A Spotlight On:
UK Smaller Companies

September | 2019

Introduction to Sector

At the end of June 2019, the IA UK Smaller Companies sector comprised of 52 funds with a combined level of assets totalling over £16bn. To meet the IA's sector requirements, funds must invest at least 80% of their assets in the bottom 10% of the UK equity market, by market capitalisation. Owing to the very nature of investing in smaller sized UK companies, funds within the sector tend to have a larger bias to domestic earnings and therefore the UK economy, versus those residing in the IA UK All Companies sector. Historically, smaller companies have generated superior returns versus their larger peers, however, it has encompassed higher levels of volatility.

Sector Nuance

Understanding a fund's capacity (the maximum amount of assets a fund can hold to successfully execute the investment strategy) and its resultant liquidity profile is crucial within the sector. Liquidity (the ease with which investors can enter into and out of an investment), generally speaking, deteriorates further down the market capitalisation spectrum. If a smaller companies fund manager is responsible for a significant level of assets, they may find themselves not being able to trade in or out of companies or even meet investor redemptions. Quantitatively based liquidity screens have been developed to provide some indication of how long it may take to trade within a company's shares and although the assumptions used may be sensible, they are only able to tell part of the story. They are a good tool for a basic check, for example, to check whether a fund manager can liquidate 10% of their portfolio within a working day, using an assumption of 20% of the average historical trading volumes. However, in reality, trading volumes can deteriorate much further than such assumptions. Stocks can be traded outside of the primary market, therefore dealing teams may be able to source significantly more liquidity. This information is often excluded from many of the standard liquidity measurement tools.

It is important to understand where your small cap fund is investing and which index to use as an appropriate benchmark for performance comparison purposes. The majority of funds within the sector are benchmarked against a Numis (Smaller Companies) or FTSE (Small Cap) index. The Numis indices include a much larger number of constituents which are spread across a larger market capitalisation range, at both the smaller and larger ends, when compared with the FTSE equivalent. In addition, both indices have variants which exclude investment companies, whilst Numis also offers a range which includes those companies listed on the Alternative Investment Market (AIM). Understanding the nuances of the available indices allows investors to use the most appropriate benchmark as some funds within the sector hold companies that have been promoted into the FTSE 250, or even the FTSE 100 if they follow a process that allows winners to run, for example. If held alongside a fund within the IA UK All Companies sector, exposure to certain companies may be doubled in such instances.

Average UK Market Capitalisation

Figure 1: Average UK Market Capitalisation

Recent Sector Performance

In general, the small cap space is inefficient, meaning it's one where active management can add significant value over time. For example, over the five years to end June 2019, the small cap market provided returns in the region of 38%, however, the average active fund within the sector produced a 55% return after fees, a 17 percentage point premium. The average smaller companies fund also outperformed the average fund within the IA UK All Companies sector, which returned 34% over the same period.

Despite the strong return profile in recent years, UK smaller companies funds have been prone to sharp and significant drawdowns. Also, at the company level, café, Patisserie Valerie, and drinks distributor, Conviviality, have both entered administration fairly recently. This should act as a reminder that investing in smaller companies can be as much about avoiding the losers as much as picking the winners. More broadly, two worthy periods of note were the days immediately following the UK's European Union membership vote, where small caps fell over 10% (compared with a fall of 3.1% of large caps) and over the fourth quarter of 2018 where small caps fell by 14% (versus a fall of 10% for large caps). Small cap managers generally struggled over both periods.

IA UK Companies v IA UK Smaller Companies - 5 Years Max Gain/Max

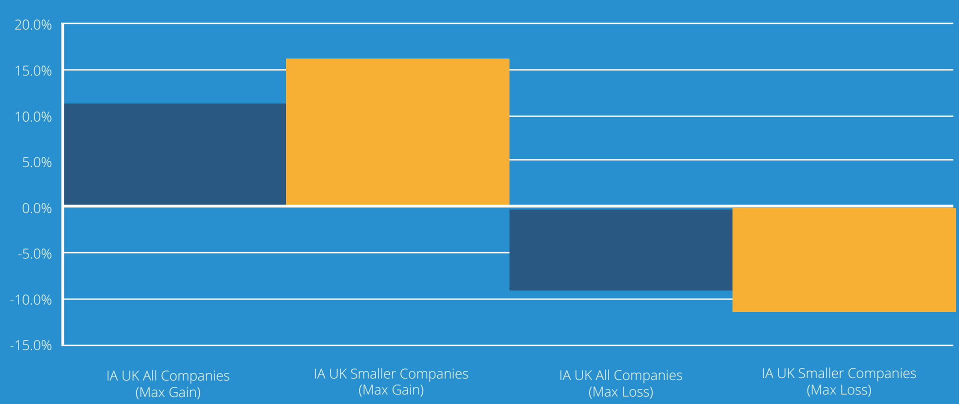

Figure 2: IA UK Companies v IA UK Smaller Companies - 5 Years Max Gain/Max Loss

Funds in Focus

Two funds within the sector that we hold in high regard are the Liontrust UK Smaller Companies and the Standard Life Investments UK Smaller Companies funds. Both invest with a bias towards high quality and growing companies, which have experienced a significant tailwind in recent years.

The Liontrust UK Smaller Companies fund is managed by the Economic Advantage team who focus on intangible strengths of the underlying companies, which by their very nature are difficult to assess using more traditional analytical techniques and therefore are often overlooked by many market participants. Furthermore, shareholder alignment is critical to the approach. The managers will simply not invest in a company if its management team do not own at least 3% of the firm's equity, and the team are prepared to sell their investment if ownership falls below this level.

The Standard Life Investments UK Smaller Companies fund is managed by Harry Nimmo, a veteran investor in smaller companies. He and the firm's smaller companies team use a proprietary quantitative tool, the Matrix, to uncover organically growing companies that have the potential to be tomorrow's larger sized companies. It is also used to monitor existing holdings.

In contrast, a fund that operates with a strict valuation discipline but one that we also hold in high regard, is the Fidelity UK Smaller Companies fund. Managed by Jonathan Winton, the philosophy centres around the principle that markets can be slow to react to the changing situations of companies and therefore the manager searches for unloved firms that are entering a period of positive change.

We would note that the Liontrust and Standard Life Investments strategies, owing to their success and subsequent growth in assets, have taken measures to stem the flow of new investment into their respective funds. Liontrust apply a higher than average fee, whereas the Standard Life Investments fund applies an upfront charge at the time of purchase. The Fidelity fund is currently open for new investment.

5 Year Total returns

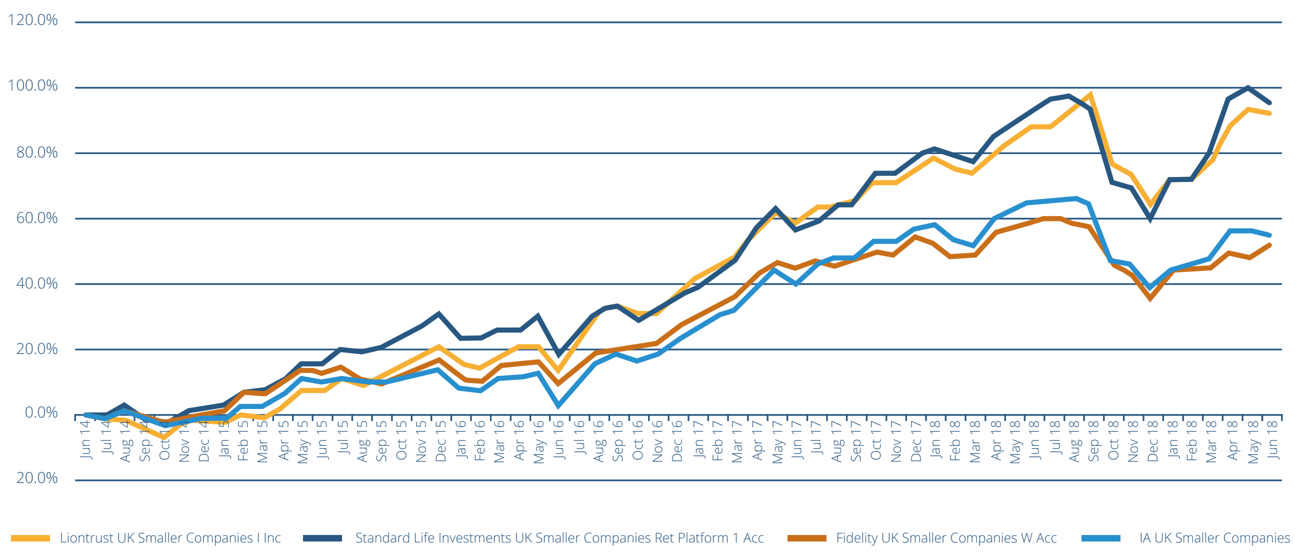

Figure 3: 5 Year Total Returns

Sector Outlook

There is a significant level of uncertainty regarding the outlook for the UK equity market. The risks associated with Brexit are on the forefront of UK investors' minds. Most small cap managers within our Academy of Funds are humble enough to admit they are not able to predict the implications of the outcome of Brexit and have tended to keep a balance of both domestic and international earners within their funds, to limit the impact of any sharp market moves. Given the dynamics of the asset class, most managers have preferred to seek companies that can grow regardless of the political backdrop, concentrating on assessing company fundamentals.

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