The research imperative

When investing in companies, if big is beautiful, is small successful, speculative, sexy or suicide? *Jamie Stewart** provides some insight

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 percent annualised returns, and 10.81 percent annualised in risk-adjusted terms, and the UK Small Cap index 2.16 percent and 2.68 percent, respectively. This is against declines of 9.38 percent annualised, and 17.49 percent annualised risk-adjusted, for the FTSE 100, and declines of 11.85 percent and 23.22 percent, again respectively, 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. Further down the food-chain, the micros and AIM stocks followed suit.

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.

Not surprisingly, supply and demand has its leading role to play in this. Growth in terms of number and value of new listings of smaller caps relative to the market overall has slowed over the last 15 years, more so during the cyclical downturn of the last 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 on a relative basis.

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

At the same time, small can be distinctly unbeautiful: a low-cap company is usually less prominent and less closely followed than the leaders, and weaknesses – even the occasional instance of blatant mismanagement and fraud – can thrive undetected.

Opportunity

But 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.

The frailties, strengths and therefore prospects of these small, mid- and micro-cap companies are as plentiful and convincing as they are difficult to identify, quantify, monitor and evaluate. One equally small word - but one with big implications - gets one there: Research. It says it all.

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 stands accused of bias, corruption, overpayment and inconclusiveness.

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. QED: 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. 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-good chance that it will keep on working well! ■

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