Why I believe in the small cap premium

John Husselbee is Head of the Liontrust Multi-Asset team

As investors take fright over inflation, interest rates, recession and war, smaller companies have taken quite a hit this year, relative to their profits – more so than their large cap counterparts. In fact, this is one of the worst periods for companies at the lower end of the market cap spectrum that I can remember since the start of my career.

As readers will know, fears of recession can be particularly damaging for smaller companies, given their propensity to lack scale, cash reserves and be less geographically diversified. When investors feel fearful, they often seek safety in the big, familiar household names.

But in spite of this backdrop, we maintain our faith in the "small cap premium", the concept that, over time, smaller companies can generate higher returns than their blue chip peers, therefore making better long-term investments.

So what will we need to see for a recovery in small caps? A recovery in markets generally, of course, and a sense among investors that the peak in inflation and interest rates is in sight, which will likely get them buying again. The trend towards "deglobalisation" as the world splinters, and as companies and governments focus more on security of supply, should also favour smaller companies, although it is important to stress that we view this as a generational shift, and not a change we expect to see in the short term.

As our investors and regular readers of our missives will know, we have positioned our multi-asset portfolios for three long-term calls: global ex-US equities are more attractive than the US, small caps should outperform large, and value should outstrip growth – all running contrary to what happened for most of the 2010s. While we remain confident in these allocations, outperformance will not come all at once, so it is sensible to retain prudent diversification rather than making a significant gamble that one particular thesis pays off.

We continue to hold a blend of asset classes and styles rather than relying on any one portfolio element and believe this will help us deliver on suitability over the long term. In our annual strategic asset allocation (SAA) rebalancing across our funds and portfolios earlier this year we implemented a fall in allocations to UK equities, including small caps. It is important to state that these moves are not tactical but rather how the data dictate we can best achieve our volatility targets. In our quarterly tactical asset allocation (TAA) scorecard, where each asset class is assigned a rating from one to five, with one most bearish and five most bullish, UK small caps are scored a four.

Once market corrections have played out, our view is that indiscriminate selling will have created a rich seam of opportunities in UK smaller companies. But in such an environment, choosing the right asset classes and fund managers will prove invaluable for investors. It will be important to have an investment process that can cut through the market noise and respond to market nuances, investing in a diversified range of asset classes, styles and funds that will provide steady returns with neither reliance on any one scenario playing out nor wholesale shifts in allocations. Once inflation has stabilised, we anticipate seeing a return to greater diversity of returns from asset classes with equities providing the driving force in terms of real returns. Our portfolios are well positioned for the opportunities we envisage coming through over the next decade, which will likely be markedly different from those seen over the last one.

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