



Neil Robson  
Fund Manager, Global Equities

## **SMALL COMPANIES OFFER GREATER POTENTIAL RETURNS OVER THE LONG TERM**

January 2012

**In difficult economic times, such as those we are currently living through, investors flock to perceived safe havens. In terms of equities, large cap, defensive companies with steady earnings streams tend to be regarded as the least risky stocks. Conversely, investors tend to shun smaller caps. The latter are regarded as being particularly vulnerable to an economic downturn for a number of reasons including:**

- Lack of cash reserves and the relatively easy access to capital enjoyed by their larger counterparts.
- Larger companies generally operate in well-established markets and may have well-known brands and products that consumers regard as necessities.
- Relative difficulty in cutting costs. While it may be fairly easy for a big company to cut costs – if only because they have large numbers of staff – it can be much more difficult for a smaller company to economize.

### **Greater growth potential**

However, there are good reasons for believing that over the long term, smaller companies hold greater investment potential than large caps, given their latent ability to grow earnings at a faster pace than well-established businesses. This partly reflects the fact that smaller companies are starting from a much lower base but also because they may have exploited untapped niche sectors or have developed new technologies or products.

### **Exploiting global growth**

Over the past few years, many smaller companies have tapped into the strength of demand in emerging markets or are gaining from secular growth and innovative new technologies. Larger companies have also exploited the growth of emerging markets but smaller companies, which tend to be more nimble than big corporates, have perhaps been quicker to do so.

Examples of companies that are enjoying robust sales in the developing world include Symrise, the German supplier of fragrances, flavourings, cosmetic active ingredients, and functional ingredients. The company's clients include manufacturers of perfumes, cosmetics and foods, the pharmaceutical industry and producers of nutritional supplements. Sales growth is being driven by demand from emerging markets, which now account for nearly half of the company's revenues.

The UK engineering company Renishaw is also bucking the economic slowdown by targeting emerging markets. Indeed, exports account for 95% of sales and the company says that as well as avoiding being reliant on the UK, its focus on overseas sales provides a wider variety of market sector opportunities, as the UK will not necessarily have all the industries in which

Renishaw's products can be applied. The company, for example, is currently seeing strong growth in Asia due to the strength of consumer electronics manufacturing in the region, including the latest generation LED TVs.

Robust emerging market sales are also driving healthy earnings growth at another UK company Rotork Engineering. The firm makes actuators – equipment that controls the operation of valves – and demand remains solid, particularly in countries such as China, which is spending vast amounts on infrastructure projects and on the water, oil and gas pipelines that require Rotork's products.

These UK companies have clearly benefited from the weak pound and, going forward, any weakening of the euro will clearly benefit Symrise and other exporters based in the eurozone. In addition, it is possible to invest in well-managed smaller companies in the eurozone that are benefiting from structural growth and that are relatively insulated from the wider debt concerns afflicting euroland. Yet the valuations of these companies have been rendered increasingly attractive by the sovereign debt crisis.

Japanese smaller companies have also benefited from their proximity to fast-growing emerging economies such as China, as well as their relative isolation from the eurozone crisis. Technological innovation is another factor powering the smaller company sector in Japan and other parts of the globe. Many of Apple's products, for example, incorporate technology supplied by Japanese smaller businesses.

#### **Attractive value**

Despite the relatively strong performance of small caps they continue to offer very good value. Indeed, Japanese small caps have been described as the cheapest asset class in the world, while in other markets they offer exceptional value both in historical terms and in relation to other assets. In Europe, for example, smaller companies are trading on similar multiples to their large cap counterparts yet, as mentioned earlier, have much greater earnings growth potential.

Over the long term, we would expect smaller companies to continue to outperform their large cap counterparts, and not just because of their faster earnings growth potential. Smaller companies, for example, are more vulnerable to takeovers than large businesses and M&A activity could be one of the key drivers of share prices in the coming years.

Much of the corporate sector is sitting on large cashpiles – reflecting companies' understandable cautious approach to investing in the current uncertain economic environment. Large companies may seek to deploy this cash to acquire smaller competitors, especially given the appealing valuations in the sector. Corporate activity is already on the up in Japan where the smaller companies sector has seen a number of Management Buyouts, an indication that company management sees considerable value in the sector. Elsewhere, however, financial markets probably need a period of stability before M&A activity accelerates.

It is also important to remember that the asset class holds considerable potential for stock pickers. This is because it contains such a diverse range of sectors and businesses. In addition, smaller companies tend to be less well researched by analysts and so provide the potential for greater returns for managers taking a detailed 'bottom-up' approach to their research.

Finally, one might expect small caps to struggle in the current era of relatively high inflation. This is because they generally lack the pricing power of larger companies, which are able to pass on higher costs to end users or are better placed to absorb price rises through economies of scale. However, good stock selection can also assist here. It is certainly possible to find small companies with strong competitive positions that do have robust pricing power.

**Good stock picking is critical to fully exploit share price weakness**

To recap, this could be a very good time to invest in smaller companies. Uncertainty about the economic outlook has hit the share prices of these companies even though some will continue to prosper even in a downturn given their exposure to structural growth and/or new technologies. Moreover, it is important to remember that smaller companies have the potential to outpace their larger counterparts given their much greater growth potential. Finally, good stock selection is essential in this area given the huge variety of companies that cover a diverse range of sectors.

**For Investment Professionals use only, not to be relied upon by private investors.** Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The mention of any specific shares or bonds should not be taken as a recommendation to deal. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Investment Services Limited. Registered in England and Wales, Registered No. 3701768, St Mary Axe, London EC3A 8JQ, United Kingdom. Authorised and regulated in the UK by the Financial Services Authority. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited ("TPSHKL"). Registered Office: 21F ICBC Tower, Citibank Plaza, Central, Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Please note that TPSHKL can only deal with professional investors in Hong Kong within the meaning of the Securities and Futures Ordinance. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. Issued in Singapore by Threadneedle Investments Singapore (Pte) Limited, 07-07 Winsland House 1, 3 Killiney Road, Singapore 239519. Any Fund mentioned in this document is a restricted scheme in Singapore, and is available only to residents of Singapore who are Institutional Investors under Section 304 of the SFA, relevant persons pursuant to Section 305(1), or any person pursuant to Section 305(2) in accordance with the conditions of, any other applicable provision of the SFA. Threadneedle funds are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and Shares are not allowed to be offered to the retail public. This document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.