Smaller Companies

The long-term opportunity

Standard Life Investments

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Introduction

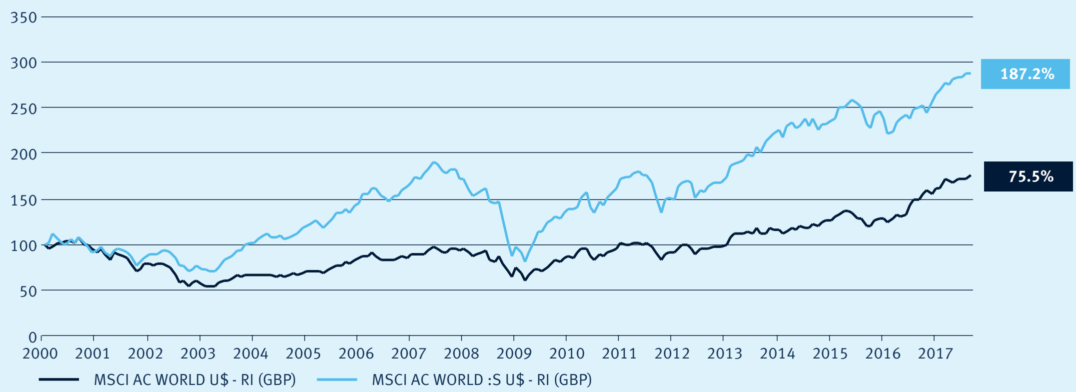
Over the longer term, smaller company returns have outstripped those of their large-cap peers - the 'smaller companies' effect. Traditional academic theory suggests that abnormal returns are fleeting, arbitraged away by investors seeking to exploit the anomaly. However, various factors suggest that the asset class could continue to generate premium risk-adjusted returns over the long term.

In this paper, we examine the reasons for these outsized returns and outline why the factors behind this small-cap effect are structural and likely to persist for some considerable time. Supported by long-term, structural tailwinds and with a proven track record of delivering strong risk-adjusted returns above those of larger-cap peers over time, smaller companies may deserve a higher allocation in investor portfolios.

The smaller-company effect

The first 10 years of the millennium were frequently described as a 'lost decade' for equities. Global stock markets generally have since strengthened considerably. However, long-term returns from large-cap and small-cap equities have diverged starkly. Indeed, between 1 January 2000 and 1 September 2017, global large-cap equities delivered a 75.5% total return. By contrast, total returns from global smaller companies have been dramatically stronger, at 187.2% (Chart 1).

Chart 1: Small and large-cap global performance



MSCI AC World Index – Total Return Index (£) and MSCI AC World Small Cap – Total Return Index (£)
Source: Thomson Datastream, 01 January 2000 to 1 September 2017

History shows that once investors come to recognise that a performance anomaly exists, they have sought to tap into it very quickly. As professors Dimson and Marsh of the London Business School have identified[1], this has meant that any 'stock market anomaly' is likely to prove not only short-lived, but may even reverse comparatively soon after it is discovered.

Investors normally gravitate towards sectors whose returns have historically been highest. Why then, despite their consistently strong returns and outperformance, is the smaller companies sector still systematically underappreciated? We outline in later sections our views on why this anomaly persists, as well as why we believe that smaller companies will remain underappreciated for many years to come.

There are powerful forces at work in the world of investing that tend to steer investors towards the largest companies and away from smaller stocks. These forces ensure that the undervaluation of smaller companies is not fully arbitraged away, allowing steady outperformance over time.

Smaller-company investing certainly entails additional considerations, such as liquidity and risk, over and above mainstream equity investing. The sheer number of companies involved also makes investing in global smaller companies a particular challenge. This places a premium on a workable and reliable investment process that – above all – has the potential to deliver consistently strong returns in the medium and longer term.

As investors become increasingly global in their outlook, the MSCI All-Country World Index has grown in prominence as the global equity benchmark. However, this index excludes smaller companies. Based on MSCI definitions, smaller companies represent as much as 14% of the combined investable universe. This means that many of those investing in global equities have bypassed the returns available from smaller companies.

"There are powerful forces at work in the world of investing that tend to steer investors towards the largest companies and away from smaller stocks"

[1]Source: 'Numis Smaller Companies Index – 2015 Annual Review,' Elroy Dimson and Paul Marsh, 15 January 2015

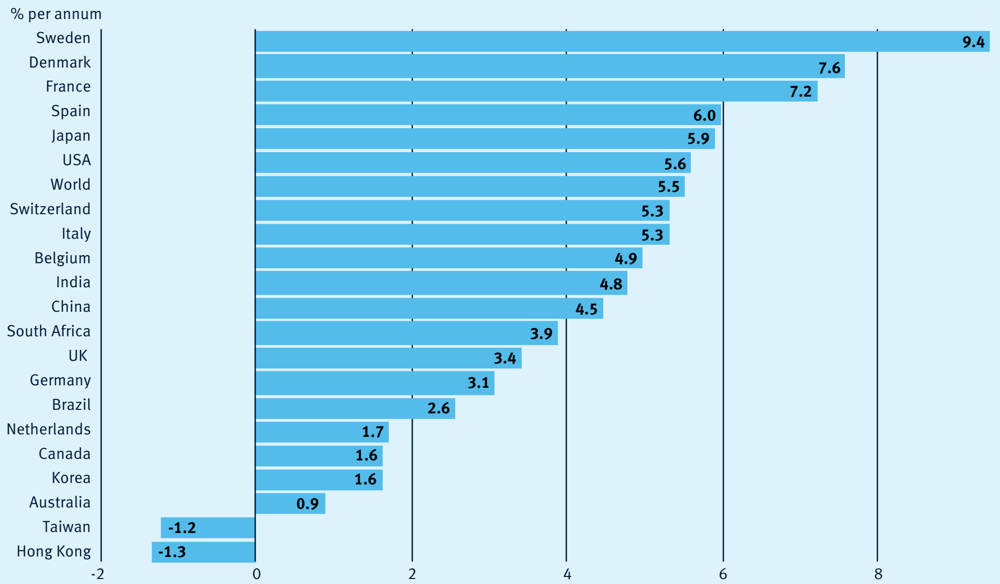
The historical evidence

Numerous studies reviewing smaller-company returns in different geographic markets have been published. This research covers, on average, 40 years and in most cases shows that smaller companies deliver a premium return over their larger counterparts.

Rolf Banz in his University of Chicago doctoral thesis, later published in the Journal of Financial Economics[2], first identified and computed the 'size effect' for US stocks. In analysing US common stocks listed on the New York Stock Exchange, he discovered that, on average, smaller companies enjoyed higher risk-adjusted returns than larger peers. In addition, his research found that this 'size effect' was long term in nature and had persisted for over 40 years.

In their research contained in the 'Numis Smaller Companies Index – 2017 Annual Review,' Dimson, Marsh and Staunton provide a comprehensive compendium of research on the 'Smaller Companies Effect'. Some of their key findings about the premium returns generated by small-cap stocks are presented in Chart 2. They find that this premium amounts to 5.5% per annum (p.a.) on a global basis over the 2000-2016 period. If compounded, this figure would clearly amount to substantial outperformance.

Chart 2: Global small-cap premia from 2000-2016



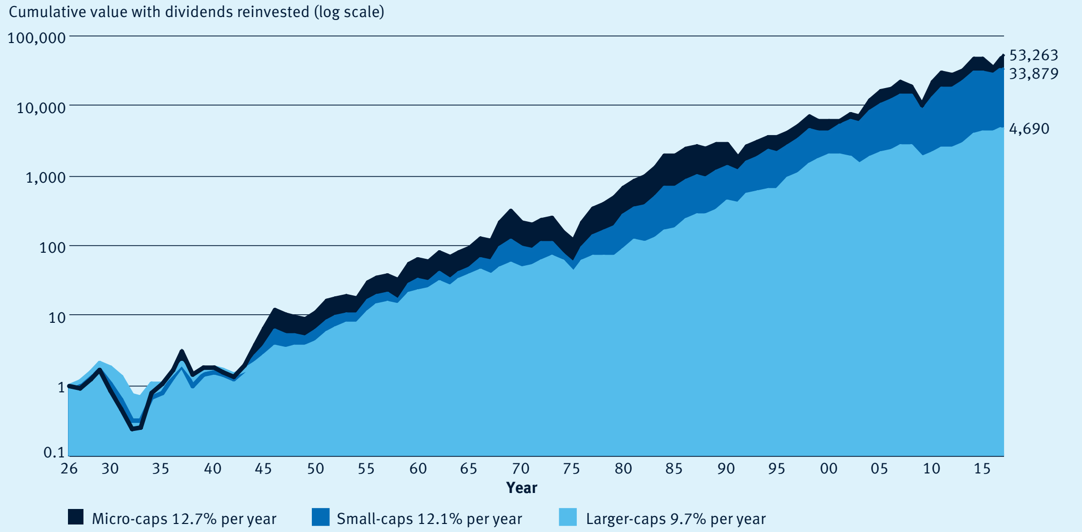
Source: Professors Elroy Dimson and Paul Marsh, Numis Smaller Companies Index – 2017 Annual Review, 16 January 2017

"This research... shows that smaller companies deliver a premium return to their larger counterparts"

[2]Source: 'The relationship between return and market value of common stocks', Rolf W Banz (published in the Journal of Financial Economics, 1980)

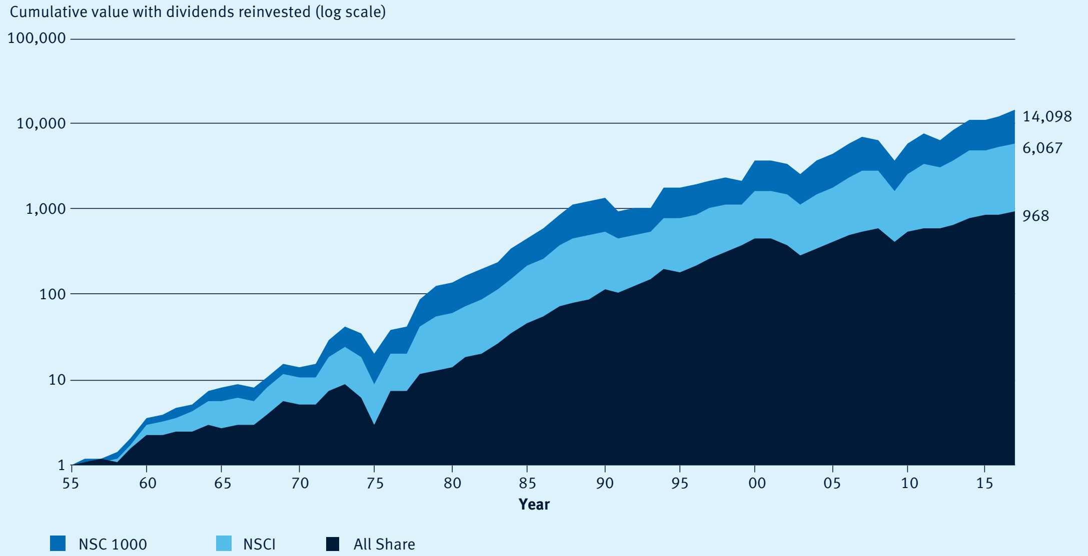
Charts 3 and 4 also depict the evidence in the US and UK markets. For both, smaller companies have outperformed their larger-cap peers over the long term.

Chart 3: US evidence



Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2017, based on total returns data from Morningstar (Ibbotson).

Chart 4: UK evidence



Elroy Dimson and Paul Marsh, Numis Smaller Companies Index, 2017 Annual Review, based on total returns for the Numis Smaller Companies indices and the FTSE All-Share Index

An under-researched sector

The economics of investment banking dictate that equity research analysts generally cover the largest companies. These typically enjoy larger free floats and greater liquidity (as well as deeper pockets when it comes to paying fees to investment banks for raising finance and corporate advice).

Consequently, it makes economic sense for some analysts and banks to restrict themselves to covering a small number of very large companies. It is not unknown for the analysts at 'bulge-bracket' investment banks to work full-time on only two or three companies. Many hundreds of pages of research about these companies are published on a regular basis. This suggests that everything that could possibly be known about each of these businesses is already known.

Things are very different when it comes to smaller companies. While the businesses themselves may be less complex, there is undoubtedly less research available about them. Indeed, on average, the sell-side community has 22 analysts covering large-cap stocks and just 6 assigned to small-caps[3]. Moreover, the small-cap research that is available is often much shallower. This information gap opens up opportunities to find compelling investment ideas that others have yet to discover.

Investment managers often neglect illiquid or 'hard-to-buy' shares, which may have restricted free floats. This may be for sound reasons, such as concerns over fund outflows dictating forced sales. However, it may be that some investment managers have shorter investment horizons and feel it is incumbent on them to trade aggressively.

"This information gap opens up opportunities to find compelling investment ideas that others have yet to discover"

[3]Source: Bloomberg, 31 December 2016

An out-of-favour sector . . . and why this will remain the case

There are two key factors that suggest smaller companies will remain underappreciated in the longer term and mean that the sector should continue to reward those investors who choose to seek it out. Both reinforce the 'smaller companies paradox'.

Institutional investor behaviour

As a whole, institutional investors follow the advice of the investment consultants who help them to design and validate their long-term investment strategies. Their world view tends not to break out smaller companies from the wider 'equity' category as an asset class. Smaller companies Requests for Proposals (RFPs) are extremely rare. This important and influential group of advisers systematically overlooks an area with strong excess return potential.

The rise of passives

Jack Bogle launched the First American Investment Trust in 1975 as the first index tracker. The first Exchange Traded Fund (ETF) started in the US in 1993. These two strategies now represent a meaningful proportion of the global stock market. Their rise was most marked in the 1990s, just when smaller companies were in the doldrums. Historically, European fund assets have been dominated by active funds. According to Thomson Reuters Lipper data, passive investments constituted only 5% of total European mutual fund assets under management (AUM) in 2004. By 2011, this figure had increased to 8% and by 2016 to 12% of AUM.

In the UK, the Investment Association's annual 2015-16 survey revealed that passive investments reached 23% of total AUM in 2015. Analysis from Moody's on the US market indicates that passive assets under management have increased from 11% in 2003 to 28.5% in 2017, a figure they say is poised to exceed 50% by 2024.

Passive equity funds lend themselves better to large-caps since they work best when the underlying shares are extremely liquid. ETFs, in turn, can be of the synthetic variety, meaning that the fund vehicle uses derivatives to mimic and replicate the asset or index being tracked. In addition, the availability of options and other derivatives for large-cap companies has combined with the rapid rise of algorithmic trading to speed up the volume of activity at the large end of the market significantly. Due to the sheer number of stocks involved and much lower levels of dealing activity, smaller companies markets are notoriously difficult to track passively. Very few small-cap passive funds are available, while derivatives are similarly hard to find in the small-cap world and are thinly traded.

Combined, these factors contribute to the ongoing systematic neglect of the smaller companies sector, despite the strong returns it can offer.

"This important and influential group of advisers systematically overlooks an area with strong excess return potential"

[4]Source: 'The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees and Performance,' Cremers, Martijn, Miguel Ferreira, Pedro Matos and Laura Starks, 13 February 2013
[5]Source: Lipper, Thomson Reuters, 'European Fund Market Mid-Year Review 2013'

Risk and risk-adjusted returns

Low risk outperforms

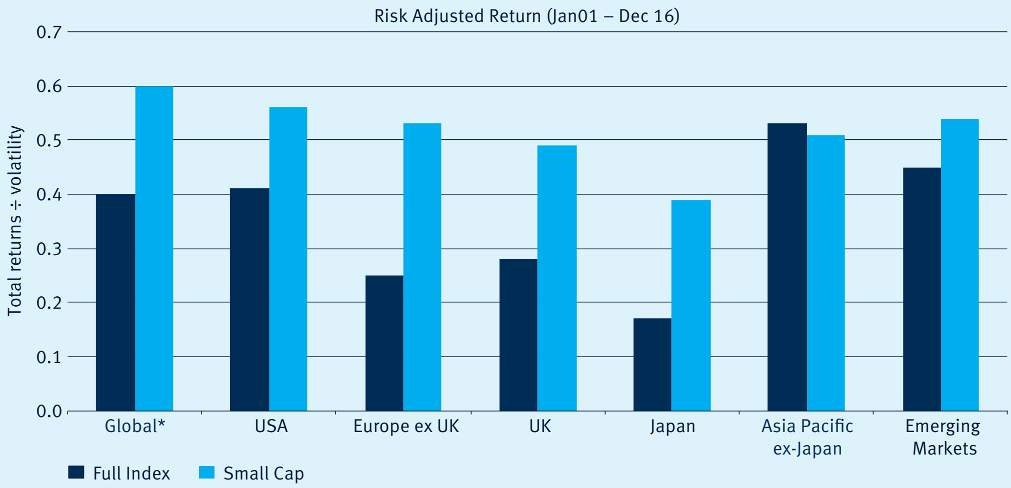
A number of the basic premises behind the Efficient Markets Hypothesis and the Capital Asset Pricing Model have been questioned in recent years. One of these is the relationship between 'risk' and 'return'. Professors Dimson and Marsh looked specifically at idiosyncratic risk (sometimes known as non-market risk, diversifiable risk or stock-specific risk). Their research focused on the Numis Smaller Companies Index (ex-Investment Trusts) between 1979 and 2012. Their research showed that the lower-risk cohort, or group, produced 5.4% p.a. higher returns than the higher-risk cohort. Ang, Hodrick, Xing and Zhang[6] also demonstrated that in many markets and over long periods, stocks with higher specific risk have tended to underperform. Indeed, this is the experience of the Standard Life Investments smaller companies team. Consequently, great care is taken when constructing portfolios.

Since the millennium, some of the largest and most stable companies in the world from a variety of sectors have either imploded or declined precipitously in value. Scale, size and international reach do not necessarily equate to low risk, as investors in RBS, Tesco, Wm. Morrison, BP or Nokia are likely to know only too well. Consequently, the risk differential between the largest and smallest companies may not be as great as might be assumed, particularly given that these larger-cap companies tend to feature among the largest constituents of market indices and consequently account for a significant proportion of their market capitalisation. The UK stock market is a good example of this concentration risk. Three sectors – financials, consumer goods and oil & gas – account for over 54% of the FTSE All-Share Index market capitalisation[7].

Small-caps outperform on a risk-adjusted basis

While lower-risk smaller companies have been shown to outperform higher-risk small-caps, the asset class as a whole also outperforms on a risk-adjusted basis. Our analysis of risk-adjusted returns over the period January 2001 to the end of December 2016 revealed that smaller company returns outstrip their large-cap peers worldwide, except perhaps for the Pacific ex-Japan region. In other words, small-caps generate higher returns per unit of risk assumed. Chart 5 depicts this sustained long-term phenomenon – strong evidence that the smaller-companies effect endures and that allocations to smaller companies can be a source of significant alpha (a measure of excess return) generation.

Chart 5: Risk-adjusted returns across the world, comparing large and small companies



*MSCI All Country World Index and MSCI All Country World Small Cap Index (all other indices MSCI indices)
Source: Standard Life Investments, 01 January 2001 – 31 December 2016

"Small-caps generate higher returns per unit of risk assumed"

[6]Source: 'High idiosyncratic volatility and low returns: International and further US evidence,' Ang, Hodrick, Xing and Zhang (Journal of Financial Economics, 2009)

[7]Source: MSCI, 11 September 2017

Selecting smaller companies for investment

Analysing aggregate market or asset class metrics is instructive up to a point. However, as bottom-up stock pickers, the team at Standard Life Investments invests in individual companies, not indices or sector averages. It is often wrong to generalise about any asset class, as growth and high-return potential can invariably still be found whatever appears to be happening at the headline market or asset class levels. Indeed, the small-cap universe is large, with the MSCI AC World Small-Cap Index alone comprising over 6,000 companies, placing a premium on manager resources and investment process. This requires an approach that looks at the entire investment universe in a consistent way to unearth high-potential opportunities and to target repeatability of performance.

Smaller companies increasingly lend themselves to this approach. Some may view 'globalisation' as a hackneyed expression nowadays, but greater globalisation has meant that global smaller company investing can now be conducted in a much more systematic and process-driven way. Convergence is taking place in all aspects of business and investment. The internet and modern communications mean that an investment manager based in Edinburgh can communicate with senior managers of smaller companies across the globe. Companies offer English language investor websites, containing company presentations and research. Investors and companies are all pursuing similar goals and national market idiosyncrasies are becoming less apparent. Slowly, accounting standards and corporate governance attitudes are converging. Investment banks around the world are assisting with international corporate access and research.

At Standard Life Investments, our long-standing smaller-company investment process emphasises predictability, visibility, quality and stability, alongside positive earnings and business momentum. Portfolios are relatively concentrated at around 50 stocks – sufficient to gain important diversification benefits, while also allowing managers to take high-conviction positions in favoured stocks. In what is a large universe, proprietary screening tools, focusing on key corporate attributes that are proven lead indicators of share price performance, are critical in helping to focus research effort and to provide a shortlist of investable stocks for further analysis. Meetings with senior company management are particularly essential for gauging the sustainability of individual businesses' growth and for reducing downside risk. Rigorous peer review also fully tests conviction in the company's prospects before stocks are selected for portfolios. We also collaborate with our colleagues covering different regions and asset classes to corroborate and test our thinking, and to increase our conviction in our investment decision-making.

Smaller companies clearly offer significant investment attractions. However, their size and breadth of investment opportunities present major challenges for all but the most skilled and well-resourced managers. A well-defined and consistent process for exploiting the returns smaller companies can offer is clearly a must if investors wish to outperform in the long term.

"The small-cap universe is large, placing a premium on manager resources and investment process"

Conclusion

Over the long run, research shows that investing in smaller companies has resulted in premium returns compared with those achieved by large-caps. That they have done so on a risk-adjusted basis is testament to their alpha-generation potential and is clear validation of the smaller company paradox.

The factors behind this paradox appear to be structural in nature. Concern on the part of some investors at least regarding liquidity and apparent risk is unlikely to dissipate soon. Meanwhile, the economics of investment banking and the sheer effort required to conduct proper small-cap due diligence are likely to ensure that research coverage and external scrutiny remain poor. Combined with other market developments, such as the rise of passive investment approaches and entrenched behavioural attitudes on the part of advisors and consultants, this suggests the sector is likely to remain overlooked. Ultimately, then, the small-cap effect should continue to provide those investors deploying a robust and consistent stock selection process with attractive long-term returns.

"Over the long run, research shows that investing in smaller companies has resulted in premium returns compared with those achieved by large-caps"

About the author

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Harry is Head of Smaller Companies Equities at Standard Life Investments. Harry joined the company in 1985 and has managed the UK Smaller Companies OEIC since its inception in 1997, in addition to managing the UK Smaller Companies Investment Trust mandate since 2003.

Building on this success, the European Smaller Companies SICAV, managed by Andrew Paisley, was launched in 2007. This was followed by the Global Smaller Companies OEIC in January 2012, which Alan Rowsell now manages.

Harry has won numerous awards during the course of his career. For instance, in 2015, Harry came first in FT Adviser's list of best-performing UK fund managers, in recognition of exceptional performance over at least 10 years.

Acknowledgements

Harry gratefully acknowledges the work of Elroy Dimson and Paul Marsh, Emeritus Professors of Finance at London Business School. Their publications include the annual Credit Suisse Investment Returns year book and source book and Triumph of the Optimists: 101 Years of Global Investment Returns. Together, they designed the Numis Smaller Companies Index (previously the RBS Hoare Govett Smaller Companies Index).

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