INVESTMENT

Looking small

Lynn Strongin Dodds questions whether investors' attention should now be focused on the small and mid cap section of the stock market

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Despite an impressive long-term track record, small and mid-cap companies are often a neglected segment of the stock market. Institutional investors tend to focus more on their larger brethren but now as the economic tide is beginning to turn in Europe, this may be their time to shine. As always selectivity is key in order to unearth the most attractive opportunities in this sector.

There is definitely catching up to do. Last year the MSCI Europe small cap was trailing far behind. It turned in a negative performance of 1.7% compared to the MSCI World Small Cap's healthy 13.25% rise and the Russell 2000's 20% hike. However, over the longer term investors have been rewarded with the MSCI World Small Cap returning around 9%, outshining its larger-cap colleagues by 5% from 31 December 2000 to 28 February 2017.

"If you look at history, there is definitely a small cap effect but they have had to weather volatility," says M&G Investments multi-asset fund manager Eric Lonergan. "The US investor has had a different experience because these stocks, as demonstrated by the Russell 2000, have outperformed. This is not the case with European investors who are still in a more risk averse mindset. However, I think there is more opportunity for profit growth and price/earnings multiples outside of the US because the rest of the world tends to lag behind the country."

Recovery

In fact, there are several signs that a sustained recovery is underway in the eurozone, even though the European stock markets have been laggards. The region has posted 15 consecutive quarters of positive growth while the unemployment rate has returned into single digits – the lowest since 2009. Moreover,

Small cap

WE SEE TWO CLEAR REASONS WHY SMALLER US COMPANIES ARE NOW PARTICULARLY ATTRACTIVE RELATIVE TO LARGE CAPS: INDUSTRY EXPOSURES AND VALUATIONS

the latest (March) preliminary purchasing manager's index (PMI) showed that Germany, Europe's largest economy, hit a record 71-month high at 58.3, followed by the overall eurozone at 56.2, its best reading since April 2011.

In addition, for the month of February, the Economic Sentiment Indicator (ESI) – which measures industrial confidence, services confidence, consumer confidence, construction confidence and retail trade confidence – posted a score of 108, which was above its 26-year average of 100. This is despite the tailwinds of French and German elections on the horizon.

This is good news for small to mid-cap stocks because "if you look at the indices you will see that they are more exposed to the domestic economy than their larger counterparts, which is why we like the sectors of consumer goods and industrials," says Morningstar portfolio manager Clémence Dachicourt. "The valuations are not that compelling but there is a growth over value bias. However, unlike large caps, in general these companies tend to be more entrepreneurial and leaner organisations so there needs to be a greater focus on not just their business but also the management team, decision-making process, margins and sales and whether their business model is sustainable."

Mandarine Uniqueat co-fund manager of European small and mid caps fund Marie Guigou also believes that small caps are more geared towards a recovery. "If you look, for example, at the Stoxx Europe Small 200 index, around 20% of the companies are exposed to the industrial goods and services sector compared to around 10% of the Stoxx Europe 600," she says. "Small and mid caps are always more expensive but today, they are trading at a P/E premium of 8% to large caps, which is below their historical P/E premium average of 15%."

Criteria

As for its investment process, the fund managers of Mandarine Unique have a set of criteria that they employ. The companies they look for have to fulfil at least one of the four criteria of uniqueness, which are no listed competition in Europe, a 25% global market share, a specific geographical bias or a technological edge. Holdings include Elis, a laundry service company that derives 80% of its profits from France where it holds a 50% market share, as well as Irish-based insulation firm Kingspan Group, the only pure-play on insulation boards and panels listed in Europe, which currently benefits from fuel efficiency regulation.

Specialist companies who have dominant positions in niche markets are also a prominent feature for J.P. Morgan European Smaller Companies fund manager Francesco Conte. On his list are luxury retailers, automotive component companies that provide parts to high-end car manufacturers such as Ferrari, Porsche and Mercedes, as well as an industrial group that has 70% of the world's market share in the manufacturing of machines that make teabags.

While European companies may be turning some heads, Hermes head of US small and mid cap Mark Sherlock believes there is value in the US. "The dramatic shift in US leadership has fundamentally changed the outlook for domestic small- and mid-cap (SMID) stocks," he says. "The consensus view that the economy was locked in a low-growth, low-inflation mode should be revisited. This changing backdrop suggests that the currently popular positioning in large-cap defensive stocks may no longer be a winning strategy. We see two clear reasons why smaller US companies are now particularly attractive relative to large caps: industry exposures and valuations."

OUR ADVICE IS TO BUILD AN ALLOCATION TO SMALL CAPS THROUGH THE CYCLE AND DO NOT USE THE PENSION FUND'S GOVERNANCE BUDGET TO TIME THE INVESTMENTS

The first reason is the same as in Europe – these stocks typically have a 70% to 80% exposure to the domestic economy, compared with 50% for large caps, according to Sherlock. Within this, smaller companies are substantially better represented in the industrial and financial sectors, and should generate stronger relative earnings momentum due to increased infrastructure spending and the margin-boosting effects of a steeper yield curve and higher short-term interest rates.

He adds that given these powerful fundamental drivers, these stocks represent good value relative to large caps. "Their current premium of a 1.1x price-to-earnings multiple over large caps is lower than the long-term average of 2x, suggesting that the market has not fully factored in the strength of the growth outlook for these companies," he says. "In contrast, large-cap defensive stocks appear expensive relative to small caps. Persisting with an allocation to these businesses at the expense of smaller companies may incur significant opportunity cost."

Ground rules

Despite the current set of prospects, there are a few ground rules that should be followed given the idiosyncratic nature of the sector. "The mispricing can be a fertile hunting ground for active managers but our advice is to build an allocation to small caps through the cycle and do not use the pension fund's governance budget to time the investments," says Redington vice president, manager research Oliver Wayne. "Allocations will also depend on the specific nature of a pension fund's asset liability management profile, but there is no silver bullet. However, it may not be suitable for well-funded funds whereas those that are may want exposure to the higher returns because they do not have to take on any leverage."

Finding an active manager though is not always easy, according to Russell Investments senior portfolio manager Ronnie Sabel. "It is difficult to access the best opportunities in small cap names and you do not want to invest in fund managers whose asset base limits their access to liquidity," he adds. "A smaller and more nimble product is better positioned to exploit the anomalies that are present in small caps."

Overall, though patience is required due to the inevitable bumps along the road. "One of the main differences with investing in small caps is that you need a long-term horizon," says Conte. "They have performed better than large caps over a 20-year period for example, except when there have been crises such as the Asian currency crisis in 1998, the dot com bubble bursting in 2000 and the global financial crisis in 2008. Moreover with over 1,000 companies to choose from in continental Europe, investors can benefit from the broader and more diversified set of opportunities, which thanks to new listing, continues to grow every year." ■