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Markets

FOCUS

16 November 2020

Within ***Focus*** we comment on extraordinary market events and analyse capital market related special topics.

Small caps, big returns

The Nobel laureates Eugene Fama and Kenneth French proved the existence of the "size" or "small cap" premium in 1993. The rationale behind the Fama-French three-factor model is that small caps – which we define as companies with a market capitalisation of €500m to €5bn – are riskier and more illiquid than large companies. Small caps should, therefore, offer investors additional returns for taking on this risk. Other studies have shown that small caps generate an excess return in the long term, even when adjusted for risk.

Small caps exhibit higher returns in the long-term than large caps…

The development of small caps since the turn of the millennium fits the picture (see Fig. 1). They have grown by more than 250% – five times more than large caps. Small caps have outperformed large companies in 14 of the past 20 years. However, there have also been phases of relative underperformance, for example during the 2007-08 financial crisis.

We look at how, beyond market capitalisation, small businesses differ from large caps. It is these differences that determine the near- and medium-term relative performance of small companies and, in our view, speak in favour of adding small-cap exposure to the portfolio.

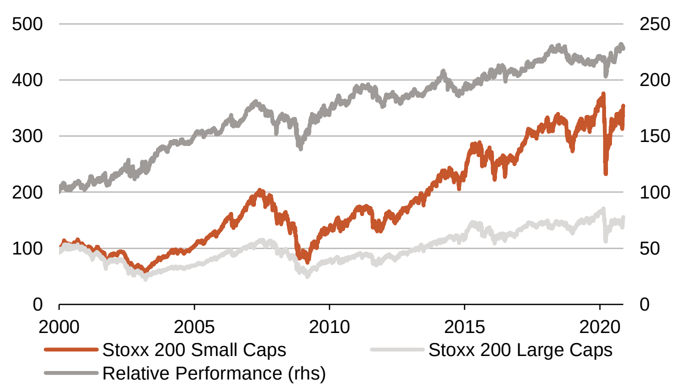
"Pure plays" with higher cyclicality...

… but also tend to lose more during crises

Looking at the relative performance of small and large caps in more detail reveals that small-cap indices have slightly higher maximum drawdowns. This phenomenon has been evident during the COVID-19 pandemic. European large caps lost close to 35%, while small caps were down by over 38%. Small caps, however, often recover more quickly from crises. For instance, in 2009 European small caps performed almost 24% better than large caps. This year, small caps are already ahead of their larger peers, despite their bigger slump during the coronavirus crisis.

Fig. 1: Small caps with significant outperformance since 2000

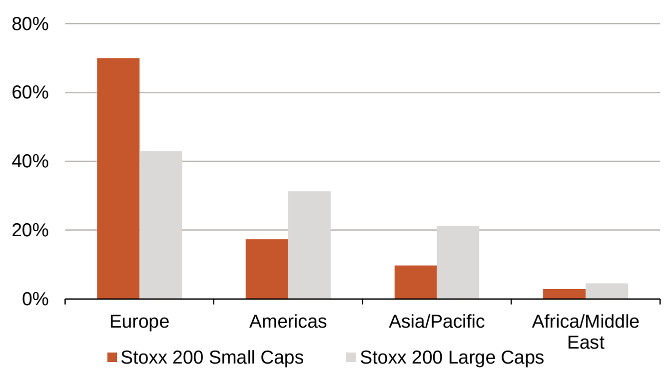
Absolute and relative performance of the Stoxx 200 Small Caps vs. the Stoxx 200 Large Caps Index normalised to 100 in 2000.



Time period: 01/01/2000-13/11/2020
Source: Bloomberg, own calculations

Fig. 2: Small caps with significantly higher exposure to Europe

Percentage of revenue of European small and large caps classified by region



As of 31/10/2020
Source: Factset

The reasons for this are manifold. First and foremost, there is the higher cyclicality due to the different sector structure of the small-cap universe. In addition, many European small caps are younger companies that generate little or no profit and/or have lower capital buffers than large caps. This makes them more vulnerable, particularly in times of financial distress, as they are more likely to rely on issuing shares to raise fresh capital. However, in such times, investors are less willing to buy newly issued shares, which increases the financing risks for small caps. They also often depend on fewer products and a smaller customer base. This makes them more sensitive to a significant economic downturn. Large caps, on the other hand, usually have strong market positions and suffer less from a downturn. Furthermore, small caps tend to have higher operating leverage than large companies because their fixed costs are a greater proportion of total costs. Their variable costs, on the other hand, are lower than those of large caps, so the contribution margin for each additional unit sold generates a higher profit for the company.

Smaller companies are often more specialised and have greater operating leverage

... lower global exposure,...

In years of strong euro appreciation, such as 2017, European small caps tend to outperform large caps. One reason for this is that they generate 70% of their sales in Europe versus only about 40% for large caps (see Fig. 2). For overseas exporters, their competitive position deteriorates as their goods become more expensive on global markets when the euro rises. Furthermore, an appreciation of the euro often goes hand in hand with an improvement in the global economy, as it did in 2017, which is a positive environment for the typically more cyclical small caps. The share of manufacturing companies in the small-cap index is almost twice as high as in the large-cap index.

Large caps tend to suffer from euro appreciation, while small caps benefit

... stronger growth,...

The strong drive for innovation and the substantial growth opportunities that characterise many smaller companies are key drivers of their better relative performance. They often invest a greater proportion of their budgets in R&D compared with their larger counterparts. Furthermore, smaller companies are usually owner-run. Accordingly, management boards often have a strong stake in their companies, which reconciles their interests with those of the shareholders. In addition, they are often world market leaders in their respective niche, where they make significant profits. They are so-called "pure plays" which represent certain investment themes undiluted. Conglomerates that have already surpassed their highest earnings growth rates are more likely to be found in the large-cap universe. This explains why small caps often show disproportionately high growth rates, not least because of their low sales and profit base. In addition to an illiquidity premium, another key driver of the long-term outperformance of small caps is that they are more likely to be acquired. Small caps are attractive acquisition candidates because they tend to possess specialist know-how and have tapped new niche markets with disproportionately high growth rates. The persistently low interest rate environment and high cash holdings of blue chips are particularly favourable conditions for takeovers.

High growth and market leadership in niche segments makes small caps attractive takeover candidates

... and more alpha opportunities

Small caps offer more opportunities for profitable stock selection than large caps. One reason for this is that the pairwise correlation between small caps is significantly lower than that of large caps. Secondly, there are significantly more ETFs and, thus, assets managed in large-cap indices. If investors buy or sell index funds, these flows affect all index constituents equally. In addition, small caps often have higher

Small caps have higher company-specific risks and are therefore less correlated idiosyncratic, ie company-specific, risks (see Fig. 3). They often depend on only one end-market and are not as diversified in terms of regions and products as larger conglomerates. As a result, individual small caps can be significantly more volatile than blue chips. Small-cap indices, however, are not necessarily more volatile than large-cap indices, due to the lower correlation of their constituents.

The significantly larger investment universe, which receives less attention from analysts, makes valuations of small caps more inefficient

Smaller companies also receive less attention from equity analysts and the media. As a result, investors have less insight into their business models and corporate culture. This creates inefficiencies in equity valuations. For active investors, this offers the opportunity for higher returns, not least because the investment universe for European small caps is huge. There are about 250 companies with a market capitalisation of more than €10bn, while there are more than 6,000 listed companies with a market capitalisation of less than €5bn. The vast range of different business models in the small-cap universe offers enormous alpha opportunities for active managers. Small-cap companies can also give investors a greater exposure to a single country, allowing them to better respond to cyclical differences between regions. This is more difficult with large caps, as major international players are much more sensitive to global growth trends.

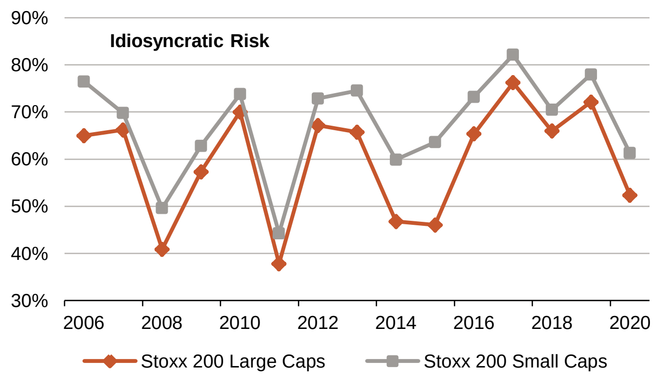
Trend towards thematic investing offers support

Small caps still have some catching up to do in communicating their ESG efforts

Two major investment flow trends are likely to influence small caps in the next few years. Increased demand for thematic investments will have a positive effect. Small caps are more likely to be found in theme funds, as these often require a certain minimum share of revenue (for example 50%) to be generated in specific fields, such as robotics or artificial intelligence. Since small caps are often pure plays in certain sectors and thus fulfil these revenue requirements, they tend to be used disproportionately in theme funds. In addition, these funds often weigh their holdings not according to market capitalisation, but weigh their holdings equally. This is an advantage for small caps, as they tend to be weighted higher in such vehicles than in common market-capitalisation indices. The ESG trend, however, is likely to be negative for small caps, at least if it is passively reflected in ETFs, which often use the ESG ratings of large index providers. Small companies often do not have the same resources as large caps to communicate their ESG activities in detail to the rating agencies. As a result, they often wrongfully receive lower ESG ratings, which in turn can lead to lower ESG flow demand.

Fig. 3: Small caps with higher idiosyncratic risks

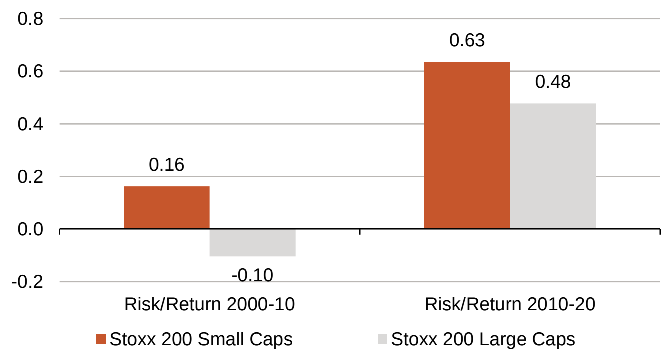
Average company-specific risk of the index constituents of the Stoxx 200 Large Cap and Stoxx 200 Small Cap Index



Time period: 01/01/2006-31/10/2020
Source: Bloomberg, own calculations

Fig. 4: Small caps with higher risk-adjusted returns

Risk/return ratio over the 10-year time periods from 2000 to 2010 and 2010 to 2020 of the Stoxx 200 Large Cap and Stoxx 200 Small Cap Index



Time period: 01/01/2000-31/12/2019
Source: Bloomberg, own calculations

Small caps also ahead on a risk-adjusted basis

Small caps have higher risk-adjusted returns than large caps

We have examined the relative performance of small to large caps after adjusting for risk, ie, comparing returns to volatility. Here, too, small caps have been ahead over the last two decades (see Fig. 4). From 2010 to 2020, for example, the risk/return ratio of European small caps was 0.63, while that of large caps was 0.48. In the decade before, large caps generated a negative return, while small caps were able to make gains. From 2000 to 2010, volatility at index level was even higher for large caps than for small companies. In the following decade, small caps exhibited slightly greater volatility yet compensated for that with higher returns.

Seasonality and cyclical recovery favour small caps right now

All in all, we consider European small caps to be attractive. This is especially true if one focuses on active funds that ensure that the companies selected have healthy balance sheets and sufficient liquidity reserves. This is often the case with owner-managed companies. Furthermore, small companies should benefit from a synchronised global economic recovery next year. The seasonality also clearly speaks in favour of small caps: historically, small caps have performed significantly better than large caps from October to April. We therefore believe that the time is right to focus more on small caps, both in the long term and tactically.

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Date: 16 November 2020

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