Struggling against the giants

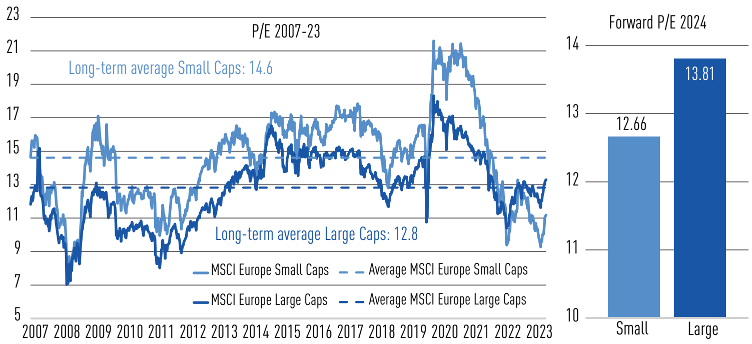
SMALL CAPS

JOSEPH MARIATHASAN

Small caps are finding it difficult to make inroads in a world dominated by the Magnificent Seven

Small caps are currently cheaper than large caps over the long run

Valuations for small caps versus large caps



Source: Bloomberg, MSCI, Lupus Alpha calculations; As of: 28.03.2024

The idea that small-cap global equities should offer a premium return over large caps has been widely accepted within the investment industry and in academia for a long time. However, recent years have seen that theory turned on its head, which raises questions over the prospects for global small caps, an asset class with nearly 10,000 investable listed companies across developed and emerging markets.

Ed Cole, head of multi-strategy equities at Man Group, points out that the traditional way of thinking about companies' economic returns is that those with large capitalisations have a competitive position that is picked at by smaller companies. The argument is that small caps should outperform because they are more nimble and able to turn quickly to attack fat profit streams to compete with large companies. Any company or industry that consistently earns a return on capital in excess of its cost of capital, should, according to classical economic theory, see that advantage eroded over time through competition. "But what started to happen with the emergence of mega-cap tech [stocks] is that very large companies have managed to build themselves competitive advantages that blow the theory out of the water," says Cole.

Outside the US, small caps have suffered as capital has flowed towards the Magnificent Seven of Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla, argues Ben Griffiths, portfolio manager at T Rowe Price. The US small-cap market of around 3,000 companies (depending on definitions) is a domestic asset class in contrast to the international nature of the 'Magnificent Seven', he says. It is a relatively liquid market, but the number of companies has been declining in recent years.

The US small-cap market also has a different sector composition to large caps, with a much higher weighting to the "real-goods economy", according to James Mendelson, portfolio manager at GMO, with small caps making up 18% of the industrials sector versus 9% in large caps; 6% versus 2% in materials; 7% versus 2% in real estate; and 15% small caps in consumer discretionary versus 10%.

Lack of listings

However, there has been a dearth of initial public offerings (IPOs) in the last few years, not only in the US but also in Europe. Marcus Ratz, small cap portfolio manager at Lupus Alpha, says: "It's a theme that we have seen over the last 18 to 24 months in the small mid-cap space, as interest rates went up valuations went down and so there has been limited appetite from investors." Some markets have seen more activity. "There was a very hot IPO market in Scandinavia, for example, and we have invested in a number of IPOs in countries like Germany, Switzerland and France," says Griffiths.

The domination of the Magnificent Seven seems to indicate that the largest companies in the world operate in markets that are 'winner takes all. The first-mover advantage for Microsoft in having built a dominant operating system in the 1980s turned into a dominant software suite in the1990s and 2000s and onwards is such an embedded advantage that is impossible to take down.

US large caps have beaten US small caps by 50% over the last decade, which is approaching 4% annualised, says Man Group's Cole. He believes one factor could be that large caps benefit from the easier availability of debt capital with the option of accessing the bond markets. Cole says: "Governments are going to have to think about how credit is allocated in the economy. If the objective is to raise productivity, increase employment and lift salaries, credit needs to be directed towards more capital and labour intensive businesses, which today are generally smaller rather than larger businesses."

Private equity competition

One small cap sector that does appear to be awash with capital is the private equity market, which overlaps considerably with the listed small-cap market. The flow of money of private money into biotechs, for example, has traditionally led to investment into listed biotechs, but Hassan Chowdhry, portfolio manager at GMO, says: "That trend has reversed itself and is one of the causes why the number of IPOs has gone down." For investors, the relative attractions of listed small caps versus private equity is controversial. "I'm a believer in the research that shows that private equity roughly represents a levered bet on small caps but with the addition of a very high fee," says Chowdhry.

Cole argues that small-cap performance outside the US has not been as bad. There are regional differences, which Ratz at Lupus Alpha says are impacting returns. "Europe is weaker on the consumer side than the US, which also has a stronger economy." Strong consumer spending driving GDP growth is also true for some parts of South-East Asia, such as Indonesia.

However, Griffiths says: "European small caps are at around 20-year lows in terms of valuation and at one of the few times ever to be at a discount to European large [caps]". European small caps are also trading at the largest discounts to the US markets that T Rowe Price has ever experienced. "So we feel that the European small-cap market is really very cheap on any metric that you can throw at it." However, he adds that the opposite is true in India. "India is a market we like very much but what we're finding that valuations are, if anything, at historic highs in that market."

UK out of favour

Ratz points out that probably 70%- 80% of European small caps have little to do with the country where they are listed or where their origin is because they are international global businesses, but there are country trends.

"Valuations have come down in the UK because the country itself is out of favour – I think for the wrong reasons." Ratz says UK small caps are at a considerable discount to large cap because they are more domestically oriented than UK large caps, which tend to be global businesses in areas such as commodities. As a result, the UK small and mid-cap discount against large caps is around 200 basis points, compared to 50bps in the eurozone.

Jonas Edholm, portfolio manager at Skagen Funds who runs a global small-cap value fund, says the efficiency of the US markets make small-cap value investing much more difficult than in Europe. "You cannot see valuation multiples staying cheap for long as there will inevitably be a takeout by an activist investor or a change of management or something else relating to the stock so our chance to capture the upside from deep discounts is much higher elsewhere." As a result, Skagen Funds' global portfolio has only 10% in US stocks.

AI and small cap

While artificial intelligence (AI) is increasingly being applied to the investment world, small-cap managers such as Lupus Alpha have so far had limited direct exposure to AI.

Griffiths says T Rowe Price has found several stocks with exposure to AI in areas like the semiconductor supply chain in Japan, the UK and Germany. Skagen is finding backdoors into AI-driven stocks by looking at the supply chain. "As well as semiconductor manufacturers in Germany, there are opportunities in, for example, copper miners as you need a lot of copper to make wires from," says Edholm.