Why UK small caps are a fertile hunting ground for active managers

Marlborough
Fund Managers

By Eustace Santa Barbara, Co-Manager of the Marlborough Special Situations Fund

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Companies aren't born as global titans. Famously, even Apple, the world's first trillion dollar market cap business, began life with two friends working in the garage of a house in California.

The stock market giants of today all began life as much smaller companies.

Small cap fund managers seek to reap the benefits of this growth trajectory by identifying which of the minnows of today have the potential to become the success stories of tomorrow.

The UK smaller companies universe, based on the Investment Association's definition, is comprised of the bottom 10% of the UK's listed stocks by market capitalisation. The figure will change as stock market values fluctuate, that means companies with a market cap of £1.64 billion or below, as at 30th November 2018.

With more than 2,000 stocks to choose from, this is a fertile hunting ground for active fund managers - those who use their experience and judgement to construct a portfolio of stocks, rather than buying all the shares in a particular index.

There are, without question, companies at this end of the market cap spectrum with the potential to grow into major global players. When that happens, those who spotted the stock's potential early can make a return of 10 or even 20 times their original investment.

It's true too, of course, that in the small cap arena there will be companies that run into serious trouble and when that happens the share price can fall quickly and sharply.

Active management is all about sifting the companies with strong growth potential, which have often developed highly innovative products or services, from the potential problem stocks and the 'me-too' businesses with less attractive offerings and less inspiring prospects.

Intensive research

It is a labour-intensive process. As Co-Managers of the Marlborough Special Situations Fund, Giles Hargreave and I work with a team of more than a dozen investment professionals, with almost 200 years' combined experience of investing in UK small caps and mid caps.

We study company reports, examine the fundamentals and, if we think there is the growth potential we're looking for, meet the management team running the business to hear first-hand their vision and strategy. Between us we'll meet between 25 and 30 companies a week and these meetings, with a chance to question the company's leadership team face to face, are an essential part of our investment process.

If we like the company's story then we'll consider investing, but initial positions are usually less than 1% of the fund. Then if the management team deliver on their goals, we'll buy more gradually over time. To manage the increased risk associated with small caps though, we hold a highly diversified portfolio of around 200 stocks and even our largest positions are rarely as much as 2% of the fund.

Less research, more opportunities

There are fewer analysts covering stocks at this end of the market cap spectrum, which helps to create opportunities for specialist fund managers to uncover hidden gems.

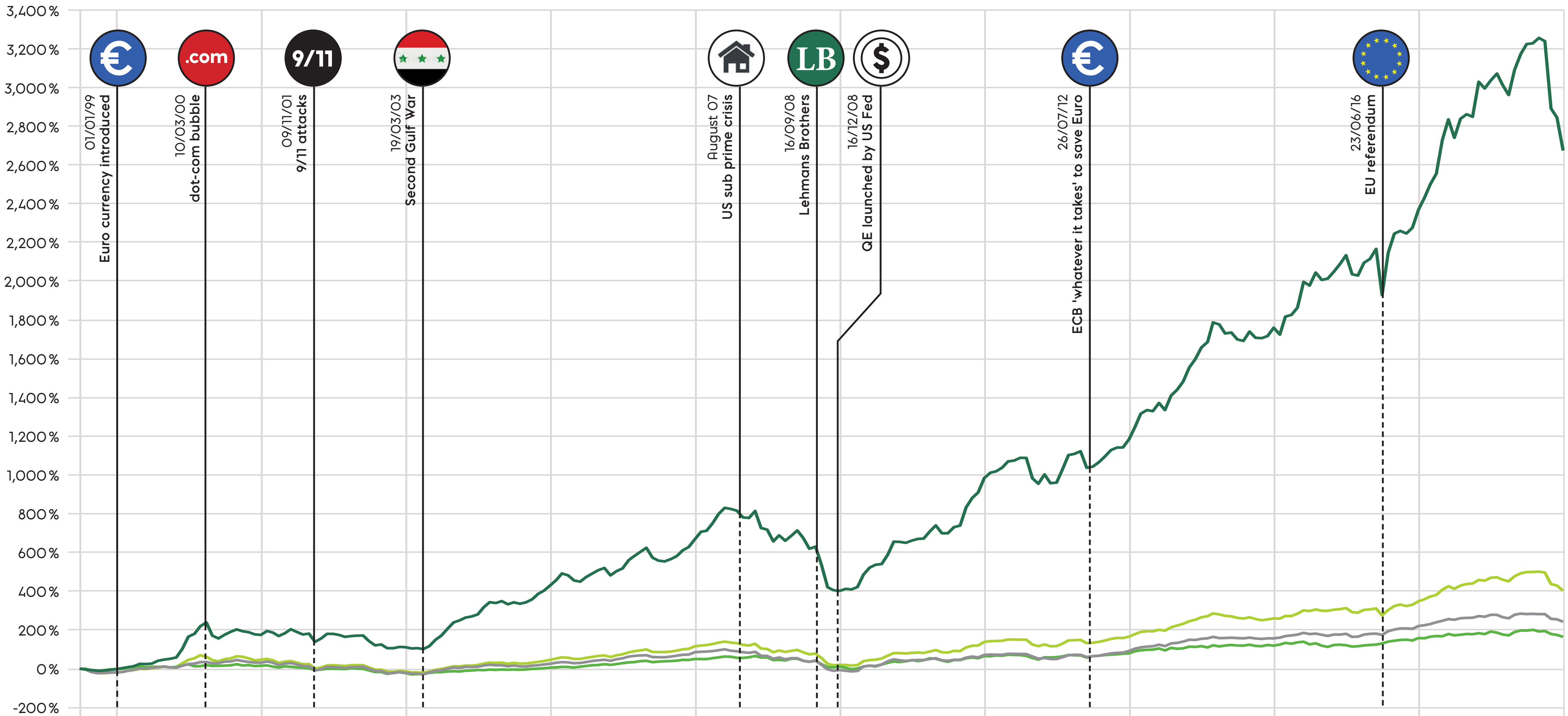
The mean average number of analysts covering a FTSE 100 stock is just over 20, but there are far fewer looking at smaller companies - around four or so for the average stock in our portfolio.

Our stablemate, the Marlborough UK Micro-Cap Growth Fund, invests in even smaller companies, primarily those with a market cap of £250m or less at the time of purchase, and there may be only two or three analysts covering some of these micro-cap stocks, based on mean average figures.

Furthermore, MiFID II regulations introduced at the start of 2018 requiring asset managers to pay for all external research are likely to result in even fewer analysts covering the UK's smaller companies. That should in turn provide still more opportunities because there may be even less research into these companies than previously.

Marlborough Special Situations

Investment Growth: 01/07/1998 to 31/12/2018



01/07/1998 31/12/1998	01/01/1999 31/12/1999	01/01/2000 31/12/2000	01/01/2001 31/12/2001	01/01/2002 31/12/2002	01/01/2003 31/12/2003	01/01/2004 31/12/2004	01/01/2005 31/12/2005	01/01/2006 31/12/2006	01/01/2007 31/12/2007	01/01/2008 31/12/2008	01/01/2009 31/12/2009	01/01/2010 31/12/2010	01/01/2011 31/12/2011	01/01/2012 31/12/2012	01/01/2013 31/12/2013	01/01/2014 31/12/2014	01/01/2015 31/12/2015	01/01/2016 31/12/2016	01/01/2017 31/12/2017	01/01/2018 31/12/2018
-3.42	174.46	3.51	1.90	-24.58	80.23	39.47	16.50	24.35	6.45	-38.65	51.82	42.35	-2.16	21.10	36.86	5.80	20.11	10.53	27.04	-11.54
-19.60	80.84	0.63	-19.13	-27.54	38.76	22.46	19.83	23.55	-6.55	-40.53	51.60	30.90	-8.95	22.60	37.50	-1.63	14.86	8.48	27.15	-11.79
-19.41	53.81	5.54	-16.89	-27.57	39.71	14.00	22.40	20.59	-10.55	-43.91	54.27	19.52	-12.53	27.82	32.77	0.89	9.17	14.29	18.15	-9.52
-1.39	24.20	-5.90	-13.29	-22.68	20.86	12.84	22.04	16.75	5.32	-29.93	30.12	14.51	-3.46	12.30	20.81	1.18	0.98	16.75	13.10	-9.47

Marlborough Special Situations P Acc	2,673.5%	IA OE UK Smaller Companies	402.0%	FTSE Small Cap TR GBP	242.1%	FTSE AllSh TR GBP	164.1%

Past performance is not a reliable indicator of future performance. Values may go down as well as up and are not guaranteed. Source: Morningstar Direct, bid-bid, net income reinvested.

Longer-term view

Investing in small caps can require patience though. It's not unusual to invest knowing that it could be one or two years before the company's story really begins to play out. In terms of how long we might expect to hold a stock, when we invest we're assessing the potential value of the company in three to five years' time. But if a business continues to achieve the growth we're looking for then we might hold it for ten or more years. Running the winners is an important part of our strategy.

A bottom-up approach, where you lift the bonnet on individual companies and really get to understand what makes them tick, is particularly important in the smaller companies arena. These are often young companies operating in markets that aren't yet fully established and that means assessing their potential requires time and expertise.

Established FTSE 100 companies are often categorised into sectors using the Global Industry Classification Standard, which allows investors to compare valuations and other metrics. That doesn't work as well with smaller, faster-growing companies bringing innovative and often disruptive products and services to market.

This means there can be a lot more work to do to assess their potential and value. But therein lies the opportunity for active managers. By applying experience and resources to identifying companies with strong growth prospects, we aim to add value for our investors over the long term.

While they may not succeed on quite the same scale as Apple, among the UK's diverse and substantial universe of companies there are certainly those with the potential to grow into global success stories. As active fund managers, it is our job to find them.

Risk Warnings

Capital is at risk. The value and income from investments can go down as well as up and are not guaranteed. An investor may get back significantly less than they invest. Past performance is not a reliable indicator of current or future performance and should not be the sole factor considered when selecting funds. Our funds invest for the long-term and may not be appropriate for investors who plan to take money out within five years. Tax treatment depends on individual circumstances and may change in the future. The Marlborough Special Situations and UK Micro-Cap Growth Funds will be exposed to stock markets. Stock market prices can move irrationally and be affected unpredictably by diverse factors, including political and economic events. The funds will invest in the shares of smaller companies which are more volatile over shorter time periods. The funds invests mainly in the UK, therefore, investments will be vulnerable to sentiment in that market, which may strongly affect the value of the fund. In certain market conditions some assets in the funds may be less liquid and therefore more difficult to sell at their true value or in a timely manner.

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