Lincoln Private Investment Office

London

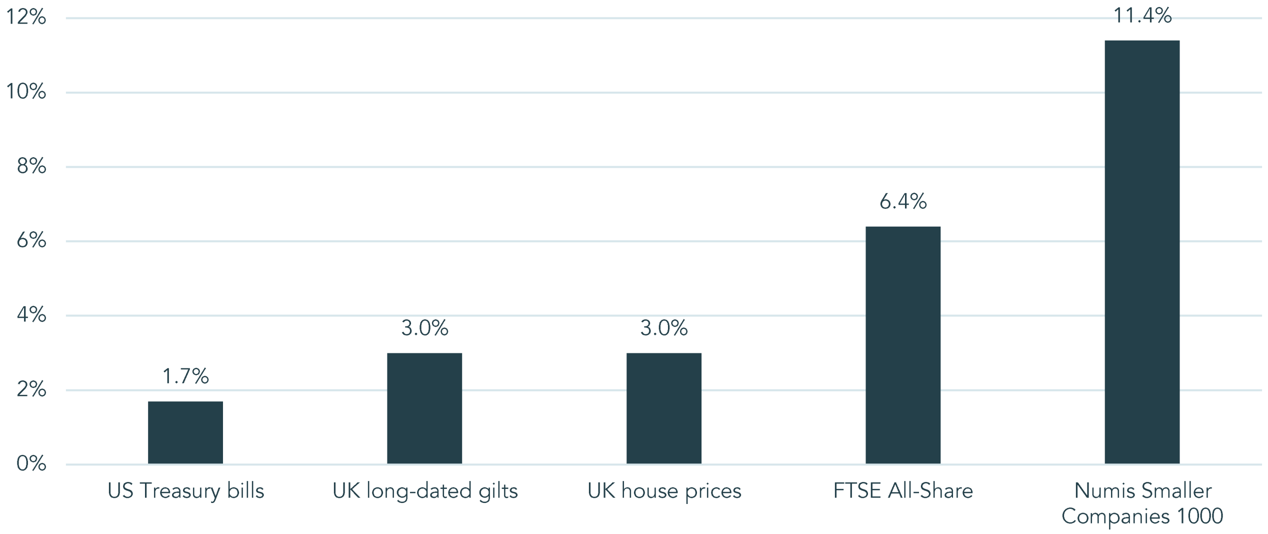
November 2019

Good things come in small packages

The UK's small cap market is one of the highest-quality and most transparent markets of its kind in the world, providing access to capital for a multitude of companies and opportunities for investors. After a lacklustre period for this sector, we reflect on recent performance and offer our perspective on the future prospects for this temporarily unloved part of the market.

Before delving into the state of the market, it is worth reiterating the basic premise that underpins the investment case for small cap equities. A significant body of research supports the view that small cap equities deliver superior returns to their large cap counterparts in the long run. The differential in historical returns is particularly marked in the UK. Below we have compared the annualised performance of the Numis Smaller Companies 1000 Index against various other asset classes. The Index tracks the smallest 1000 companies in the UK equity market, which have an average market capitalisation of £191m. Since 1955, this cohort has produced an annualised total return of 11.4% above inflation, compared with 6.4% from the FTSE All-Share, which has a higher weighting to larger companies.

Annualised real returns,1955-2018



Source: Numis, 2019

One could be forgiven for forgetting this past outperformance given the returns from UK small caps over the past 24 months. In the 2 years to the end of September 2019, the Numis Smaller Companies 1000 Index returned -10%, compared with a positive 8.6% total return from the FTSE All-Share Index. This disparity is partly down to the ongoing Brexit drama and its knock-on effect on the UK economy. UK small cap shares have suffered in this period of Sterling weakness, as businesses' profits are threatened by the rising costs of non-domestically sourced inputs. To illustrate the correlation, we have charted the performance of the Numis Smaller Companies 1000 Index against the Sterling-US Dollar (GBP/USD) exchange rate since the Brexit referendum. As we will come on to discuss, this has deterred institutional investors from allocating to UK equities.

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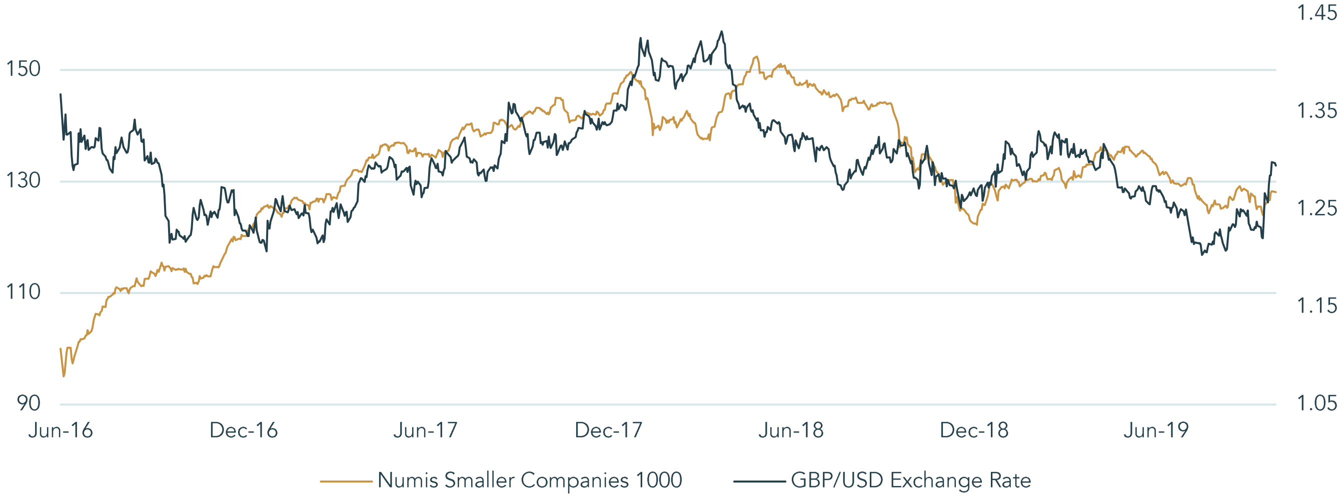
Numis Smaller Companies 1000 Index versus GBP/USD



Source: Bloomberg, 2019

If Brexit created a cloud over the UK small cap sector, then the well-publicised fall from grace of fund manager Neil Woodford made it rain. Woodford's flagship Equity Income Fund was suspended in June to deal with rising redemptions after a prolonged period of underperformance. After several extensions to this suspension, the Fund's administrators took the decision to wind up the Fund, fire Neil Woodford as manager, and plan the return of cash to investors. The Fund's downfall was the 'illiquidity' of a significant proportion of its investments.

Searching for higher returns, Woodford made several investments in unlisted, private businesses, which do not trade at all. When he wanted to trim these positions to raise cash to meet redemptions, he had nobody to sell to. Instead, he sold his larger more liquid positions, resulting in the private companies becoming a larger proportion of the Fund, eventually breaching the 10% limit imposed by the regulator. Once the fund was suspended, Woodford sought to reposition it by selling many of his small company holdings. This created a short-term technical overhang which weighed on small cap share prices, irrespective of their fundamentals. Whatever one's views are on the Woodford strategy, the episode has undoubtedly hampered returns in UK small caps and damaged sentiment in the sector.

The saga has reinforced two messages we have discussed with clients since our inception. We favour capacity constrained funds and believe illiquid investments should be accessed via correspondingly illiquid structures. Our discretionary allocation to UK small caps is through a capacity constrained, appropriately sized fund. It does not own any unlisted businesses and has strong liquidity controls in place to cope with redemptions as and when they arise. The same is true of the UK micro cap fund in our advisory offering. For exposure to the uncorrelated returns available in unlisted companies, we discuss with clients the benefits of specialist private equity managers on an advisory basis.

UK equities started the year as the least popular asset class in the Bank of America Fund Managers' Survey. In subsequent surveys throughout the year, UK equities have been consistently unpopular. Additionally, within their thin allocation to the UK, investors have favoured larger exporting companies that benefit from a depreciating currency. Companies with domestic revenues, typically smaller businesses, have been among the least popular investments. The graph overleaf illustrates how JP Morgan's basket of UK 'domestic' equities has performed against UK 'exporters' since the 2016 referendum. A striking feature of the comparison is the severe period of underperformance of domestics in the last twelve months, as Sterling slumped and concerns mounted over the UK economy.

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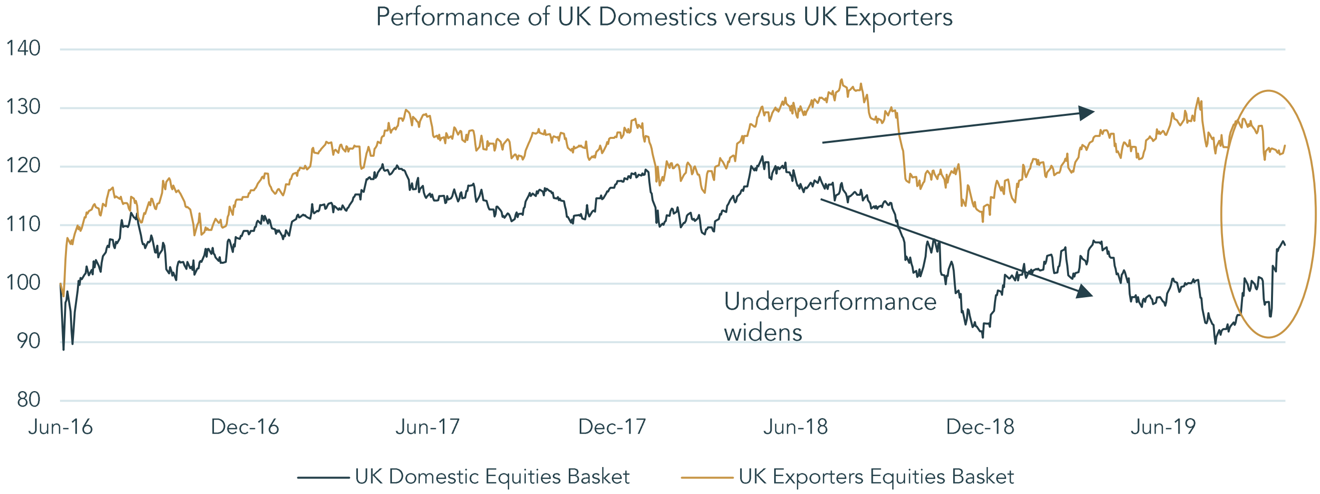

Source: Bloomberg, 2019

Far from viewing recent history as discouraging, we believe that now is an excellent time to be investing in UK small caps. The section circled in gold on the chart above highlights the recent period when Brexit deal prospects were improving, Sterling was rallying, and we saw a corresponding outperformance of domestically focused equities. We believe investors will continue to rotate back into UK domestic equities, supporting our conviction that this trend will prevail in the medium term.

Beneath this shifting sentiment, the fundamentals of the UK economy are supportive for small companies. The Bank of England's Michael Saunders argues that a reasonable Brexit deal could release pent-up business investment, boosting economic output. Illustrative of the possible magnitude of this boost, the Bank has claimed that corporate investment is depressed by c.25%. Economic bright spots elsewhere include the labour market, with 850,000 jobs created since the 2016 referendum. Similarly, the consumer looks in reasonably good health, with wages growing ahead of inflation.

There is also scope for a fiscal tailwind for the UK economy. Government net investment currently sits at 2% of GDP, below European peers and the UK's historical average. We see room for an uplift as political risk subsides. Clearly, the extent and sector focus of this fiscal stimulus will be determined to some degree by the outcome of the December General Election. However, we expect to see a loosening of the Chancellor's purse strings which we believe would be supportive for domestic smaller companies.

Aside from the favourable investment backdrop, we have seen a structural change that will create opportunities for active fund managers. The EU's MiFID II directive, effective from January 2018, has forced fund managers to slash the fees they pay to external analysts for their research. Equity research has become a less profitable enterprise for investment banks and the number of analysts has fallen as a result. The reduction in analyst coverage has been most marked in the small cap sector because there are fewer funds here to sell research to. Companies with a market cap under £100m have on average just 2 analysts, compared with an average of 21 analysts covering >£10bn companies. This will allow fund managers to exploit their superior understanding of these businesses compared with the wider market.

Pulling the strands of the investment case together, it is clear to us that good things really do come in small packages. In addition to the power of compounded earnings growth over the long term, which is an ever-present attraction of small cap investing, we have identified near-term catalysts that should be supportive of small cap share prices. Moreover, we believe the trade-off between risk and reward is attractively skewed to the upside.

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