Small is beautiful

Charles Gave | GaveKal | 27 May 2015 |

At the end of the 1980s, the world changed with the collapse of the Soviet Union and the start of China's renaissance. The next two and a half decades were marked by a mass movement towards globalisation. We now have a long enough history to determine who the winners were over those 25 years. The answer is very simple - small countries.

If I build an index of countries which have the following characteristics:

1. They have fewer than 10 million inhabitants.
2. They retain their monetary sovereignty.
3. They have enjoyed the rule of law, since at least 1970.

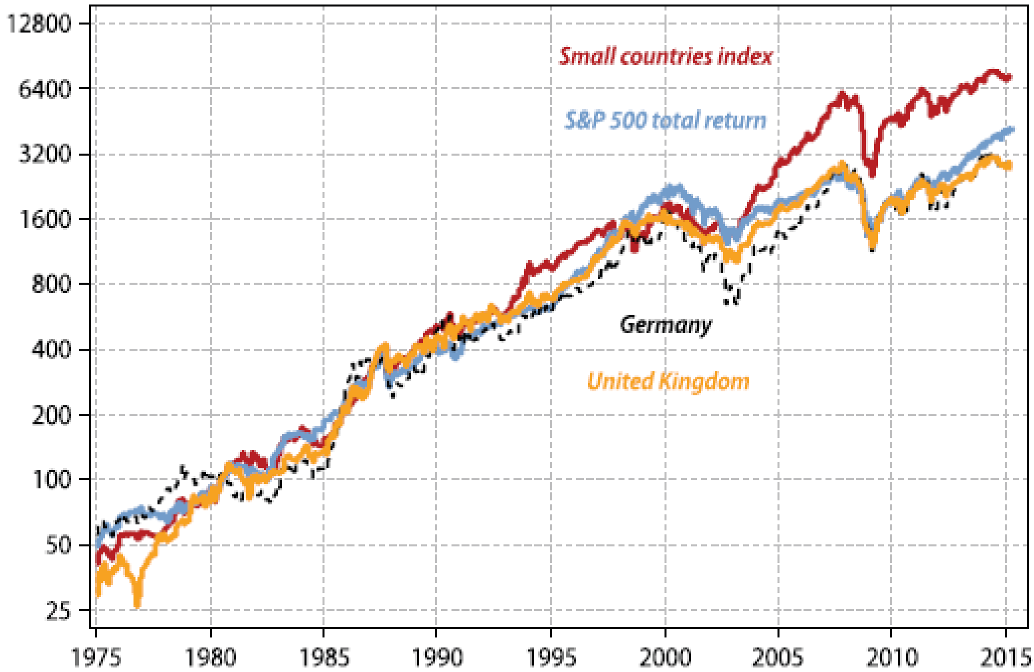
I come up with seven constituents: Denmark, Norway, Sweden, Switzerland, New Zealand, Singapore and Hong Kong (technically not a country, but as good as one for my purposes). Together, these seven countries - three Northern European social democracies, two Asian city states, one maker of cuckoo clocks and one producer of outstanding rugby players - have outperformed the world's major developed markets in no uncertain terms.

To demonstrate this, I built an equally-weighted index of these six countries using the total return of the MSCI stock index for each in US dollar terms. In Figure 1, I compare this "small is beautiful" index to "normal" competitors, including the US Total Return Index and the equivalent UK and German indices.

There are a couple of things to note:

- The move towards globalisation "killed" Japan. When the world entered a period during which one had to be nimble-footed to prosper, Japanese companies found themselves at a bit of a loss.
- The big winners were the small countries, where companies have always been nimble-footed because if they were not, they disappeared.

Figure 1: The "small is beautiful" index and competitors



Sources: Gavekal Data/Macrobond

This makes perfect sense. In a globalising world, a premium will naturally develop on the financial markets of countries which can operate politically at a lower cost. Put bluntly, managing the state is simpler and easier when your population is fewer than 10 million. A more responsive and more responsible state tends to be a better-managed state (which does not necessarily mean a smaller state). And, a better-managed state tends to translate into a higher rate of economic growth and higher earnings. In a nutshell, small states seldom indulge in demagogy. When they do, it does not last long, as they are not too big to fail (consider Sweden in 1992).

With the benefit of hindsight, to outperform the US index, the World index, the German, the Japanese, or any index for that matter, all you had to do was buy an index of small countries because they are where you find the efficient companies (many far from small) that prospered not because of subsidies, but because they were the best at what they do.

Small countries cannot waste capital nurturing national champions. The states are well managed, the social contracts strong, and the accountability of the political class enforced ruthlessly by the populations. We can be pretty sure that the rule of law protects private property. And, finally, they were smart enough to retain their monetary sovereignty, giving them the flexibility to adapt constantly to a challenging environment. It is in small countries that Joseph Schumpeter's creative destruction applies most effectively, since governments are not big enough to save zombie companies, while electorates frown upon grand government plans.

The investment conclusion is obvious - overweight good companies listed in small countries. My next step will be to build an index for the total return of bond markets to see if I get the same results. Stay tuned.

Charles Gave is Founding Partner and Chairman of GaveKal Research. GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.
