Investing In Small & Mid-Caps

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The small-cap dilemma

Small-caps promise so much as an asset class. But Joseph Mariathasan outlines just how difficult it can be to create a viable business out of managing them

Small-Caps Business Model

The interests of institutional investors and fund managers are often not aligned. That can be due to the nature of performance benchmarks, sometimes to fee arrangements. But sometimes the asset class itself might not lend itself to producing an attractive set of returns at fee rates that are seen to be fair to both investors and managers.

That may well be the case for global small-cap equities. Their relative illiquidity and lack of research coverage throws up great opportunities as well as challenges – but few small-cap strategies can combine low turnover with high capacity and the ability to generate alpha.

Small-caps account for around 15% of the global equity universe, comparable to the size of emerging markets, yet their weightings in typical portfolios appear to be much less than this market weighting would suggest. In the UK IMA sector aggregates, for example, investors' exposure to global smaller companies is only around 1% of the global growth sector. But while

there has been plenty of discussion about the merits of ensuring that exposures to emerging markets are at last equal to their current share of global market cap, the same cannot be said of small-caps.

Dedicated smaller company strategies are a difficult business proposition. They require at least the same or, arguably, much more work per company. The high idiosyncratic risks – and greater risk of bankruptcy and fraud – require close monitoring and well-diversified portfolios. And things are only getting tougher: broker coverage of smaller companies in Europe has actually diminished since the financial crisis as investment banks cut back on staff.

"In many fund management organisations, running small-cap portfolios is seen as a training ground for new fund managers before they are let loose on greater things," says Simon Hallett, managing director at Cambridge Associates. "Arguably it should be the reverse."

The killer for most fund managers contemplating putting in the necessary resources is capacity, where there is a direct conflict of interest between institutional investors and their fund managers.

"If a firm is building a high-conviction portfolio of 50-70 stocks, they have to be careful on capacity as they can end up making a market in their own stocks," Hallett warns. "If the firm experiences difficulties that have nothing to do with fund performance, such as a personnel change, clients may pull their investments and force the firm to sell stocks, increasing pressure on the remaining clients to pull out, rather than being left with the least-liquid stocks in the portfolio."

For Cambridge Associates, this means that analysis starts with identifying which fund managers have a true all-cap capability, which would alleviate the financial pressures that a pure small-cap manager could face: "What is the remit of the firm? Are they only following the top 300 or so stocks so they cannot identify any undervalued stocks below that cut-off?"

Warning sign

While Cambridge Associates like boutiques generally, the firm faces the dilemma that a specialist small-cap firm needs hundreds of millions under management to ensure the revenues to fund the resources that institutional investors would expect, while the total capacity of a typical active small-cap strategy might not be much more than €2bn. The sweet spot in which a fund management firm can gain new clients from consultants is therefore very small. "One of the characteristics we look for in managers is the ability to close their strategy to new investment at the appropriate point," says Halett. "It is a warning sign for us when their assets have grown to the point that they have become just asset gatherers."

Given these hurdles, why should investors be interested in small-caps at all? Two potential opportunities present themselves: first, the small-cap premium; second, the pure relative valuation story against larger companies; and third, the alpha opportunity.

Eugene Fama and Kenneth French showed that over long periods of time smaller companies have outperformed their larger counterparts, because smaller companies are more risky. Hallett, though, sounds a warning. "The risk premium that small-caps may offer also depends, like emerging market equities, on the price at which you acquire the assets," he says. "Unless you expect a higher return on equity, why should you expect higher earnings growth? Like a lot stylistic effects, the historical data series only starts when they are cheap. If the valuation is wrong, you won't earn a premium."

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On a fundamental level small-caps look healthy, despite the turmoil in the markets.

"European small-caps are much better placed today than they were both in the 2008 crisis and in that of 2001-03," says Götz Albert, head of small & mid-caps at Frankfurt-based Lupus alpha – which is overweight Scandinavia, Benelux and Germany, neutral on UK and heavily underweighted to southern Europe. "We do have some southern European stocks in Italy, a few in Spain, a small number in Greece – but none in Portugal. Switzerland has been heavily hit by their exchange rates and whilst Swiss companies are used to a strong currency, the recent developments mean they have been heavily affected, so we have decreased exposures. Some drug makers do not export to Greece now, as they don't get paid. But there are a couple of small-cap companies in Greece that have a strong international presence and are suitable for investment. In Spain, though, a lot of small companies are oriented to the construction industry and are under pressure, so it does not make sense to invest."

Small-cap fund managers in Europe are all expressing similar themes, according to Bram Bikker, fund selector at Altis Investment Management: "European small-cap managers are all underweight the peripheral countries, [but also] focusing on companies without a lot of exposure to them." He also sees a lot of fund managers looking at niche companies with specific expertise that makes them M&A candidates for big firms that can add value by marrying these specialisms to strong distribution networks.

Small-cap companies have also benefited from building up exposures to emerging markets – whether directly or via supplying larger companies with increasing emerging-market revenues. Nick Hamilton, head of global equity products at Invesco Perpetual, notes that Invesco invests in aircraft component manufacturers that supply Boeing, for example.

Comparing small-cap with large-cap valuations needs to be handled with care since the sector makeup, a key determinant of the volatility of earnings, is very different. The small-cap universe is more cyclical, with larger exposure to consumer discretionary and industrials (as opposed to the consolidated industries such as energy, consumer staples, and the ex-government utilities and telecoms companies that make up the bulk of many large-cap indices). "If we do go into a deep recession, small-caps will lose earnings – perhaps even all earnings," warns Hamilton. "They are very operationally geared."

Trading costs

That would generally inform in favour of diversification, and structural rather than tactical exposure (not least because trading small-caps is expensive). But, on the other hand, price dispersion across small-cap stocks is consistently higher than across large-caps, while correlations are lower – the potential is there to outperform the small-cap index, but the broader the remit, the more challenging outperformance becomes.

"Very few people can manage small-cap actively on a global basis," says Hallett. "Think of the resources that you would need to do the due diligence to ensure that you have sufficient confidence in the management teams and the businesses you invest in, spread across the globe. Passive or quant strategies may be the best way to manage global small-cap." Bikker concurs: "Having local regional managers makes sense, compared with large-cap managers where having strong macro views counts for more."

Invesco Perpetual, which runs a global strategy, disagrees. It is not alone: other firms compete with them, and Aberdeen Asset Management is reported to be planning a strategy. Invesco believes that it is large enough to devote the required resources, deploying eight regionally-focused portfolio managers backed up by the firm's centralised research and top-down macro asset allocation.

If you don't buy that, the drawbacks of limited capacity and expensive transactions can be circumvented. Take the semi-passive strategy of Dimensional Fund Advisers (DFA), for example. DFA used the Fama and French findings to produce portfolios that essentially buy all the stocks within the size universe, giving their portfolios immense capacity and diversification. Trading costs are kept low by the fact that ►

◄ the strategy is not attempting to minimise tracking error against an arbitrary index. Hallett describes the DFA approach as halfway between passive and active quantitative approaches.

Garrett Quigley, co-founder of Global Systematic Investors (GSI) and former investment director at DFA in Europe, believes there are more systematic return effects that can be captured in small-caps to produce strategies that can outperform a passive benchmark, have low turnover to minimise transaction costs, and offer high capacity. He and his GSI co-founder, Bernd Hanke (formerly at Goldman Sachs Asset Management), argue that the historical data series are long enough and robust enough to research a broad range of factors that generate excess returns in small-cap stocks, which they group into six return themes that they use to screen the global universe of 10,000 or stocks. The themes are: valuation and momentum; operating efficiency; quality; management behaviour; analyst sentiment; and earnings sentiment and seasonality.

What DFA and GSI have in common is a portfolio construction approach that is structured around minimising trading costs, rather than tracking error. For an investor, this does make sense, since trading costs represent a real diminution of return, while tracking error against an arbitrary index has no value beyond measuring a manager's risk profile against a passive benchmark.

Successful small-cap investment is difficult to undertake and traditional approaches are difficult to scale up to a size that many of the largest fund managers can get excited about. Yet, for institutional investors, that should not be a reason to neglect the asset class. Matching an index does not make sense if it entails undertaking arbitrary turnover. A better goal might be to explore approaches that explicitly target low turnover while maintaining an alpha-seeking philosophy. It is the ability to integrate trading with stock selection that is the key to success in small-caps.

The 800-pound gorilla

UK exposure – or lack of it – has been decisive in European small and mid-caps. But Martin Steward finds that managers have also had to contend with a difficult 'risk-on, risk-off' environment

Strategy Review **European Small & Mid-Caps**

What is the UK's place in Europe? Don't stop reading. This isn't another dissection of last December's EU Summit. It is, rather, the question that every European small and mid-caps manager must ask itself. The widely-referenced HSBC Smaller European Companies index includes more than twice as many businesses from the UK as it does from Germany, mighty home of the Mittelstand. In terms of market-cap the UK is nearly three times as significant. That's unfortunate, because all of the managers featured in our review find more opportunities outside the UK, where markets remain less well-covered by analysts.

Kempen Capital Management uses the HSBC index to benchmark its Sustainable Small Cap strategy, but explicitly cuts the UK weighting by half to create a more representative reference. The result, today, is a very slight underweight – rather than the 16 percentage points suggested by comparison with the standard index.

Danske Capital's European Equities Small-cap strategy benchmarks against a Morgan Stanley index that weights the UK even bigger – but it has even less UK than Kempen's at a 27 percentage point underweight. "Frankly, I find it difficult to understand why the UK is such a big part of the benchmark," says chief portfolio manager Ivan Larsen.

Similarly, ODDO Asset Management's Avenir Europe strategy is about 23 percentage points underweight the UK. Head of mid-cap equity, Pascal Riégis, articulates why that has been so significant in the slide down the Mercer performance universe between Q2 and Q3 of 2011 (see page 47): "UK exposure has been very positive this year. Take two comparable companies, one based in the UK, one in continental Europe, and the UK firm trades at an 8-10% premium."

In the meantime, European small-cap strategies like Threadneedle's or RCM's (both underweight the UK only around seven percentage points) are outperforming.

So why bet so hard against Britain? Ironically, ODDO's top holding – UK-based Rolls Royce – might offer the clue. Riégis and his co-managers Grégory Deschamps, Sébastien Maillard and Frédéric Doussard, like the aeroplane-engine business model, in general, with its high barriers to entry and recurring maintenance revenues – they also own France's Safran. "We are fortunate in Europe to have two genuine world leaders among the handful of global competitors," he says. And that is the key. The world comes to France and the UK for these products. "The companies we invest in also have an international profile and business model," says Riégis. "But half the UK market is purely domestic – financials, real estate developers, retailers."

Exposure to global markets is a long-term theme that makes a lot of sense. While it can lead into pro-cyclical industrial sectors and experience volatility when global growth slows, it doesn't have to be that way. Alongside Rolls Royce, ODDO his also able to pick out stocks in the defensive med-tech sector on the same international-growth theme, like its fourth-largest holding, Fresenius. Riégis thinks that the potential in its 2008 acquisition of APP Pharmaceuticals has yet to be fully realised; it has opened up a vast new US hospitals market to the German firm, where its bags-within-bags intravenous technology will significantly improve shelf life and reduce hospital costs once it is FDA-approved.

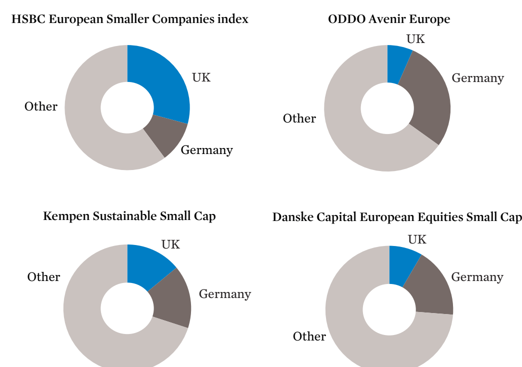
But it's also not just about solid German and Dutch markets. If you want to be contrarian, the international theme can lead you to some intriguing places – like Iberia. Mirroring ODDO's Fresenius play, Danske holds Spanish med-tech blood plasma specialist Grifols, which recently acquired the US firm Talecris Biotherapeutics. "This merger makes Grifols a leading player in this industry," says Larsen. "It's been one of the best performing med-tech stocks during 2011."

In the consumer staples area, Danske also owns Portuguese supermarket chain Jerónimo Martins ("It's not about Portugal but about Poland," says Larsen, alluding to its ownership of the Biedronka brand); Spain's Distribuidora Internacional De Alimentacion (DIA), with growing footprints in Latin America and China; and its compatriot Viscofan, producer of artificial food casings – another company with a truly global footprint, in terms of acquisitions and sales offices from the US to China.

"It's not about the domicile of a company, but about what it's doing and where it is generating revenue," says Larsen. "We don't see ourselves as thematic investors but, of course, you will identify some themes in the stocks you pick – for instance, exposure to emerging markets is interesting."

Rory Hammerson, manager of the Kempen strategy, warns that emerging market demand taps can be turned off painfully sharply – but concedes that it has been a key source of incremental revenue growth for companies in unloved domiciles. Just outside its top 10 page 52 ►

1. UK underweights in pan-European funds



Sources: HSBC; ODDO Asset Management; Danske Capital; Kempen Capital