



Simon Atherton is one of our Senior Investment Managers on the Directly Invested team. He has significant experience of the UK equity market across a range of market capitalisations and has worked on specialist Mid Cap Funds as well as the Smaller Company portion of a UK Life Fund. He also has experience of managing portfolios within the charity sector, particularly those with ethical mandates. This month Simon investigates the patterns emerging in the FTSE Small Cap index and whether there is potential value to be found within this 'asset class'.

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Senior Investment Manager**

A graduate in Economics from Bath University, Simon has worked in the investment industry since 1983. He has 26 years' investment experience having worked at Tyndall, BZW Investment Management, Prolific and Aberdeen Asset Management. During his career he has managed various UK funds across the full market capitalisation range. More recently he worked at RC Brown Investment Management where he managed the European assets of a large ethical charity. He was also involved in the management of ethical, retail and pension funds. He joined Principal in October 2007.

Small fish in a big pond. Should we chase after smaller companies today?

After a difficult 2008, the emergence of the green shoots of economic recovery has thrust UK smaller companies to the fore once again. To mid-August, with dividends reinvested, the FTSE 250 index has risen by 36.6%; the FTSE Small Cap by 42.0% whilst the FTSE 100 index has returned just 9.7%.

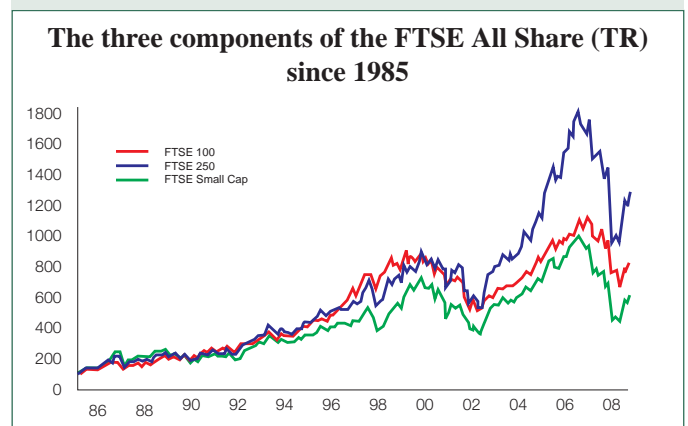
Does this matter? The FTSE Small Cap index, which comprises the very smallest companies in the FTSE All Share, is made up of 265 companies, and yet represents just 2.2% of the FTSE All Share index. To put this into context, HSBC is currently the largest company in the UK market and represents on its own 7.6% of the FTSE All Share. The weighted contribution to performance is, therefore, much greater in individual large companies.

However, the return from investing in smaller companies has, over a number of periods, differed significantly from the returns from the main market. It is often stated that smaller companies outperform over the longer term. However, this bald statement masks a more complicated picture. If we divide the FTSE All Share into three components, the largest companies in the FTSE 100, the next 250 in the FTSE 250 and then the tail in the FTSE Small Cap index - and then plot their respective performances against each other over time, we can identify three distinct phases.

Figure 1 shows the history of the total returns from these three sub-indices. This shows the strong outperformance of the FTSE 250 over the last fifteen years.



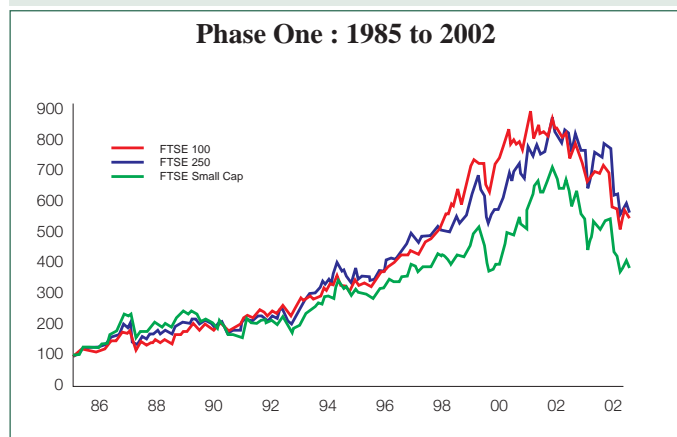
Figure 1



Source: Thomson Datastream

However, if we break this longer period up into three distinct phases, we can see that for a very large proportion of the period under consideration there was relatively little divergence in performance. Between the end of 1985 and the end of 2002 (see Figure 2) the difference between the total returns from the FTSE 100 and the FTSE 250 indices was minimal, and indeed for a considerable period in the late 1990s larger companies were ahead of their mid-sized peers, whilst the smallest stocks lagged.

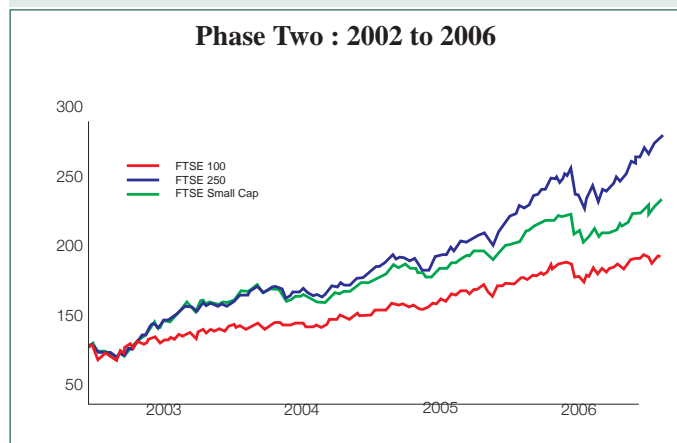
Figure 2



Source: Thomson Datastream

Between the end of 2002 and the end of 2006, as the markets recovered from the Second Gulf War and the bursting of the technology bubble, the FTSE 250 and the FTSE Small Cap outpaced the FTSE 100 massively (Figure 3).

Figure 3



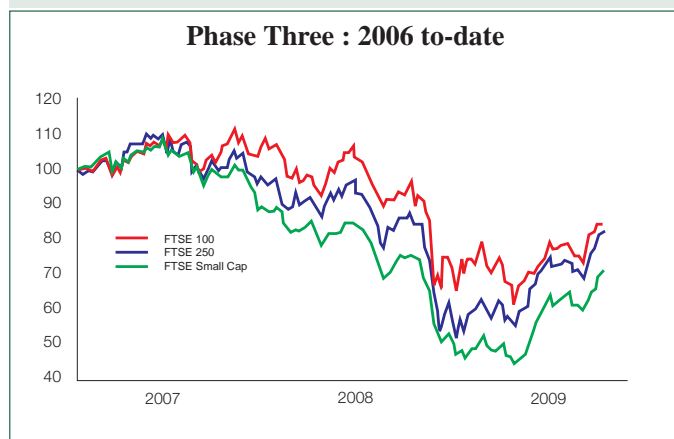
Source: Thomson Datastream

Then in the final phase, stretching from the end of 2006 to the present day and as the full horrors of the credit crunch came to bear on equities, the situation reversed (Figure 4).

This all begs the question as to what might have been driving these differences in performance.

There are significant differences between the FTSE Small Cap and the market as a whole. Smaller companies are most overweight in classic basic industries, general industrials, cyclical services, IT and most significantly,

Figure 4



Source: Thomson Datastream

investment companies. They are most underweight in resources, non-cyclical consumer goods, non-cyclical services, utilities and financials. For example, the oil and gas sector represents around 21% of the FTSE 100 index but only 1.7% if the FTSE Small Cap. Banks make up 18.9% of the FTSE 100 and do not feature at all in the smaller indices. Conversely industrials represent just 4.1% of the FTSE 100 but fully 18.6% of the FTSE Small Cap.

Such differences are a natural reflection of the recent trend of globalisation and the requirements for economies of scale in certain industries and sectors. For example, the low weighting in resources, oil and gas in the FTSE Small Cap is a reflection of successful businesses achieving economies of scale organically or, just as often, unsuccessful ones being swallowed up by larger companies to arrive at the same end.

In a low inflation, low growth environment, smaller companies will find it difficult to achieve pricing power and fund sustainable growth. Large companies are better diversified and arguably better placed to adapt to a change in the trading environment. In addition, a number of small companies are also exposed to industries in secular decline, such as the decline of the UK manufacturing base in the face of the rise of outsourcing to low cost producing countries.

A number of smaller stocks also exhibit characteristics not particularly suited to the quoted sector, for example family businesses have gained quotes purely to realise some capital for the founders. Lowly rated, low growth businesses find capital is hard and expensive to obtain to fund expansion or acquisitions. In addition, the cost of a quote is high, and corporate governance issues and reporting are expensive to manage.

Of course, scale has also become a feature of the fund management industry. The trend for globalisation has tended to make large companies larger and has increased the struggle that small companies face. Smaller companies are no longer as important to a large, well-diversified fund management groups, as they were ten years ago. Large funds prefer deep liquidity when both buying and selling. This is not available in smaller capitalised stocks. There is

generally a higher proportion of management ownership in small companies and the free float is therefore smaller. Also, as institutional fund management shareholdings have grown bigger in line with fund management consolidation, so percentage holdings have increased and become more difficult to trade. Large companies naturally have a relatively high degree of liquidity, which helps when investment decisions have to be re-assessed, whereas smaller companies with problems tend to become long-term holdings. Often holdings in them can only be sold when there is a willing buyer, rather than when the seller desires.

Since 2002, it is likely that the strength in small cap stocks had as much to do with the creation of the credit bubble as it did with fundamentals. We were in an era of ultra-high risk tolerance, cheap and plentiful finance and aggressive take over activity - particularly from the private equity sector, which tends to focus on smaller companies. It was the age when the economic cycle of boom and bust had been 'abolished' by fiat from on high and when corporate financiers declared that the only good balance sheet was a highly indebted one.

In short, the extraordinary performance of small companies from the period between 2002 and 2006 was as much a reflection of the excesses of the times, as it was of the underlying quality of the companies involved.

So far in 2009 the FTSE 250 and FTSE Small Cap index have both risen much more sharply than the larger FTSE 100. Can this be sustained?

We seem now to be in for a long period of adjustment to recover from the credit-led bubble of the last few years.

Global growth seems likely to be lower than previously, with the UK beset by more problems than most and therefore likely to suffer from poorer growth still. Taxation is going to rise, and doubtless taxes on capital and entrepreneurship with them. Debt finance, whilst very cheap at official rates, is neither especially cheap nor especially plentiful to smaller companies today as banks rein in their willingness to lend and try to shrink their bloated balance sheets. Risk moderation is the order of the day for bankers and investors alike. Attitudes to debt have changed very markedly, and it will be some time before private equity is ready to drive forward the next wave of mergers and acquisitions.

None of this seems to offer an especially favourable environment for investing in smaller companies from here, even if recovery funds may have their attractions. It also makes it more important than ever to gain proper diversification from the sector.

Nonetheless, if we wish to give Directly Invested portfolios exposure to this sector, we would look to do this through a third party specialist fund. There are around 65 of these in the IMA UK Smaller companies sector. In addition, there are a significant number of quoted investment vehicles. By concentrating on long-term performance and consistency through the economic cycle, it is possible to narrow down the choices available in the investment universe. Funds such as the Old Mutual UK Select Smaller Companies fund have such a track record and it is currently the favoured small company fund of the Principal Managed Funds team.

MARKET LEVELS AND MOVEMENTS TO 31 JULY 2009

UK Equities

	Index	vs Last Month %	YTD Total Ret %
FTSE 100	4,608	8.5	6.8
FTSE 250	8,000	7.9	28.1
FTSE SmallCap	2,392	6.9	31.5
FTSE All Share	2,354	8.4	9.4

Overseas Equities

	Index	vs Last Month %	YTD %	YTD (£) %
US (Dow Jones)	9,172	8.6	4.5	-9.4
Europe*	130	9.5	12.7	-0.5
Japan (Nikkei)	10,357	4.0	16.9	-3.5
Pacific*	325	10.6	41.0	28.3

*based on FTSE All-World Indices Europe ex UK and Pacific ex Japan respectively

UK Valuation Yardsticks

Market P/E	13.3	(historic, FTSE All Share)
Index Linked Yield	0.92%	(over 5 years, 5% inflation)
Market Yield	4.1%	(net historic, FTSE All Share)
Base Rate	0.5%	

Bond Yields

	Now %	End 2008 %
UK	3.8	3.1
US	3.5	2.3
Germany	3.3	2.9
Japan	1.4	1.2

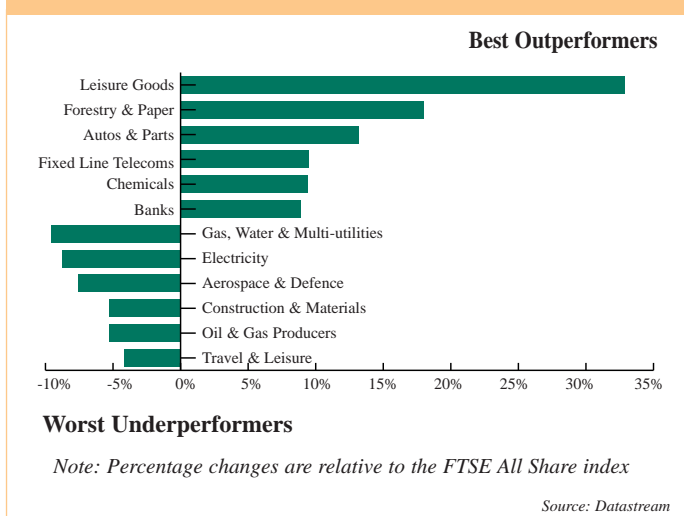
(based on ten year Government bonds)

Currencies

	Current Rate	YTD %
£ vs US\$	1.7	15.3
£ vs Euro	1.2	13.1
£ vs Yen	157.8	21.1

Source: Datastream

Sectors of the Month



FTSE 100 Index



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