FOCUS

Dispelling the myths of small & mid cap investing

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Many European equity investors are drawn to large caps because of tradition and visibility, but often dissuaded from looking further down the cap structure due to long-held misconceptions. This raises the question of whether prevailing scepticism has unduly supressed exposure to a dynamic asset class that has outperformed large caps in 12 out of the last 17 years, and year-to-date is outperforming the large cap index by 5.5%.



Claire Shaw
European Mid & Small Cap Equities Expert

« Dividends and small and mid caps are not an oxymoron. »

— *Claire Shaw*
European Mid & Small Cap Equities Expert

While against popular perception, our view is a selective approach to small and mid caps can not only provide investors with a robust exposure to high-growth companies, but also deliver outperformance, regardless of the economic backdrop. In my latest investment update, I seek to dispel some of the key myths that continue to pervade around small and mid-sized companies.

Inherently riskier

The notion small and mid caps are inherently riskier is undermined by a legacy of spectacular blow-ups in the large-cap arena – Enron and WorldCom are just two high-profile cautionary tales.

Investors should not assume as a company's cap size increases, its inherent risk diminishes. Understanding a company's risk factors is not knowing where a company is going or how it is run, but comprehending how a company, regardless of size, can retain a competitive edge.

Smaller means weaker

This also reveals a second related myth around small cap investing: 'smaller means weaker'. By having a selective approach and undertaking in-depth research, investors can get access to leaner, less leveraged balance sheets that are unlikely to be as buffeted by economic storms as some of their large-cap peers.

For us, the secret to small and mid-cap investing lies in buying high-quality businesses with net cash balance sheets and cheap valuations. This allows investors to benefit from strong alpha produced by small and mid caps but without the associated increase in risk.

Beware volatility

It can be argued small-cap companies, as a group, are more vulnerable to changes in the economic cycle and periods of heightened volatility. However, this is an over simplification that masks an important investment point; for investors seeking to identify high-quality businesses in the space, volatility, on the contrary, should be embraced.

For conviction investors, periods of time where certain stocks are out of favour creates optimum buying opportunities. Our research edge lies in buying unknown and unloved stocks – Lucara, one of the foremost producers of Type IIa diamonds is a perfect example of this process.

Lucara is not widely covered by the sell side and the market was punishing its shares for suffering a perfect storm of negative factors in 2017. These short-term and essentially cyclical factors offered an attractive entry point – we bought an incredibly profitable company (EBITDA margins of 55% and ROE at 28%) trading on very cheap multiples, with double-digit free cash flow yields and a 4% dividend yield. Over the long-term, volatility is a friend to patient and long-term investors.

Lack of dividend yield

A long-held income argument, which encourages large-cap investing, is that strong and stable stocks with entrenched market positions focus on creating shareholder value and growing dividends. This may be true, but it's not exclusive to larger-sized companies.

Through our investment process, we often identify companies which can generate good shareholder returns and have high levels of net cash. While the myth of an arid yield environment in small and mid-cap space persists, there are plenty of companies generating free cash flow.

Paying 'the small-cap premium'

The small-cap premium has been well established, but it is an over-generalisation. Over time, we can expect higher average returns for small caps over larger companies, but this does not mean that we should blindly plant seeds with the expectation that trees will grow.

Through our process we actively avoid paying up for the small-cap premium. We engage in forensic analysis and scenario planning before investing in high-quality companies at the point of maximum pessimism, where the small-cap premium is diminished. Russian-Ukranian tensions in 2014, the oil price plummeting to below $30 in 2015 and the Italian banking crisis last year were all themes we invested in at a point where sentiment was at its worst and fear was at its highest.

It is easy to say you are a contrarian, but the reality of execution is difficult and requires real conviction in your process and philosophy. Small and mid-cap investors will endure a heightened level of volatility. However, as contrarian investors, hostility towards certain stocks, sectors and countries is what gets us excited.

By definition, the stocks in our portfolio are often diametrically opposed to our peers' allocations. For conviction investors, the persistence of myths and an inefficient market for small and mid caps has created a fertile ground for true active managers.

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