

SMALL SHARES

edited by: Polly Fergusson

How to spot the beautiful in the small

What can investors learn from the way small caps have outperformed their larger peers? And what role does research play? Eden Group's Jamie Stewart has some ideas for the future

UK smaller companies have stolen a march on their leaders recently and investors have been examining what they missed and the reasons why they failed to spot them, and working out how to spot the remaining 'hidden gems'.

Over the past four bearish years, the FTSE 250 and Small Cap indices have outperformed on both the downside and on the upside. From 2000 to 2004, the FTSE 250 Value index has provided 7.08% annualised returns (10.81% annualised in risk-adjusted terms) and the UK Small Cap index has returned 2.16% and 2.68% respectively. This is against declines of 9.38% and 17.49% for the FTSE 100 and declines of 11.85% and 23.22%, again, respectively in each case, for the FTSE 100 Growth index. Even the AIM and micro-cap indices have followed suit.

What can investors extrapolate from such outperformance and what wisdom can be gained to harness future potential? Unfortunately, the difficulties are threefold. One, technology and quantitative methodologies have become very sophisticated. Two, companies are as much living organisms as are investors and markets. Three, hindsight is astonishingly helpful in providing and even fabricating conclusions. However value lies in defining the trends and changes that will hold good for some time rather than just explaining yesterday's successes.

As the dot.com boom escalated during the late 1990s a raft of technology leaders left the mid-sized and smaller companies well behind, their prices surging as institutions felt compelled to chase them upwards. Further down the food-chain, the micro caps and AIM stocks followed suit.

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



Jamie Stewart

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 structure

By early 2000, when it all went soggy, investors in the liquid, large 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. The lesser caps significantly outperformed the greater on both the upside and the downside, not to speak of the recovery that has followed.

Not surprisingly, supply and demand has a leading role to play. Growth in the number and value of new listings of smaller caps, relative to the market overall, has slowed over the past fifteen years, even more so during the cyclical downturn of the past five. There has also been an increase in de-listings taking companies private. The hidden virtue of de-listing is that weaker companies with fewer prospects and less robust cash positions may disappear and enhance their competitors and indices.

The demand side has seen a greater number of more sophisticated retail investors emerge; their portfolios and unit sizes can readily accommodate the smaller caps that institutional managers 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 structure. The outcome is that smaller caps are thriving in a happier environment better suited to their nature.

But Small can also be distinctly unbeautiful: low-cap companies are usually less prominent and less closely followed than the leaders, and weaknesses – even occasional blatant mismanagement and fraud – can thrive undetected; for example the ongoing court case into Versailles Trade Finance Versailles is the Parmalat of UKSmallCo Land. Management style and strategy gain higher gearing in younger companies: Unilever will scarcely wobble if someone gets a flow chart wrong or a figure out of place, but UKSmallCo can expire. Forewarned is forearmed.

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Forward-thinking investors will not dedicate resources to a smaller company simply because it is there. They should recognise that, where there is inadequate research, there lies opportunity.

The frailties, strengths and prospects of these small, mid and micro-cap companies are as plentiful, but at the same time difficult to identify, quantify, monitor and evaluate. One small word has big implications and says it all: 'research'.

Of all equity market changes over the recent past, the role and profile of research has arguably shifted most. Paradoxically it is the sharpest potential facilitator of high-quality stock selection. Yet it is the trickiest factor to identify and the most difficult to pin down. Analysis has had stick from all sides and all comers at the hands of Spitzer, Myners, the FSA's CP176, and others. It has claimed what are now household names in the City – analyst victims such as Grubman, Meacher, Blodgett and Kent, and stands accused of bias, corruption, overpayment and inconclusiveness.

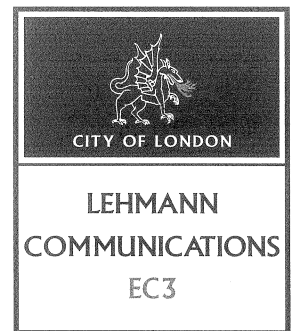
Within this rather discoloured context, research and analysis regarding smaller and mid-size companies has also emerged somewhat tainted. There is arguably less scope for generating ill-gotten gains through research that 'ramps', largely because the shares are less liquid. But generally, the lower the capitalisation, the less reliable the traditional research will be.

One answer is independent research, which steers clear of most of the hurdles and pitfalls that can hinder traditional broker research. Apart from carrying out your own investigations into a company, there are more independent research boutiques being set up, often stuffed with well-respected analysts from senior investment banks disillusioned with existing outfits.

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 bonsai trees and babies, are cute and desirable, but the best ones are almost equally as hard to deal with. Do your research, decide on your time-horizon, stick to it unflinchingly and 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-good chance that it will keep on working well ■

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