Marlborough
Fund Managers

Q&A: Why there's big potential in smaller companies

September 2019

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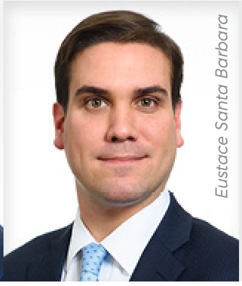
Giles Hargreave


Eustace Santa Barbara

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Giles Hargreave and Eustace Santa Barbara, Co-Managers of the Marlborough Special Situations Fund, discuss the historic outperformance of the UK's smaller companies and explain their superior long-term growth potential.

How would you summarise the case for investing in UK smaller companies?

GH: "Paul Marsh and Scott Evans from the London Business School published some excellent research earlier this year showing the historic outperformance of UK smaller companies compared to the FTSE All-Share.

"As part of an annual exercise, they looked at the performance of the Numis Smaller Companies Index (NSCI), which is comprised of the bottom 10% by value of all companies listed on the main market of the London Stock Exchange.

"The LBS academics, whose research was published in January[1], found that £1 invested in the companies in the NSCI in 1955 would, with dividends revinvested, have grown to £6,417 by the end of 2018. If you'd invested instead in the real minnows of the Numis 1000, which is the smallest 2% of the market, excluding investment companies, then your return would have been more than double that, £15,213. By contrast, if you'd put your £1 into the FTSE All-Share it would have grown to only £991.

"That's what happened in the past and you can't, of course, rely on the fact that it'll happen in the future, but we're strong believers in the superior growth potential of smaller companies.

"Smaller companies tend to be younger businesses, often shaking up existing markets with innovative new products and services or opening up completely new markets. When a smaller company's products or services take off, there's huge potential for growth.

"They're also likely to have a smaller team and greater flexibility, so they can be more agile and quicker to seize on a new opportunity by, for example, bringing out a new product. By contrast, large companies can be like oil tankers, it takes them a while to adjust their direction to do that.

"So in our view it's arguably easier for a smaller company in a dynamic market to grow its market share and double its market cap from £250m to £500m than it is for a FTSE giant operating in a mature market and with a market cap of £70 billion or £80 billion to achieve the same kind of growth."

How does investing in smaller companies differ from investing in large caps?

ESB: "One of the key differences when you're investing in smaller companies is the sheer number of opportunities to choose from. A fund manager investing just in the FTSE 100 and the FTSE 250 is only going to have 350 companies to look at. We can select the most attractive opportunities from almost 2,000 stocks, including those listed on the Alternative Investment Market (AIM), FTSE SmallCap, FTSE Fledgling and the lower reaches of the FTSE 250. That means there are always interesting new companies coming on to our radar.

"Another thing about smaller companies is that there are fewer investment analysts researching them. The mean average number of analysts covering a FTSE 100 stock is just over 20, but there are far fewer covering smaller companies. There are, on average, only five analysts across the industry covering each stock in our portfolio[2]. That means there are more opportunities for investment teams like ours to uncover hidden gems with growth potential that may not yet have been fully appreciated by the wider market.

"But - and it's an important but - when a small company runs into trouble, and this does happen, the share price can fall very sharply. To help manage some of that risk we have more than 160 stocks in the fund, so if one does go wrong the overall impact is potentially less serious. We believe diversifying in this way is very important in the smaller companies arena."

How has the uncertainty around Brexit affected the smaller companies you invest in?

GH: "There's a misconception that smaller companies are overwhelmingly focused on the domestic economy, which means they'll all have been hit hard because of the protracted uncertainty around Brexit and the effect on the UK economy.

"That's simply not the case though. If you look at our fund, around half the revenues of portfolio companies come from overseas.

"As an example of the increasingly global nature of many small caps, one of our top ten holdings is SDL, which is a language translation software and service provider to many of the largest companies in the world.

"In 2018, 43% of their revenues were generated from the US and the rest of North and South America, 21% from Europe (excluding the UK), the Middle East and Africa, 25% from the Asia Pacific region and only 11% from the UK.[3]

"Future, another one of our larger positions, is a global multi-platform media business. It owns leading titles in a number of specialist areas including technology, gaming and music. The company has established itself as the leading publisher of online tech news in the US and now generates more than half of its revenues there.[4]

"We also hold a considerable number of companies that have carved out a niche for themselves, where there are few, if any, other businesses offering a similar product or service. If their customers have limited alternatives, that can give the company pricing power, which should provide a degree of protection from economic shocks associated with political events like Brexit."

Generally, smaller companies are perceived to be less liquid than large caps, how do you manage this in the portfolio?

ESB: "Because we hold such a diversified portfolio, even our largest positions are rarely as much as 2% of the overall value of the fund. This strategy of carefully controlling exposure to each individual company helps to manage liquidity risk.

"In addition to the sharp focus Giles and I have on liquidity management, Marlborough's Risk Team conduct their own ongoing liquidity analysis on the fund, as they do with all of their funds, modelling a range of scenarios and stress-testing the portfolio."

What do you look for when you're considering investing in a company?

GH: "We like to see strong management running the business. Eustace and I work with a large team and between us we'll meet 25 to 30 companies a week. We like to hear them articulate the business story and see how they answer our questions. There really is no better way to gauge the quality of a leadership team.

"It's always interesting too to see innovative products and services with the potential to disrupt markets or create new ones.

"It's important to point out though that even when we like a company's story, we'll only start with a relatively small investment. Our initial positions are usually less than 1% of the fund.

"In terms of what would put us off investing in a company, broadly speaking, we'll avoid 'me-too' businesses, those with weaker products and services that aren't really doing anything new or interesting and which have a lot of competitors.

"We like to see management who are themselves invested in a company. So, generally, we'll also tend to avoid companies where management aren't incentivised by being shareholders themselves.

"Something else we tend to be wary of is buying into a company where the share price is falling. It can be tempting, of course, when a stock suddenly becomes a lot cheaper but often there's a very good reason for the share price going south, which means there's further to go. So, we'll look very carefully before investing."

How would you characterise the investment outlook?

ESB: "The US-China trade war, concerns about a global economic slowdown and, of course, the lack of clarity around Brexit, all continue to weigh on investor sentiment.

"Indeed, because of the political uncertainty caused by Brexit, many global investors are allocating less to the UK equity market than they have done historically. That does mean though that it now looks cheap relative to comparable markets. On simple fundamental metrics such as price-to-earnings multiples, the UK is trading at close to the greatest discount seen in the last 25 years relative to other developed equity markets such as the US and Europe.[5]

"It's also hard to ignore a macro environment in which interest rates remain low, as does reported inflation. If that persists, the backdrop will be supportive for equities.

"In addition, equities continue to look attractive compared with fixed income investments. Around a quarter of the bonds issued by companies and governments worldwide, nearly £14 trillion worth, are currently trading on negative yields.[6]

"Finally, it's worth remembering that over the medium to long term, what we believe matters when investing in UK equities is the quality of the company, rather than the political backdrop. We're continuing to identify well-managed dynamic smaller companies with strong long-term growth prospects and, because the UK market is unloved, they're often trading on highly attractive valuations."

Source 1: Numis Smaller Companies Index 2019 Annual Review, 16/01/19

Source 2: Bloomberg, 12/09/19

Source 3: SDL PLC final results for year ended 31/12/2018

Source 4: Future PLC 2019 H1 Results, P.3

Source 5: Panmure Gordon, Valuation Monthly, September 2019

Source 6: Financial Times 09/09/19, FTfm supplement, P.6

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