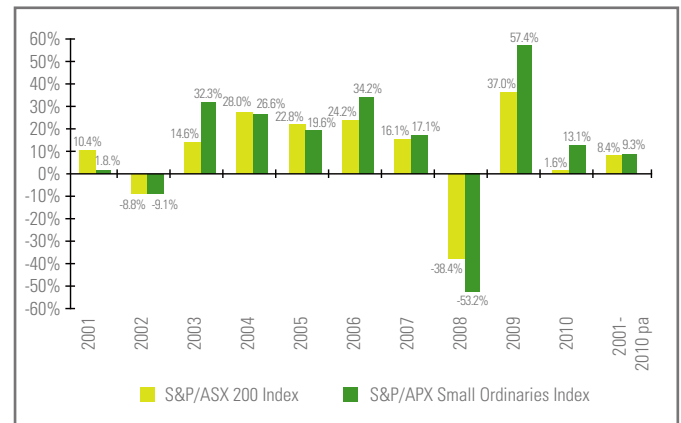


Source: SSgA, S&P/ASX

HIGHER RETURN AND HIGHER RISK

Small cap stocks generally represent less established companies. While this makes them faster growing and potentially more profitable, it also means they are much more volatile than well established large cap stocks. Figure 5 shows, while producing a slightly better return over the last decade, small caps had also experienced higher volatility than the broader market. As a measure of risk, standard deviation (or variation of returns) was significantly higher for small caps than the broader market index for the 10 years ended December 2010 (Figure 6). For small caps over this period higher return has in fact meant higher risk.

FIGURE 5: HISTORICAL ANNUAL PERFORMANCE, DECEMBER 2000 – DECEMBER 2010



Source: SSgA, S&P/ASX

FIGURE 6: RISK AND RETURN FOR 10-YEAR ENDED DECEMBER 2010

	10 Years Return	10 Years Standard Deviation
S&P/ASX Small Ordinaries Index	9.27% pa	18.73%
S&P/ASX 200 Index	8.40% pa	13.58%

Source: SSgA, S&P/ASX

SPDR S&P/ASX SMALL ORDINARIES FUND

Exchange Traded Funds (ETFs) have become increasingly popular among both institutional and retail investors as a means of gaining passive exposure to a market segment or index. An ETF contains a basket of shares that tracks a specific index, providing instant diversification compared to a single share. ETFs can be bought and sold on listed stock exchanges through brokers just like normal shares, giving investors full control and flexibility over their investment.

Benefits of investing in a passive ETF include trading flexibility, diversification, low management costs and transparency. Given they are passively managed, ETFs tend to have lower turnover than actively managed funds, which can reduce overall transaction costs. Another major advantage of an ETF strategy is its transparency. Transparency levels are high; investors usually have access to the underlying index methodology, with performance and regular reporting also required by the Australian Securities Exchange.

The SPDR® S&P/ASX Small Ordinaries Fund tracks the S&P/ASX Small Ordinaries Index and has been launched with a particular view to investors seeking exposure to the small-cap segment of the Australian equity market. Investors should consult the PDS which is available from <http://www.spdrs.com.au> before investing.

POTENTIAL INVESTORS:

- **INVESTORS SEEKING AN ECONOMICAL, PRECISE, WELL-DIVERSIFIED EXPOSURE TO SMALL CAP SEGMENT OF THE AUSTRALIAN EQUITY MARKET:** The ETF provides exposure to a diverse set of stocks and sectors in the S&P/ASX Small Ordinaries Index, a small cap benchmark for Australian equity market.
- **INVESTORS SEEKING LONG-TERM GROWTH** looking for exposure to the high growth potential offered by smaller size companies – most large and successful companies started as a small company.
- **INVESTORS WITH A TOLERANCE FOR VOLATILITY:** while providing the potential for higher returns over time, historically small caps have experienced higher volatility and aren't necessarily suitable for every portfolio, especially for investors with a shorter investment horizon.

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* This AUM includes the assets of the SPDR Gold Trust (approx. US\$58 billion as of December 31, 2010), for which State Street Global Markets, LLC, an affiliate of State Street Global Advisors serves as the marketing agent.

¹ Source: S&P/ASX as at 31 January 2011

² Source: <http://www.fmgil.com.au> and FMG's 2010 Annual Report

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These investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities. Diversification does not ensure a profit or guarantee against loss.

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