

# Why UK small caps are a fertile hunting ground for active managers

By Eustace Santa Barbara, Co-Manager of the Marlborough Special Situations Fund

**This information is for Financial Advisers only and should not be relied upon by Retail Investors.**

Companies aren't born as global titans. Famously, even Apple, the world's first trillion dollar market cap business, began life with two friends working in the garage of a house in California.

The stock market giants of today all began life as much smaller companies.

Small cap fund managers seek to reap the benefits of this growth trajectory by identifying which of the minnows of today have the potential to become the success stories of tomorrow.

The UK smaller companies universe, based on the Investment Association's definition, is comprised of the bottom 10% of the UK's listed stocks by market capitalisation. The figure will change as stock market values fluctuate, but at the time of writing that means companies with a market cap of £1.75 billion or below, as at 30th September 2018.

With more than 2,000 stocks to choose from, this is a fertile hunting ground for active fund managers - those who use their experience and judgement to construct a portfolio of stocks, rather than buying all the shares in a particular index.

There are, without question, companies at this end of the market cap spectrum with the potential to grow into major global players. When that happens, those who spotted the stock's potential early can make a return of 10 or even 20 times their original investment.

It's true too, of course, that in the small cap arena there will be companies that run into serious trouble and when that happens the share price can fall quickly and sharply.

Active management is all about sifting the companies with strong growth potential, which have often developed highly innovative products or services, from the potential problem stocks and the 'me-too' businesses with less attractive offerings and less inspiring prospects.

## Intensive research

It is a labour-intensive process. As Co-Managers of the Marlborough Special Situations Fund, Giles Hargreave and I work with a team of more than a dozen investment professionals, with almost 200 years' combined experience of investing in UK small caps and mid caps.

We study company reports, examine the fundamentals and, if we think there is the growth potential we're looking for, meet the management team running the business to hear first-hand their vision and strategy. Between us we'll meet between 25 and 30 companies a week and these meetings, with a chance to question the company's leadership team face to face, are an essential part of our investment process.

If we like the company's story then we'll consider investing, but initial positions are usually less than 1%

of the fund. Then if the management team deliver on their goals, we'll buy more gradually over time. To manage the increased risk associated with small caps though, we hold a highly diversified portfolio of around 200 stocks and even our largest positions are rarely as much as 2% of the fund.

## Less research, more opportunities

There are fewer analysts covering stocks at this end of the market cap spectrum, which helps to create opportunities for specialist fund managers to uncover hidden gems.

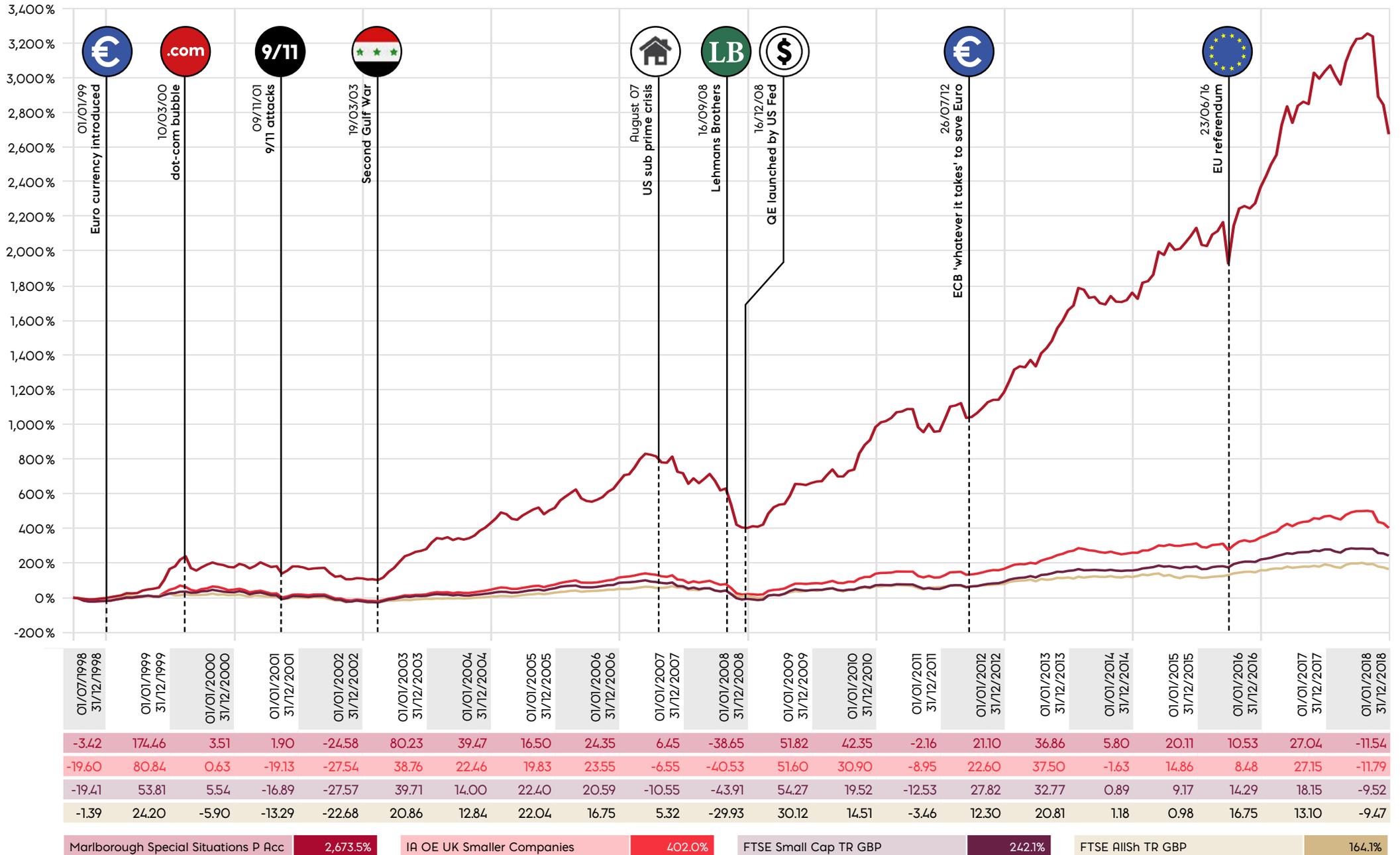
The mean average number of analysts covering a FTSE 100 stock is just over 20, but there are far fewer looking at smaller companies - around four or so for the average stock in our portfolio.

Our stablemate, the Marlborough UK Micro-Cap Growth Fund, invests in even smaller companies, primarily those with a market cap of £250m or less at the time of purchase, and there may be only two or three analysts covering some of these micro-cap stocks, based on mean average figures.

Furthermore, MiFID II regulations introduced at the start of 2018 requiring asset managers to pay for all external research are likely to result in even fewer analysts covering the UK's smaller companies. That should in turn provide still more opportunities because there may be even less research into these companies than previously.

# Marlborough Special Situations

Investment Growth: 01/07/1998 to 31/12/2018



Past performance is not a reliable indicator of future performance. Values may go down as well as up and are not guaranteed.

Source: Morningstar Direct, bid-bid, net income reinvested.

## Longer-term view

Investing in small caps can require patience though. It's not unusual to invest knowing that it could be one or two years before the company's story really begins to play out. In terms of how long we might expect to hold a stock, when we invest we're assessing the potential value of the company in three to five years' time. But if a business continues to achieve the growth we're looking for then we might hold it for ten or more years. Running the winners is an important part of our strategy.

A bottom-up approach, where you lift the bonnet on

individual companies and really get to understand what makes them tick, is particularly important in the smaller companies arena. These are often young companies operating in markets that aren't yet fully established and that means assessing their potential requires time and expertise.

Established FTSE 100 companies are often categorised into sectors using the Global Industry Classification Standard, which allows investors to compare valuations and other metrics. That doesn't work as well with smaller, faster-growing companies bringing innovative and often disruptive products and services to market.

This means there can be a lot more work to do to assess their potential and value. But therein lies the opportunity for active managers. By applying experience and resources to identifying companies with strong growth prospects, we aim to add value for our investors over the long term.

While they may not succeed on quite the same scale as Apple, among the UK's diverse and substantial universe of companies there are certainly those with the potential to grow into global success stories. As active fund managers, it is our job to find them.

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## Regulatory Information

Marlborough International provides access via offshore cells, which act as feeder funds into the award-winning Marlborough fund range.

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