

Weekly Digest

Week ending **10 December 2017**

Small cap, big opportunity

Investing in small cap equities is typically perceived to be a riskier investment with high levels of volatility and sub-par returns. In particular, post-Brexit many investors would shy away from such companies in the UK because they are often more exposed to the domestic economy, although that is not always the case. In the UK over the last five years, smaller cap companies have actually outperformed large caps by over 3 per cent per annum. This possibly argues against the traditional small cap perception, and portfolio managers believe there are several sustainable factors arguing the case for a dedicated, long-term allocation to small cap companies.

Firstly, the small cap universe is less efficient from a pricing perspective, which presents an opportunity for superior returns over the long term. Small cap stocks typically have far less sell side analyst coverage, with some having no coverage at all. This is partly due to limited broker research resources to cover the huge number of small cap equities available, and the unprofitable nature of such coverage in light of lower brokerage revenues. MiFID II legislation, which will take effect from 3rd January 2018, is likely to put further pressure on the breadth of broker coverage of small caps due to new FCA rules on receipt of research.

In addition to low broker coverage of smaller companies, there is also meaningfully lower buy side assets under management in small cap strategies, likely due to the higher research demands and capacity constraints that it introduces.

A lack of freely available, in-depth and up to date information makes it far harder for investors to make a fully informed pricing decision; hence the dispersion of perceived mispricing is likely to be higher. This presents a huge opportunity set of market inefficiencies that a skilled manager can take advantage of.

Small cap equities often have greater growth potential, partly due to their lower sensitivity to global macroeconomic themes. Small companies often benefit from a niche product or service, which combined with innovation and a greater scope to rapidly expand operations, enables growth almost irrespective of the global macroeconomic backdrop and to a certain extent the domestic economic backdrop. Hence small cap companies are often better positioned to expand in a low growth environment.

Large cap companies frequently takeover niche, well performing small cap companies as a key tool to increase growth and expand. This is commonplace, and presents small cap investors with an additional source of return. This is particularly beneficial as it may not be necessary for an investor to wait for the market to correct an identified mispricing.

Lastly, analysis of historical performance demonstrates that small cap equities have delivered strong returns, without meaningful additional risk. In the ten years to the end of November 2017, the MSCI AC World Small Cap index achieved an annualised return of 7.5% with annualised volatility of 18.4%, while the MSCI AC World index posted a 5.2% annualised return with 17.1% annualised volatility. In this time period it is evident the small cap space outperformed the broader index, with only slightly greater volatility.

Given all of the above factors, it is worth noting that not all small cap companies present the same return opportunities. In order to gain access to the best potential opportunities, portfolio managers believe it is important to invest with niche and experienced active managers, with a structure designed to best exploit the aforementioned factors.

The Marketplace

- UK strikes divorce agreement with the EU
- US unemployment rate remains at 17 year low
- Eurozone final Q3 GDP growth reading at 0.6%
- US trade deficit rises to nine month high
- Global equities rise during the week

Market Focus

US

- The trade deficit hit a nine month high, rising from USD 44.9 billion in September to USD 48.7 billion in October.
- Employers added 228,000 new jobs in November with the unemployment rate holding steady at 17 year low rate of 4.1%. Continuing in the labour market, growth in average weekly earnings missed expectations, at 2.5% year-on-year versus a 2.7% survey expectation.
- The nomination of the new Federal Reserve chair Jerome Powell was passed by the Senate Banking committee by a 22-1 vote.
- US equities ended the week up 0.4%, while Treasuries fell 0.1%

UK

- On Friday, the UK struck a divorce agreement with the EU, advancing negotiations to the next phase. Reports indicate the 'divorce bill' will amount to GBP 35-39 billion while the EU-UK statement details there will be no 'hard border' with Ireland. In addition, EU citizens living in the UK and vice-versa will have their rights to live, work and study protected.

EU leaders meet on Thursday at a European Council summit to discuss the agreement. European Commission president Jean-Claude Juncker is confident leaders will approve the deal.

- UK PMIs were weaker than expected, with the composite PMI at 54.9 versus 55.8 expected and the services PMI at 53.8 versus 55.0 expected.
- During the week UK equities rose 1.3%, while Gilts fell 0.6%.
- Sterling fell 0.8% versus the US Dollar, although advanced 0.5% versus the Euro, partly in response to the UK-EU divorce agreement.

Europe

- Eurozone Q3 GDP final reading was unrevised at 0.6% quarter-on-quarter.
- In Germany, at the SPD party conference a majority of members voted to allow their leader Martin Schulz to engage in coalition talks with Angela Merkel's CSU/CDU.
- Eurozone final reading composite PMI was 57.5, one of the highest readings in the developed world and is a six year high for the Eurozone.
- German factory order growth was above market expectations at 0.5% month-on-month in October versus -0.2% expected.
- Continental European equities rose 1.5% during the week, while Euro-area government and investment grade bonds both rose 0.1%.
- Brent crude fell 0.5% in the week

Oliver Cooper & Oliver Cooper

Asset Class/Region	Currency	Currency returns			
		Week ending 8 Dec. 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.4%	0.2%	20.0%	19.7%
United Kingdom	GBP	1.3%	0.9%	7.3%	10.5%
Continental Europe	EUR	1.5%	0.6%	12.6%	16.0%
Japan	JPY	0.4%	0.7%	21.2%	21.8%
Asia Pacific (ex Japan)	USD	-0.5%	-0.7%	32.0%	28.3%
Australia	AUD	0.1%	0.4%	10.3%	12.9%
Global	USD	0.2%	-0.2%	20.6%	20.5%
Emerging markets equities					
Emerging Europe	USD	0.4%	-0.1%	14.4%	18.3%
Emerging Asia	USD	-0.2%	-0.7%	38.1%	33.8%
Emerging Latin America	USD	-1.0%	-0.6%	17.8%	19.1%
BRICs	USD	0.0%	-0.7%	36.9%	34.6%
MENA countries	USD	0.3%	0.3%	-2.2%	-0.5%
South Africa	USD	-2.9%	-4.9%	19.0%	21.0%
India	USD	1.5%	0.5%	33.8%	31.7%
Global emerging markets	USD	-0.4%	-0.9%	31.4%	29.2%
Bonds					
US Treasuries	USD	-0.1%	0.3%	2.4%	2.4%
US Treasuries (inflation protected)	USD	0.0%	0.4%	2.7%	2.5%
US Corporate (investment grade)	USD	0.0%	0.4%	5.9%	6.5%
US High Yield	USD	0.0%	0.1%	7.2%	8.0%
UK Gilts	GBP	-0.6%	0.4%	0.8%	2.6%
UK Corporate (investment grade)	GBP	-0.3%	0.4%	3.6%	5.5%
Euro Government Bonds	EUR	0.1%	0.6%	1.6%	2.8%
Euro Corporate (investment grade)	EUR	0.1%	0.3%	3.1%	4.0%
Euro High Yield	EUR	-0.2%	-0.1%	6.8%	8.0%
Japanese Government	JPY	0.1%	0.0%	0.1%	-0.1%
Australian Government	AUD	0.1%	-0.2%	4.3%	4.1%
Global Government Bonds	USD	-0.6%	-0.5%	6.1%	5.7%
Global Bonds	USD	-0.5%	-0.4%	6.7%	6.5%
Global Convertible Bonds	USD	-1.8%	-2.2%	8.1%	7.9%
Emerging Market Bonds	USD	0.0%	0.2%	7.8%	8.4%

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-0.7%	-0.4%	3.7%	4.6%
Australian Property Securities	AUD	-0.2%	-0.1%	1.8%	5.9%
Asia Property Securities	USD	-0.3%	-0.5%	24.2%	18.0%
Global Property Securities	USD	-0.2%	-0.3%	13.7%	13.8%
Currencies					
Euro	USD	-1.3%	-1.1%	11.7%	10.7%
UK Pound Sterling	USD	-0.8%	-0.8%	8.4%	6.4%
Japanese Yen	USD	-1.3%	-0.9%	3.1%	0.4%
Australian Dollar	USD	-1.5%	-0.8%	4.3%	0.5%
South African Rand	USD	0.9%	0.3%	0.3%	0.0%
Swiss Franc	USD	-1.9%	-0.9%	2.6%	2.3%
Chinese Yuan	USD	-0.4%	-0.1%	5.1%	4.4%
Commodities & Alternatives					
Commodities	USD	-2.5%	-1.4%	0.3%	0.9%
Agricultural Commodities	USD	-2.1%	-1.6%	-5.1%	-5.2%
Oil	USD	-0.5%	-0.3%	11.6%	17.6%
Gold	USD	-2.8%	-1.9%	8.3%	6.6%
Hedge funds	USD	-0.3%	-0.4%	4.8%	5.0%

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