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Unrequited love

UK small caps are still unloved in spite of a relatively strong second-half showing in 2010.

Those who have called every major market move wrong for three years (missing the rally of 2009, missing out on gold, staying overweight in bonds not equities in 2010) – I refer to the UK professional fund management industry – are just not interested; it is only private investors who are backing this sector.

Right now the ‘professionals’ are busy getting out of bonds (too late) and switching into liquid equities.

That means they are paying high double-digit price-to-earnings (p/es) for FTSE 350 stocks and ignoring a raft of quality small caps on middle single-digit p/es.

If the pros do dabble it is in wild card oil or gold plays – where inevitably their speculation (not investment) will

come a cropper.

There are some valid reasons for being wary of small caps.

The UK economic recovery is fragile and domestic small caps are thus more exposed to that than internationally spread FTSE 350 stocks. But we would argue this is more than discounted in price.

We see little value in the speculative (exploration, rather than product) resource plays in the small-cap world although it is these stocks which performed best in this universe during 2010 as a herd.

Individually one or two came a cropper as exploration proved unsuccessful leaving no hope that they would ever achieve production.

The value lies in profitable smaller companies with a clear scalable growth model and few balance sheet constraints which can often be

bought on mid- to low-single-digit multiples.

We suspect that with UK PLC enjoying relatively strong balance sheets, the value realisation process will start with a raft of M&A activity as larger companies pick up the bargains that investors ignore. This in turn should drive a sub-sector re-rating.

Moreover, we do not expect managers – cognisant of the corporate threat to their jobs – to allow this valuation gap to persist.

The braver ones will rid themselves of the excessive costs of an AIM listing by going private – a process normally undertaken at a 30 per cent premium to prevailing market prices. Others will simply buy back shares.

When will the overdue re-rating occur? That we cannot say.

Our instinct is that it is already starting to gather momentum. But it will happen.

And as such buying small caps on low ratings which discount weaker UK economic growth seems a lot smarter than following the herd into the FTSE 350 on ratings which allow no room whatsoever for macroeconomic slippage.

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