IMPERIUM CAPITAL

momentum

Weekly Digest

25 November 2019

Small can return big

– *Stephen Nguyen, CFA*

As small cap stocks have continued to lag their large cap peers, with the Russell 2000 US small cap index posting returns of 7.8% per annum over the past 3 years compared to 14.5% for the US main board, S&P 500, so the difference in valuations (as measured by price to book) has grown to its widest level in the past 20 years. Could this provide an attractive point to gain exposure to small cap stocks? Whilst valuations have limited predictive power in the short term, in our opinion they are a very reliable indicator of longer-term returns.

We believe investors should consider an allocation to small cap stocks as a longer-term holding in a well-diversified portfolio, in order to boost returns. Whether investors opt for a regional or global approach, or a combination of both, over the long term there are many factors which should work in their favour.

The greater levels of inefficiency, growth, likelihood of takeovers and potential for outperformance are all attractive characteristics of small cap equity investments. We believe the best way to access these opportunities and effectively manage the inherent risks is via specialist and focused active managers. In particular, those with a strong and detailed fundamental bottom-up approach are well placed to obtain and analyse pertinent information associated with these smaller firms, in order to take advantage of the superior upside potential on offer relative to large caps or passive strategies.

Smaller companies typically have lower levels of coverage by sell side analysts with many having none at all. Following recent regulatory changes and continuing cost pressures across the industry, this trend is likely to continue, which increases the chance of mispricing.

Better growth potential is another appealing reason, particularly in the current low growth environment. Small cap growth rates can be less sensitive to global macro conditions as most of these businesses are more domestically focused. Many smaller firms offer more niche products and services, which again allows them to grow and expand with less reliance on macro tailwinds.

Lastly, small companies are more likely to be taken over by larger firms or private equity investors, so it is not always necessary to wait for the market to correct instances of mispricing.

Small cap companies may offer attractive returns for investors, but they are not without risks. We believe these risks are often misunderstood or exaggerated, however. The most obvious concern is complete business failure and bankruptcy, leading to a permanent loss of capital for investors. This is not a risk solely for smaller companies and can take place across the market capitalisation spectrum as many investors discovered during the Global Financial Crisis (GFC). As with any investment, this risk is best mitigated by conducting thorough due diligence by a specialist investment team and combining this with a strong and robust portfolio construction process.

Small cap stocks have been more volatile than their large cap peers in the past, which leads many investors to believe they also significantly underperform during times of stress. Looking back at the GFC, the smaller cap index (Russell 2000) did indeed underperform the larger index (S&P 500), but the magnitude was not significant (~54% peak to trough drawdown versus ~53%). Smaller cap stocks do tend to be more volatile, but over time investors can be compensated for this additional variability. Over the last 20 years*****, smallcap stocks have delivered higher risk-adjusted returns relative to larger firms in the US, UK and globally.

Or, put more plainly, small can return big.

* Bloomberg, MSCI 1999-2019

The **Marketplace**

- Recession risks fade as global triggers stabilise
- Hopes of US/China 'phase one' trade deal dashed
- Brent crude gained 0.1% ending the week at $63.4 a barrel
- Gold fell 0.3 % ending the week at $1462.7 an ounce

Market **Focus**

US

- US equities ended their six-week run of gains last week amidst concerns over trade, falling 0.3% on the week
- Jobless claims rose to 227k last week, sending the four-week moving average up to 221k, the highest level since June
- Speculation that a 'phase one' trade deal between the US and China was imminent were dashed last Wednesday, with both sides indicating the chances of completion this year is unlikely
- US Treasury yields rose by 0.4% last week.

Europe

- Composite PMI for the euro-area fell to 50.3 in October narrowly avoiding contraction. This was below forecaster estimates
- The advance consumer confidence indicator for the euro area rose to -7.2 (vs. -7.3 expected) in November
- European equities fell 0.6% primarily over concerns over the impasse in the US/China trade war
- Germany has narrowly missed recession as the economy grew by 0.1% in Q3. Hopes of a significant rebound are minimal with the Bundesbank expecting stagnation in Q4.

UK

- In UK election news, the parties released their manifestos with Labour's notably proposing to raise tax revenues by 10% and levying a windfall tax on oil companies. The Conservative party have posted a double-digit lead in all recent opinion polls
- Composite PMI fell to 48.5 pushing the UK further into contraction territory. Consensus estimates are for a 0.2% drop in GDP for Q4
- Equity markets rose by 0.4% on the week.

Asia/Rest of The World

- China's chief trade negotiator was 'cautiously optimistic' about reaching a 'phase one' trade deal before the year, but US support for protestors in Hong Kong has been a major factor in derailing talks
- The Bank of Japan has not purchased any domestic ETFs for over a month (3/4 of the domestic ETF market is state-owned) leading to speculation that the central bank is scaling back its stimulus program
- Japanese equities fell last week by -0.8%
- South African equities rose by 1.3% amidst raised hopes of a central bank rate cut.

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 22 Nov. 2019	Month to date	YTD 2019	12 months
Developed Market Equities					
United States	USD	-0.3%	2.5%	25.6%	19.1%
United Kingdom	GBP	0.4%	1.4%	13.0%	9.1%
Continental Europe	EUR	-0.6%	2.0%	24.2%	19.2%
Japan	JPY	-0.3%	1.5%	15.9%	6.5%
Asia Pacific (ex Japan)	USD	-0.4%	0.3%	12.5%	11.7%
Australia	AUD	-1.2%	1.2%	23.6%	22.9%
Global	USD	-0.4%	1.9%	22.9%	16.9%
Emerging markets equities					
Emerging Europe	USD	-0.4%	0.8%	25.9%	22.2%
Emerging Asia	USD	-0.2%	0.8%	11.6%	11.0%
Emerging Latin America	USD	0.9%	-2.2%	8.6%	8.1%
BRICs	USD	0.8%	0.2%	14.0%	12.0%
MENA countries	USD	0.7%	2.3%	3.7%	4.4%
South Africa	USD	1.4%	4.5%	4.9%	3.5%
India	USD	0.0%	-0.7%	7.9%	13.5%
Global emerging markets	USD	0.0%	0.7%	11.1%	10.2%
Bonds					
US Treasuries	USD	0.4%	-0.4%	7.7%	10.4%
US Treasuries (inflation protected)	USD	0.6%	0.3%	8.5%	9.3%
US Corporate (investment grade)	USD	0.4%	-0.1%	13.7%	15.2%
US High Yield	USD	-0.2%	-0.1%	11.6%	9.5%
UK Gilts	GBP	0.0%	-1.5%	8.2%	10.1%
UK Corporate (investment grade)	GBP	0.0%	-0.6%	10.4%	11.5%
Euro Government Bonds	EUR	0.2%	-0.8%	7.9%	9.7%
Euro Corporate (investment grade)	EUR	-0.1%	-0.4%	6.2%	6.5%
Euro High Yield	EUR	0.0%	0.2%	9.3%	8.5%
Japanese Government	JPY	0.2%	-0.5%	2.3%	3.4%
Australian Government	AUD	0.6%	0.3%	10.2%	13.0%
Global Government Bonds	USD	0.2%	-1.1%	5.9%	8.4%
Global Bonds	USD	0.1%	-0.8%	6.4%	8.4%
Global Convertible Bonds	USD	-0.1%	0.8%	8.7%	7.8%
Emerging Market Bonds	USD	0.8%	0.5%	9.9%	12.2%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 22 Nov. 2019	Month to date	YTD 2019	12 months
Property					
US Property Securities	USD	-1.2%	-3.2%	23.3%	15.5%
Australian Property Securities	AUD	-1.6%	-0.3%	18.1%	16.6%
Asia Property Securities	USD	1.4%	-2.7%	9.3%	11.2%
Global Property Securities	USD	-0.3%	-2.2%	19.5%	15.4%
Currencies					
Euro	USD	-0.3%	-1.1%	-3.7%	-3.4%
UK Pound Sterling	USD	-0.6%	-0.8%	0.6%	-0.3%
Japanese Yen	USD	0.1%	-0.6%	0.9%	4.0%
Australian Dollar	USD	-0.5%	-1.5%	-3.7%	-6.5%
South African Rand	USD	0.0%	2.4%	-2.3%	-6.6%
Swiss Franc	USD	-0.8%	-1.1%	-1.5%	-0.3%
Chinese Yuan	USD	-0.4%	0.0%	-2.3%	-1.5%
Commodities & Alternatives					
Commodities	USD	-0.3%	0.9%	7.8%	-0.1%
Agricultural Commodities	USD	-0.3%	-0.6%	-4.6%	-6.0%
Oil	USD	0.1%	5.2%	17.8%	1.3%
Gold	USD	-0.3%	-3.3%	14.1%	19.2%
Hedge funds	USD	-0.1%	0.4%	6.6%	5.0%

Source: Bloomberg. Past performance is not indicative of future returns

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The Rex Building, 62 Queen Street, EC4R 1EB

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