European Gazette

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Process is everything for Pan European Smaller Companies

Two factors have interested us in Europe in 2021. First, there has been a value rally since November 2020, particularly in smaller companies. The onset of the pandemic in Europe in early 2020 initially saw value and cyclical stocks, typically tied to consumer and business spending, perform poorly. But as the continent emerged out of the first wave towards the end of summer 2020, this began to reverse

By **Mine Tezgul,** Portfolio Manager

Second, as elsewhere around the world, inflation has been rising, albeit it remains at historically low levels and actually saw a short-term decline in June 2021.[1] There has been much talk in the US of the Federal Reserve looking through rising inflation, seeing it as a short-term phenomenon. That said, even if the US begins to raise interest rates it is unlikely Europe will do so to the same timetable or extent.

Recognising these factors, our European smaller companies team began to explore slightly more cyclical themes in Summer 2020, while still maintaining a quality bias. The business models of the companies we like give them competitive advantage and, ultimately, pricing power. If inflation were to recur to a material extent this can threaten the valuation of long-term assets. But if you have pricing power you can pass on the rising costs to consumers; if you don't, you can't. So pricing power is the key defence, and so it is even more critical to focus on companies that have it.

Despite this tweak, our approach and team for European smaller companies portfolios remains consistent: I have been a portfolio manager for two years, alongside deputy fund manager Philip Dicken who has been involved since 1997.

The continued case for small cap

Smaller companies as an overall category carry more risk and can get hit more severely by an economic downturn if they are less diversified and have fewer resources to draw on. So how is it European smaller companies performed so well during the recent crisis?

The positive case for small cap is well known: smaller companies tend to be more entrepreneurial than their larger peers, focusing on specific niches. A high proportion of owner-managed businesses, as well as greater corporate flexibility, yields better long-term capital allocation to value-creating investments. In addition, the smaller companies' universe has a number of attributes that can generate more alpha for the active investor:

1) **Smaller companies can grow more**
It is statistically clear that it becomes more difficult to generate extra growth the bigger a company is. An incremental €1 million of profits for a company which already generates €1 billion is no big deal, whereas for a company with only €5 million it means 20% growth.

2) **The market becomes less efficient lower down the market cap scale**
Research and media coverage tends to be thinner for smaller companies. So broader investor understanding of companies' business models, corporate cultures and earnings potential is less. This creates a valuable opportunity for the diligent investor to identify mispriced securities – by accessing or developing insights which are tough to unearth and are not already headline news in the financial press.

3) **Smaller companies are less liquid**
Lower liquidity adds to the inefficiency of the asset class and can result in stocks being mispriced for long periods of time. In times of crisis or market corrections the active investor can take advantage of this market inefficiency – buying cheap or selling dear.

4) **Undiluted exposure to investment themes** There are numerous product niches and investment themes to which large cap investors can struggle to get effective exposure. Large conglomerates find the value of their more interesting divisions diluted by other, less interesting divisions in legacy areas and by central overheads. Smaller company investing allows portfolio managers to gain pure exposures to the most attractive themes in the market.

Against such a diverse and exciting market, we implement a clear and consistent investment approach. This enables us to identify high-quality companies, which often make strong long-term investments. Competitive advantages are a hallmark of such businesses, allowing them to grow and/or sustain returns. These include:

Cost advantage A company with a cost advantage can produce goods or services at a lower cost than its competitors, allowing them to undercut competitors on pricing or achieve higher profitability.

Efficient scale benefits Companies with such benefits are operating in a market that only supports one or a few competitors, limiting rivalry.

Switching costs These are those obstacles that keep customers from changing from one product to another, as the switch would make life complicated or expensive for the customer.

Network effect This occurs when the value of a good or service increases for both new and existing users as more people use that good or service.

Intangible assets These are things such as patents, government licenses and brand identity that keep competitors at bay by encouraging or enforcing loyalty to a product or service.

So, despite an ongoing environment of uncertainty across the globe, our quality and growth-oriented investment philosophy, fundamental bottom-up process and long-term approach have served us well in good and bad markets. By remaining loyal to our process we navigated 2020's wide-ranging market environments and aim to continue doing so in future.

“Smaller company investing allows portfolio managers to gain pure exposures to the most attractive themes in the market

[1] Bloomberg, July 2021.

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