PRESS CUTTING

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If Big is Beautiful, is Small Successful, Speculative, Sexy or Suicide?

***Jamie Stewart** of Eden Group argues that the key to successful investment in the small cap sector is independent research.*

MARKETS reflect aggregate sentiment. Many participants' injured pride and disbelief at the way in which UK smaller companies have stolen a march on the leaders over the recent period have left them searching for credible excuses and reasons as to what they missed and why.

Over the last four bearish years, the FTSE 250 and Small Cap indices have outperformed on both the downside and on the upside. From January 2000 to January 2004, the FTSE 250 Value index has provided 7.08% annualised returns and the UK Small Cap index 2.16%. This is against declines of 9.38% for the FTSE 100 and declines of 11.85% for the FTSE 100 Growth index. Even the AIM and microcap indices have followed suit.

What can one extrapolate and infer from what went on – wisdom with which to harness future potential?

The difficulties are threefold:

First, technology and quantitative methodologies have become very sophisticated.

Second, companies are as much living organisms as are investors and markets.

Third, hindsight is astonishingly helpful in providing and even fabricating conclusions. Value lies in defining the trends and changes which will hold good for some time yet rather than just explaining yesterday's successes.

There is an understandable case for saying that, during the late 90s, as the dot-com boom shamelessly escalated, an ever-broader raft of technology leaders, their prices surging as institutions felt compelled to chase them upwards, left the mids and smalls well behind.

The moment came when technical analysts, momentum and rotation fanatics, quants and value-hunters all spotted the widening arbitrage opportunity and went for them despite the well-worn cautions. The mid, small and micro-cap indices outperformed as the leaders started to tire.

In early 2000, when it all went soggy, investors in the liquid, large cap shares turned and ran – but those holding the smaller companies, many more experienced than their predecessors and having taken their positions only recently, hung on and effectively protected their own prices.

After that, recovery-seekers and bottom-fishers joined those who recognised the recent resilience of the smaller stocks and bought more, lifting prices and profiles. Thus the lesser caps significantly outperformed the greater on both the upside and the downside, not to speak of the recovery which has followed.

The investor with vision, instinct and wisdom will not dedicate resources to smaller companies purely because they are there. He recognises that, where there is inadequate research, there lies opportunity.

Of all equity market changes over the recent past, the role and profile of research has arguably seen most shift. Paradoxically, it is the sharpest potential facilitator of high-quality stock-selection, yet the trickiest one to identify and the slipperiest to pin down. It has had stick from all sides and all comers at the hands of Spitzer, Myners, the FSA's CP176, and much more…it has claimed victims such as Grubman, Meacher, Blodgett and Kent...and stands accused of bias, corruption, overpayment and inconclusiveness.

"Reach for the best available research – decide on your time horizon, and stick to it"

Within this rather discoloured context, research and analysis as regards smaller and mid-size companies has not come out untainted. The nature of the segment is such that there is arguably less scope for generating mildly or blatantly ill-gotten gains if that is one's wont, largely because the shares are less liquid; Q.E.D.: the lower the capitalisation, the less reliable – let alone impressive – the traditional sell-side research will be.

The answer is independent research. Independent research steers clear of most of the hurdles and pitfalls that can hinder traditional "bundled" broker research. The absence of corporate advisory and issuing work is, by definition, a no-go area for the independents; the challenge for them lies in naturally restricted exposure and trading volumes, which ultimately channel the more rarefied rewards to fewer, better research entities.

One thing is certain: smaller caps, like bonsais and babies, are cute and desirable but the best ones are almost equally as hard to deal with. Reach for the best available research, preferably independent; decide on your time-horizon, and stick to it unflinchingly; keep your nerve. There is little new in that finding, but by logic it is therefore a time-honoured formula, and there is a fair-to-better chance that it will keep on working!

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