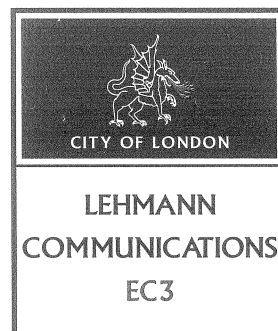


# PRESS CUTTING

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## It's a mini adventure

If a big company is supposed to be beautiful for institutional investors, does that mean small is successful, sexy or suicidal? Independent research is the key to knowing, says **Jamie Stewart**



**Many investors' injured pride and disbelief at the way** in which UK smaller companies have stolen a march on the leaders in recent years have left them seeking credible reasons for what they missed and why.

Over the past four bearish years, the FTSE 250 and small cap indexes have outperformed the FTSE 100. From January 2000 to January 2004, the FTSE 250 Value Index has given 7.08 per cent annualised returns and the UK Small Cap Index 2.16 per cent. This contrasts with a decline of 9.38 per cent for the FTSE 100.

Can we learn anything from what has happened here? Hindsight is astonishingly helpful in providing – and even fabricating – conclusions. The real value lies in defining the trends that will hold good for some time, rather than explaining yesterday's successes.

There's an understandable case for saying that the technology leaders – their prices surging as the dotcom boom escalated shamelessly and institutions felt compelled to chase them upwards – left the mids and smalls well behind in the late 1990s. The moment came when technical analysts, the momentum and rotation fanatics, the "quants" and the value-hunters all spotted the widening arbitrage opportunity and went for it, despite the well-worn cautions. The mid, small and micro cap indexes outperformed the leaders as they started to tire. When it all went soggy in early 2000, investors in the liquid large cap shares turned and ran, but those holding the smaller companies hung on and effectively protected their own prices.

After that, the recovery-seekers and bottom-fishers joined those who recognised the resilience of the smaller stocks and bought more of them, lifting prices and profiles. So it was that the lesser caps significantly outperformed the bigger ones on both the upside and the downside, not to mention the recovery that has followed.

Unsurprisingly, supply and demand have had a leading role to play in this. Growth in terms of the number and value of new listings of smaller caps relative to the market overall has slowed over the past 15 years – and more so during the cyclical downturn of the past five. There has also been an increase in the number of de-listings that have made companies private again. The hidden virtue of de-listing is that the weaker firms, with fewer prospects and less robust cash positions, may disappear and thereby improve the relative position of their competitors and indexes.

The demand side has seen the emergence of a greater number of sophisticated retail investors. Their portfolios and unit sizes readily accommodate smaller caps, which institutional investors may have to avoid. The market-wise retail investor acts increasingly like the

first-time buyer in the housing market by actively supporting the cause of market activity further up the chain. The result has been that smaller caps are thriving in a happier environment better suited to their nature.

At the same time, though, small can be distinctly unbeautiful. Low cap firms are usually less prominent and less closely watched than the leaders, so weaknesses – even the occasional instance of mismanagement or fraud – can go undetected until it's too late. Unilever will scarcely wobble if someone gets a flowchart wrong or a figure out of place, but it could be the death-knell for UKSmallCo. Forewarned is forearmed.

But investors with vision, instinct and wisdom will not dedicate resources to smaller companies purely because they are there. They recognise that opportunity knocks where there is inadequate research.

The prospects of these small, mid and micro cap companies are as plentiful and convincing as they are hard to identify, quantify and evaluate. One equally small word – but one with big implications – is the key: research. Of all recent equity market changes, the role and profile of research has arguably seen the most shift. Paradoxically, it's the sharpest potential facilitator of high-quality stock selection, yet the trickiest one to identify and the hardest to pin down. The research community has taken flak from the Spitzer inquiry, the Myners review, the Financial Services Authority's consultation paper 176 and many others. It stands accused of bias, corruption, overpayment and inconclusiveness.

In this rather discoloured context, research and analysis with regard to smaller companies has not come out untainted either. The nature of their market is such that there is arguably less scope for generating ill-gotten gains, largely because the shares are less liquid. The lower the capitalisation, the less reliable – let alone impressive – the traditional sell-side research will be.

The answer is independent research. This steers clear of most of the pitfalls that can hinder traditional "bundled" broker research. Since independents do not combine corporate advisory services with issuing work, the challenge for them lies in naturally restricted exposure and trading volumes, which ultimately channel the more rarefied rewards to fewer, better research bodies.

One thing is certain: smaller caps, like bonsais and babies, are cute and desirable. But the best ones are almost equally hard to deal with. Reach for the best available research, preferably independent; decide on your timescale and stick to it unflinchingly; and keep your nerve. There's little new in that advice, but it's therefore a time-honoured formula, and there's a fair to good chance that it will continue working well.

**Jamie Stewart** is head of institutional marketing and independent research at Eden Group