It's a small world after all

A recent rally in smaller companies could be the start of a long-term recovery...

Update
30 May 2024

It may finally be happening. UK smaller companies might finally be on the charge. We have been saying the market may be an investment opportunity for a while now due to its very attractive valuations, and the past month has seen a sharp recovery in markets, with a UK smaller companies index up double-digits in just a few months. Smaller companies underperforming has not just been an issue in the UK though. Below, we explore how smaller companies globally have struggled in the past couple of years for a variety of factors, and argue this period is coming to an end. Markets have rallied hard in the past couple of weeks, with smaller companies doing particularly well from mid-April onwards but we believe this could be just the beginning of a long-term recovery. Valuations are still considerably below their long-term averages, and there are many factors that could drive a long-term recovery.

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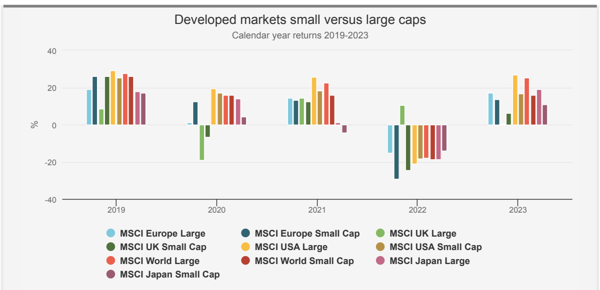
UK maybe OK...?!

There has been quite the remarkable change in the outlook for the UK in just the past month. Inflation is only slightly above its long-term target, potential interest rate cuts are on the horizon with just enough time to squeeze in an election in first. Meanwhile, the more domestically orientated FTSE 250 Index is up c. 4.5% (over one month to 24/05/2024).

This improving outlook has been noted by HSBC, which has called the UK a "golden buying opportunity" due in part to valuations, noting a 23% discount to US peers in a note published in May. This followed an upgrade from UBS earlier in the month, where the investment bank moved UK equities from their least to most preferred asset. Whilst these comments were directed at the broader UK market, the opportunities within smaller companies has not been lost on private equity which has been very active with M&A in the UK, primarily within small and mid-caps (SMID). The SMID-cap space has seen a flurry of activity in the past couple of years, with 2023 seeing an average bid premium of 51% of the prevailing share price, demonstrating the considerable value on offer.

However, whilst the opportunity in UK small caps has attracted bids, and the wider market beginning to capture the attention of institutional investors, it is not the only market where smaller companies have underperformed their larger peers. In fact, this is a trend that has been repeated across many developed markets such as Europe, Japan and the US. This can be seen in the chart below which shows performance of small caps versus large caps in these geographies plus a global aggregate over the past five years. In 2023, small caps underperformed in all areas, except for the UK, though in this country the 2022 differential had been particularly wide, with smaller companies underperforming large caps by c. 35%. We have shown this in the chart below, where a negative figure represents a year of large-cap outperformance, and vice versa, across a series of developed markets.

Fig.1: Small Versus Large Caps



Source: Morningstar
Past performance is not a reliable indicator of future results

This recent underperformance is particularly notable when considered in context of a longer time frame. Over the past 20 years, small caps have outperformed either in the majority or an equal number of years, in all regions with the exception of the US. The UK has led the way in this instance with 13 out of 20 years of small-cap outperformance. Furthermore, when small caps have had good years, they have delivered better relative performance than in the years when large caps have led the market. Europe has been being the standout in this regard with an average small-cap outperformance of 13.7% versus large-cap outperformance of 6.6%. Outperformance in the good years has not been so pronounced in Japan, though we think corporate governance reform has the potential to change this trend, as we discuss later.

Aggregate Small Vs Large Performance

	EUROPE	UK	US	GLOBAL	JAPAN
Number of years Small Cap outperforms	12	13	9	10	10
Average Small Cap outperformance (%)	13.66	15.29	7.32	6.49	6.69
Average Large Cap outperformance (%)	6.64	13.61	5.18	4.54	8.24

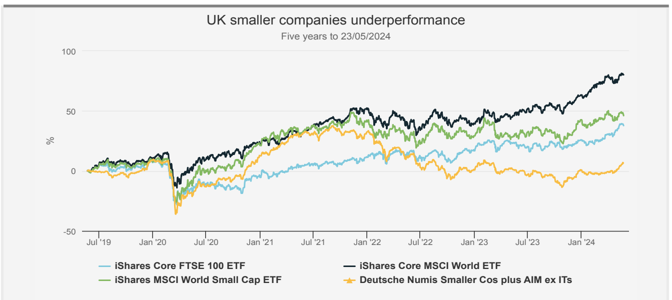
Source: Morningstar

As a result of these near-term challenges, valuations in smaller companies are now very depressed. According to data from Morningstar, the small-cap indices are all trading at valuations below their large-cap peers. This is even the case in the global index, with a small-cap PE ratio of 15.4x versus large caps of 21.8x despite small caps traditionally offering better growth prospects. We would caution though that these figures are based off trailing 12-month earnings which will have been affected by the global slowdown in the past year which typically affects smaller companies more.

This is one of the primary reasons behind the recent small-cap underperformance. Smaller companies typically struggle in periods of weak economic environments due to their less diversified revenue streams and customer base, more limited access to finance and higher exposure to domestic consumers, amongst other reasons. As such, smaller companies tend to do worse in falling markets. However, this often reverses in market recoveries where smaller companies can capitalise on their better flexibility to capture the bounce-back.

The roller coaster ride seen in UK smaller companies over the past five years is a good example of this. From the beginning of the period to the depths of the covid crisis in May 2020, the Deutsche Numis Smaller Companies plus AIM ex Investment Trust Index, a common benchmark for UK smaller companies trusts, fell c. 18%, while the large-cap FTSE 100 Index fell c. 13%. However, over the same period, the MSCI World Index was up cumulatively 4.7%, a 23-percentage point outperformance. From this nadir though, UK small caps then rose 57.9% over the following year, significantly beating its large-cap peer, the FTSE 100 Index, and even returning more than double that of the MSCI World Index which rose 25.4%. This can be seen with the yellow line steadily closing in on the black line of the MSCI World ETF Index. A similar pattern can be seen in the World Small Cap ETF Index, where the cumulative performance gap to its large-cap peer has widened from early 2023 onwards.

Fig.2: One-Year Performance



Source: Morningstar

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UK smaller companies began underperforming again from mid-2021 onwards, as concerns over high inflation caused fears of a recession. As a result, UK small caps have ended the five-year period up only 6.5%, behind the FTSE 100 Index's return of c. 39%, the MSCI World Index's return of 78.2% and the S&P 500 Index's return of 97.1%. In the past few weeks, UK small caps have begun to recover sharply though which could arguably be the start of another long-term rally, should the economic outlook continue to improve.

The poor market from mid-2021 was particularly hard felt at the lowest end of the market cap spectrum. We wrote about the state of play in micro caps in **our recent article**, though Richard Staveley, manager of **Rockwood Strategic (RKW)** has managed to significantly outperform the market in his time running the trust. His highly concentrated portfolio, which he manages with an active approach, has delivered very strong returns. Richard is speaking at our **upcoming smaller companies event** where a host of managers will speak each day on the prospects for their area of the market.

Chris Berrier, manager of **Brown Advisory US Smaller Companies (BASC)** will be discussing the prospects for his trust also. The US has been one of the key drivers of global markets over the past few years, though this has been primarily centred around the so-called 'Magnificent Seven' which have provided the bulk of the index's returns. In turn, this has contributed to large caps dominating inflows which led to small caps lagging their large-cap equivalents in 2023. However, over the long term, just like in the UK, US smaller companies tend to outperform their large-cap peers. Furthermore, they have historically performed well in absolute terms when interest rates and inflation cycles start to decline. With valuations very low, and the trust at a discount of c. 11%, this could prove an opportune entry point to BASC.

As we discussed earlier, the smaller companies story in Japan is a little different as they haven't managed to beat their larger peers over the long term. However, **AVI Japan Opportunity (AJOT)**, despite the management team's small-cap focus, significantly outperformed both the smaller companies index and peers in 2023. The managers have been focusing on the corporate governance story since the trust's inception in 2018 and focus on the small-cap end of the market in order to have the biggest impact from their activist approach. The year saw a resurgence of interest in the Japanese story, particularly surrounding corporate governance reforms. As early adopters of this successful approach, and the strong performance that has come with it, AJOT's presentation will shine a light on the future potential for the sector.

One trust covering all of these geographies as well as Europe is managed by Nish Patel, the new manager of **Global Smaller Companies (GSCT)**. GSCT offers investors access to a diversified portfolio of global equities that may help the volatility associated with smaller companies. Nish will continue to apply a valuation-focused approach which means the portfolio can often look different to peers. This has contributed to some strong periods of performance recently. Despite this, the trust remains at a wide discount versus its own history, along with the average of its sector. As such, we believe this could prove an attractive entry point to this diversified strategy and a more rounded way of accessing the potential of the asset class.

Conclusion

Smaller companies around the globe have faced a number of headwinds in the past couple of years which has contributed to them falling to very attractive valuations. Much of this weakness has been linked to fears of a global economic slowdown as high interest rates, caused by high inflation, have worked their way through the economy and dampened demand. However, these factors have arguably peaked. Inflation is back to near target levels in most major economies and the next move in interest rates is more likely to be a cut than a hike. It is in these recovering environments that smaller companies often do best, and often enjoy a strong and sustained recovery. As such, we believe there is potentially a lot to play for in smaller companies.

To hear a range of developed market managers discuss the nuances on their markets, we will be hosting a smaller companies event later in June.

Click here to register for our small caps event

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