Giles Hargreave: what I've learned in 20 years of small cap investing

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Giles Hargreave

Citywire AAA-rated Giles Hargreave marked 20 years managing the Marlborough Special Situations fund on 1st July. Here he shares the key lessons he has learned about investing in small caps over the past two decades.

The UK's smaller companies market can provide a fertile hunting ground for investors. The size of these stock market minnows means they can grow quickly, seizing opportunities by entering new markets or launching innovative products.

Historically smaller companies have grown their earnings faster than their large cap counterparts and, with more than 2,000 stocks to choose from, the range of opportunities is far greater than higher up the market cap spectrum. At the same time, there are far fewer analysts looking at smaller companies - providing opportunities for those with the expertise and resources to do their own research.

However, small caps can also be significantly more volatile. I have seen my share of 10-baggers and even 20-baggers over two decades managing the fund, but I have also seen the disasters, where promising-looking companies hit the buffers and investors lose most or, in some cases, all of their money.

Spread your risk

When a smaller company suffers a significant setback and investors rush for the door then liquidity can dry up quickly and the share price plummets. It is never a pleasant experience, but no matter how careful your analysis and painstaking your research, it will happen from time to time. The trick is to ensure that when one stock blows up the damage to the overall portfolio is limited.

Our approach is to hold a spread of around 200 companies. Initial positions will be less than 1% of the fund. Then, if the company delivers on its promises, we may buy more. However, even our largest positions are very rarely more than 2.5% of the portfolio.

Do not snatch profits

One of the most important lessons I have learned is that snatching profits too early can be a serious mistake. Instead, let your winners run. Sometimes a star in your portfolio might double its share price in a year and it will be very tempting to sell. But, if you still believe in the company's growth story, you can be richly rewarded for having the patience to hold on.

We bought into James Fisher, the marine engineering service company, in 2003 when the share price was £1.40. We have held it ever since and the share price is now north of £18.

Meet company management face to face

It is very rare for us to invest without meeting the management face to face first. In smaller companies, the quality of the management team is even more important than in large caps. With fewer people at the helm of a small company, the positive (or otherwise) influence of each of them will have a proportionately greater effect.

To gauge the quality of a company's management, there is no substitute for sitting down with them. It is also the best way to understand their plans for the business. Meeting face to face really does make an enormous difference.

Do not lose your money more than once

You may have invested a substantial sum in a company, only for it to run into trouble and issue a profit warning, sending the share price plunging. It may be tempting to buy more shares at the lower price, but experience has taught me that, unless there is a very good explanation for the problem, buying into a stock when the share price is falling is generally a mistake. Better instead to invest your capital in a successful company with a rising share price.

Work with a large team

If you are holding a portfolio of around 200 stocks you need a large team to maintain thorough coverage of your existing holdings, while also researching new opportunities.

It also means you have the resources to meet a lot of companies. My Co-Manager Eustace Santa Barbara and I work with a 12-strong investment team and between us we meet an average of around 30 companies each week. That underlines the final lesson I have learned, which is that at this end of the market cap spectrum the sheer number of companies means there will always be interesting new opportunities.

Giles Hargreave is Co-Manager of the Marlborough Special Situations fund, which holds some or all of the stocks mentioned. The views expressed are his own and should not be construed as investment advice.

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Risk Warning

The past is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and you may not get back the amount you originally invested. The Fund invests in smaller companies which carry a higher degree of risk than larger companies. The shares of smaller companies may be less liquid and their performance more volatile over shorter time periods.

Regulatory Information

Marlborough International provides access via offshore cells, which act as feeder funds into the award-winning Marlborough fund range. Past performance is not a guide to future performance. The value of investments and the income derived from them may fall as well as rise and the investor may not get back the amount originally invested. Changes in exchange rates may cause the value of the funds to rise or fall. The European Multi-Cap, UK Micro-Cap Growth, Special Situations and Multi Cap Income funds invest in smaller companies, which carry a higher degree of risk than larger companies and may result in a volatile NAV. The UK Multi-Cap Growth, UK Micro-Cap Growth, Special Situations and Multi Cap Income funds invest mainly in the UK. Therefore they may be more vulnerable to market sentiment in that country. Some of the funds may use derivatives to protect the value of the fund assets or to reduce the costs of investing, although this may not be achieved. It is not anticipated that the use of derivatives will have any significant effect on the risk profile of the funds. Investment in the Marlborough feeder funds can only be made on the basis of the relevant prospectuses, which are available from Marlborough International Management Limited on request or via www.marlboroughinternational.gg.