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

What is the attraction of investing in the UK’s smaller companies?

"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.

"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.

"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. 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.

"When a smaller company gets it right, there's the potential to grow from a stock market minnow into a major global player. When that happens, investors who spotted the potential early can
reap the benefits. 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."

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

"We like to see strong management running the business. We 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 won't only start with a relatively small investment. Our initial positions are usually less than 1% of the fund and even our largest holdings are rarely as much as 2%.

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

"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."

"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."

"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."
Source 1: Bloomberg, 12/09/19.
Source 2: SDL PLC final results for year ended 31/12/2018
Source 3: Future PLC 2019 H1 Results, P3