

C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT

EUROPEAN SMALL CAPS: MOUNTING CONCERNS, BUT STAY THE COURSE

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European Small Caps Mounting Concerns, but Stay the Course

Small-cap stocks on both sides of the Channel have performed quite well this year, though their momentum could begin to diminish under the force of several headwinds. This may already be occurring in the United Kingdom where the FTSE 100 Index has managed to eke by the FTSE SmallCap Index (SC) this year by 71 basis points (17.1% versus 16.4%).

Small caps on the Continent, however, have posted stellar figures and they do not appear to be slowing down at all. Year-to-date, small caps, as represented by the S&P/Citigroup Europe ex U.K. EMI Index, have bested the large-cap S&P/Citigroup Europe ex U.K. PMI Index by 7.4 percentage points (29.0% versus 21.6%).¹ In addition, 14 out of the 17 small-cap constituent countries have outperformed U.K. small-caps, as represented by the FTSE SC, with seven racking up 30%+ returns.

Small Caps Dominating

Small-cap stocks in the United Kingdom have been on a tear since January 1999, posting an 81.1% cumulative return, compared to only 13.6% for the FTSE 100. Since its 1986 inception, however, the FTSE SC has been beaten by the FTSE 100, posting cumulative returns of 609.3% and 730.2%, respectively (Table A).

Small-cap shares on the Continent have bested large caps since January 2001, posting cumulative returns of 28.6% and -8.5%, respectively. Since its June 1989 inception, the large-cap index has outperformed its small-cap brethren by 129.6 percentage points, posting cumulative returns of 413.9% and 284.3% (Table B).

Uncertain Macro Environment

Macroeconomic conditions, if they become less accommodative in coming months, may weigh against small caps. The sector typically outperforms as the economy emerges from recession, and tends to underperform during the later stages of the economic cycle and when liquidity begins to dry up. Although the Bank of England (BOE) and European Central Bank have both expressed concerns about headline inflation, neither has initiated a tightening cycle; indeed, the BOE lowered policy rates in August. The main economic worry throughout the region centers on the effect of rising oil prices and the possibility of slowing U.S. demand.

¹ Throughout the rest of this paper, we will adopt the shorthand “continental small caps” when referring to the S&P/Citigroup Europe ex U.K. EMI Index, and “continental large caps” for the S&P/Citigroup Europe ex U.K. PMI Index.

Sector Level Disparities

U.K. equities as a whole have been primarily driven by energy and economically sensitive shares this year thus far (Table C). Year-to-date returns for the FTSE SC and FTSE 100 have been quite similar, despite some considerable performance disparities within the same industry groups, as well as significant differences in industry weightings. Large caps are heavily concentrated in resources, 27.0%; financials, 25.5%; and non-cyclical consumers, 18.9%; while small caps are concentrated in financials, 35.9%, and cyclical services, 26.8%. Within resources, while small caps have significantly outperformed large caps thus far this year, the industry group accounted for a much larger proportion of the FTSE 100's returns, due to its substantial market cap weighting in the index. Large-cap non-cyclical consumer goods shares thrashed their small-cap counterparts, and have contributed considerably to the year-to-date returns of the FTSE 100. Small caps outperformed by a wide margin in the financials sector to which it has a heavier weighting than do large caps. Similarly, small caps benefited from their relatively high exposure to and outperformance in cyclical services.

Continental shares are also heavily concentrated in a few sectors. The large-cap PMI Index is most heavily exposed to financials (33.7%), with energy a distant second (8.7%). The EMI Index is also concentrated in financials (20.5%), but has comparable exposure to industrials, 22.2%, and consumer discretionary, 19.2%, (Table D). The outperformance of the small-cap index was primarily driven by the strong relative performance of industrials to which it has a significantly higher exposure. While large caps benefited from overweights in energy and financial shares, large-cap shares in these sectors underperformed small caps, and the performance contribution was not enough to overcome the impact of industrials on a relative performance basis.

Expensive, but Could Get Richer

From a valuation standpoint, small caps on both sides of the Channel appear expensive. This is not an unambiguous finding, however, because earnings are highly volatile and because valuation data have a limited history (Tables E through G). In the United Kingdom, although small-cap earnings have been extremely unstable since 2002, the FTSE SC is moderately expensive compared to its own historical averages and to the FTSE 100. This might be expected given the prolonged outperformance of small caps. The FTSE SC's current price-earnings (P/E) of 38.9 is only slightly above its 12-year average of 37.2; however, this is significantly higher than the ratio's 15 to 20 range during 1998-99 when the small-cap rally initially began. In addition, the FTSE SC's dividend yield (DY) has dropped to 2.0, which is approximately two standard deviations below its post-1993 average. Relative to large caps, small-cap shares are about one standard deviation more expensive than they have been on average since 1993 based on their dividend yields, while they are slightly expensive on the basis of their relative P/E ratios. As represented by the S&P/Citigroup U.K. EMI Index, however, small caps are only slightly overvalued compared to their historical averages, which date back to 1989.

Continental small caps have also become expensive relative to their own historical averages as well as to large caps. This contrasts with the overall picture in 2003 when small-cap valuations were quite supportive. However, valuations could become more stretched, as demonstrated by 1999 when the price-book and price-cash earnings measures climbed to two standard deviations above their post-1989 averages.

In sum, small caps have several strikes against them: their rally appears long in the tooth, while equity valuations have become less supportive. Cyclical stocks are turning in stellar returns, while it appears as if defensive stocks are beginning to register gains, indicating that the small-cap equity cycle *may* be transitioning into its final phase. While small-cap valuations look roughly fairly priced based on P/Es, other measures suggest they have become stretched. We recommend investors with a dedicated small-cap manager move to a more neutral allocation, which has historically been around 5%.²

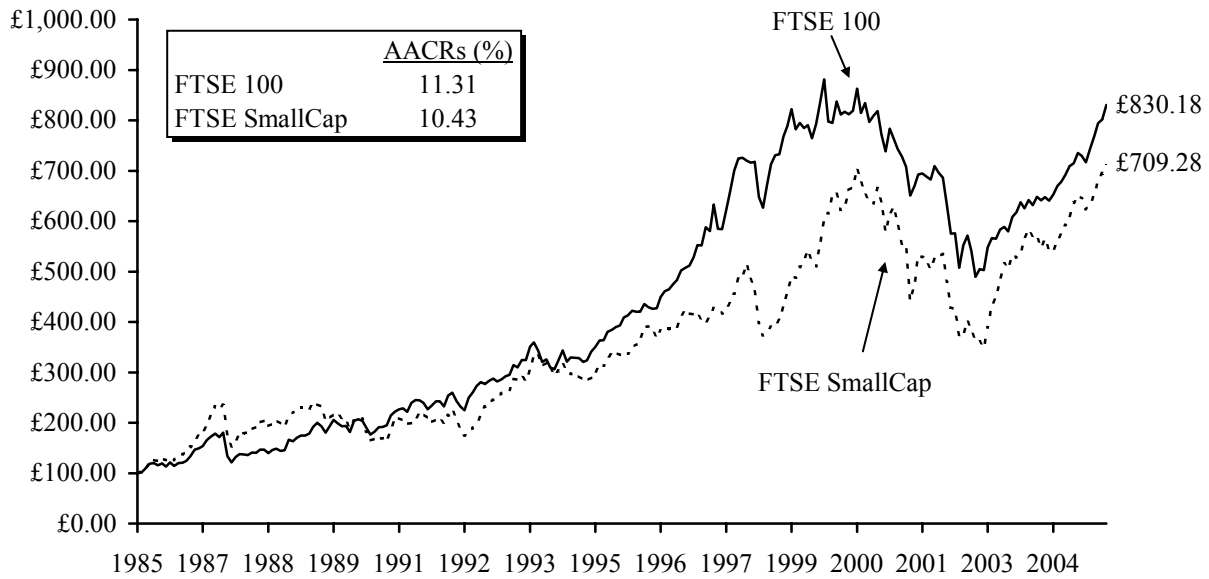
² Since 1986 the FTSE SC has accounted for an average 5.6% of the FTSE All-Share's total market cap.

Table A

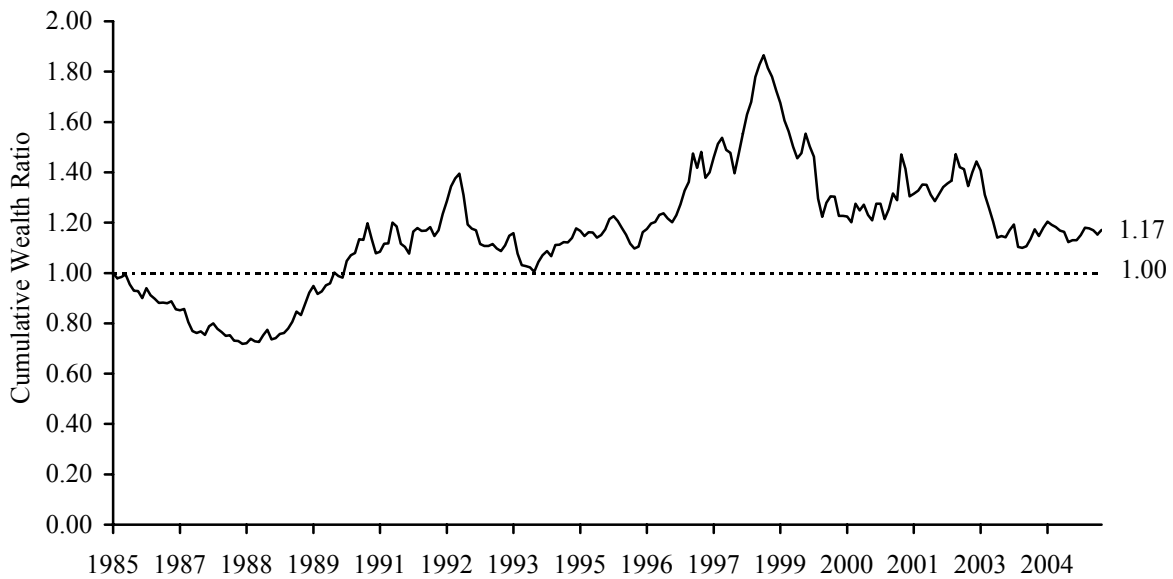
CUMULATIVE WEALTH OF THE FTSE 100 AND FTSE SMALLCAP

1 January 1986 - 30 September 2005

**Cumulative Wealth Index
(31 December 1985 = £100)**



**Relative Cumulative Wealth Index
(FTSE 100/FTSE SmallCap)**



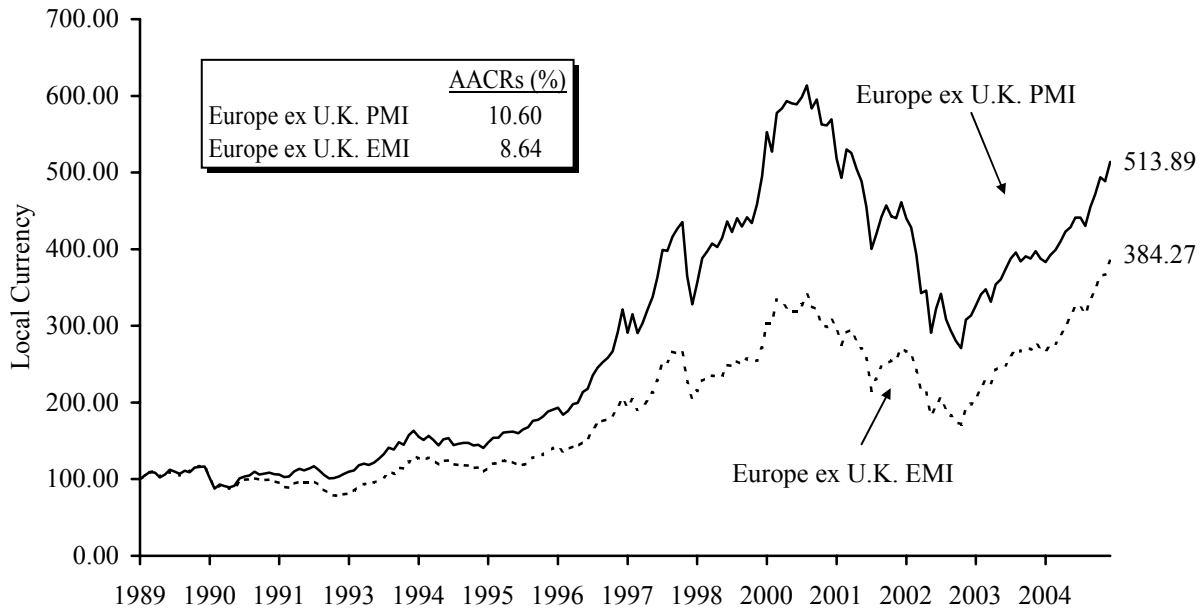
Sources: FTSE International Limited and Thomson Datastream.

Table B

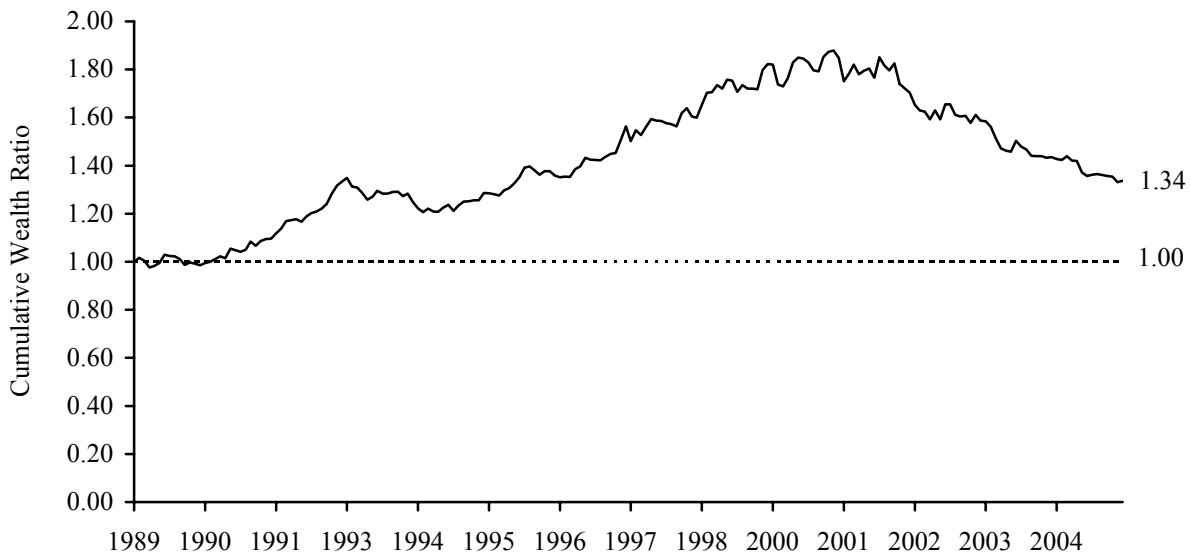
**CUMULATIVE WEALTH OF THE S&P/CITIGROUP EUROPE EX U.K. PMI (LARGE CAP)
AND S&P/CITIGROUP EUROPE EX U.K. EMI (SMALL CAP)**

1 July 1989 - 30 September 2005

**Cumulative Wealth Index
(30 June 1989 = 100)**

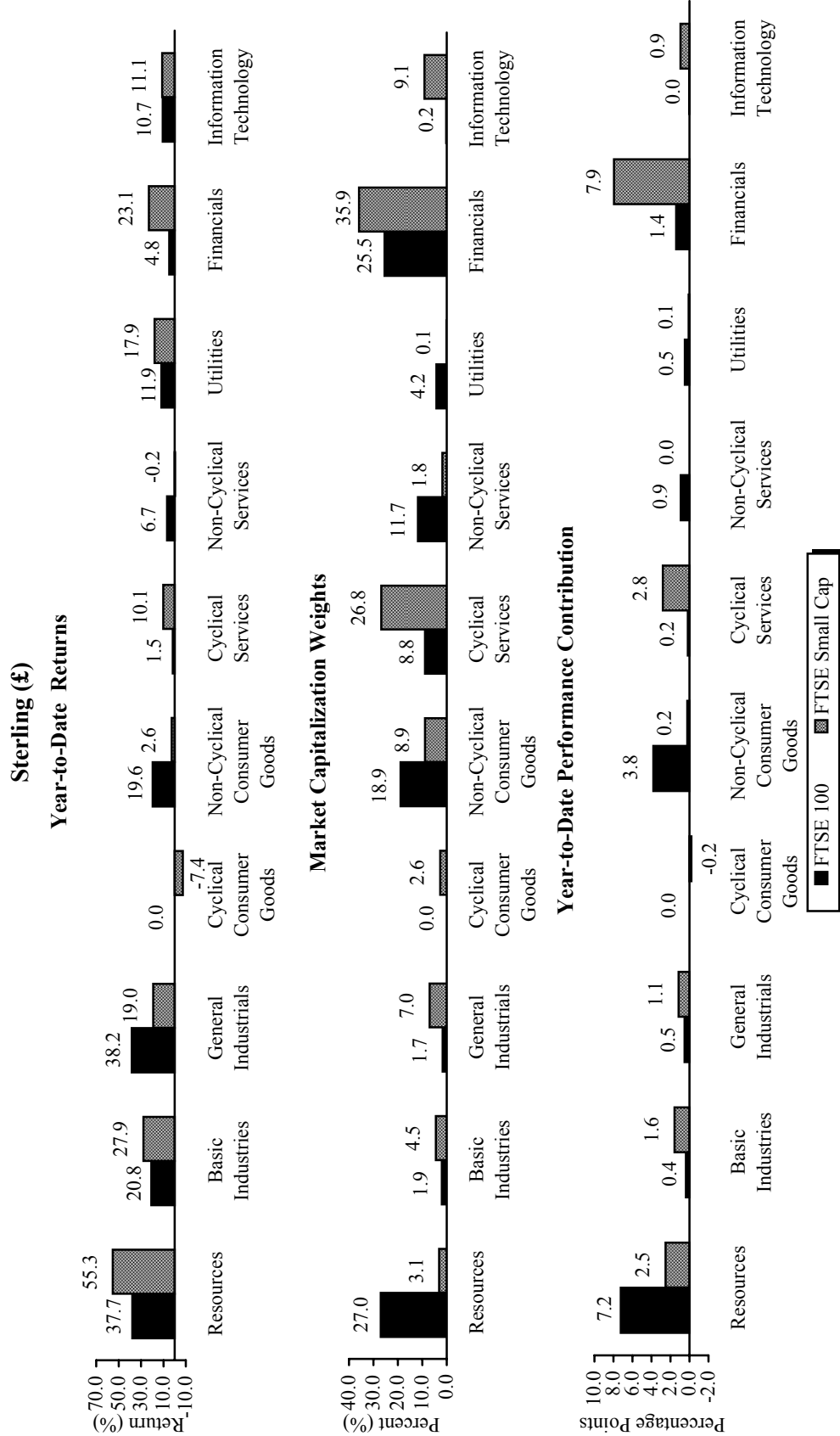


**Relative Cumulative Wealth Index
(Europe ex U.K. PMI/ Europe ex U.K. EMI)**



Sources: Citigroup Global Markets and Standard & Poor's.

Table C
FTSE 100 AND FTSE SMALLCAP
As of 30 September 2005

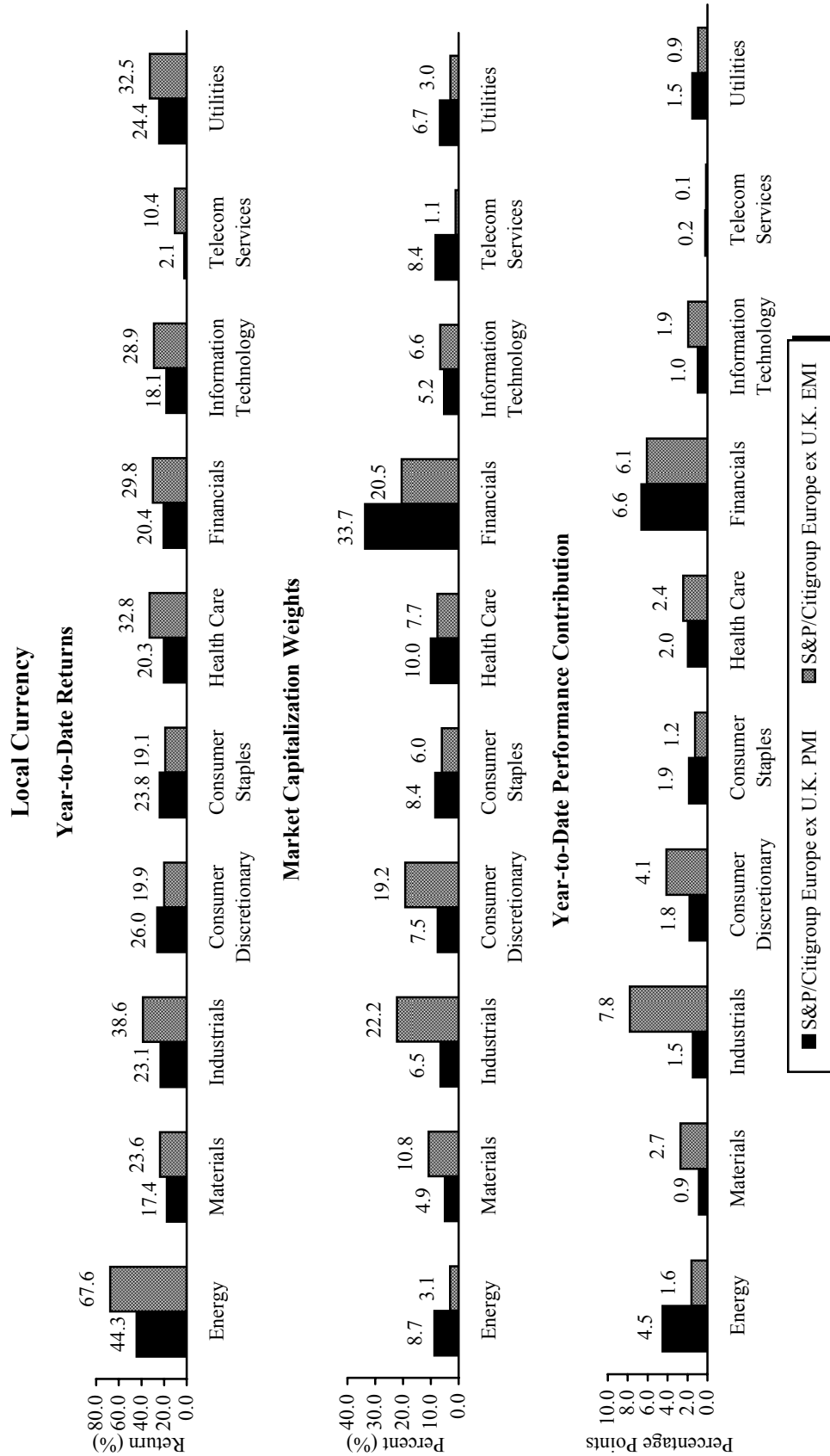


Sources: Factset and FTSE International Limited.

Note: FTSE 100 has no representation in the Cyclical Consumer Goods economic group.

Table D
S&P/CITIGROUP EUROPE EX U.K. PMI AND S&P/CITIGROUP EUROPE EX U.K. EMI

As of 30 September 2005

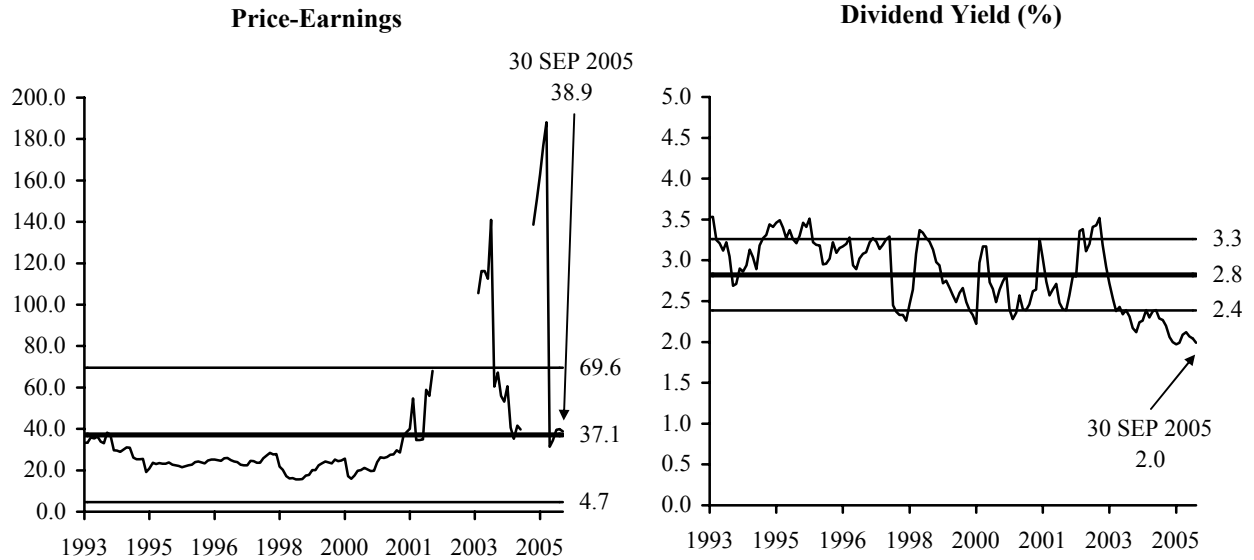


Sources: Citigroup Global Markets and Standard & Poor's.

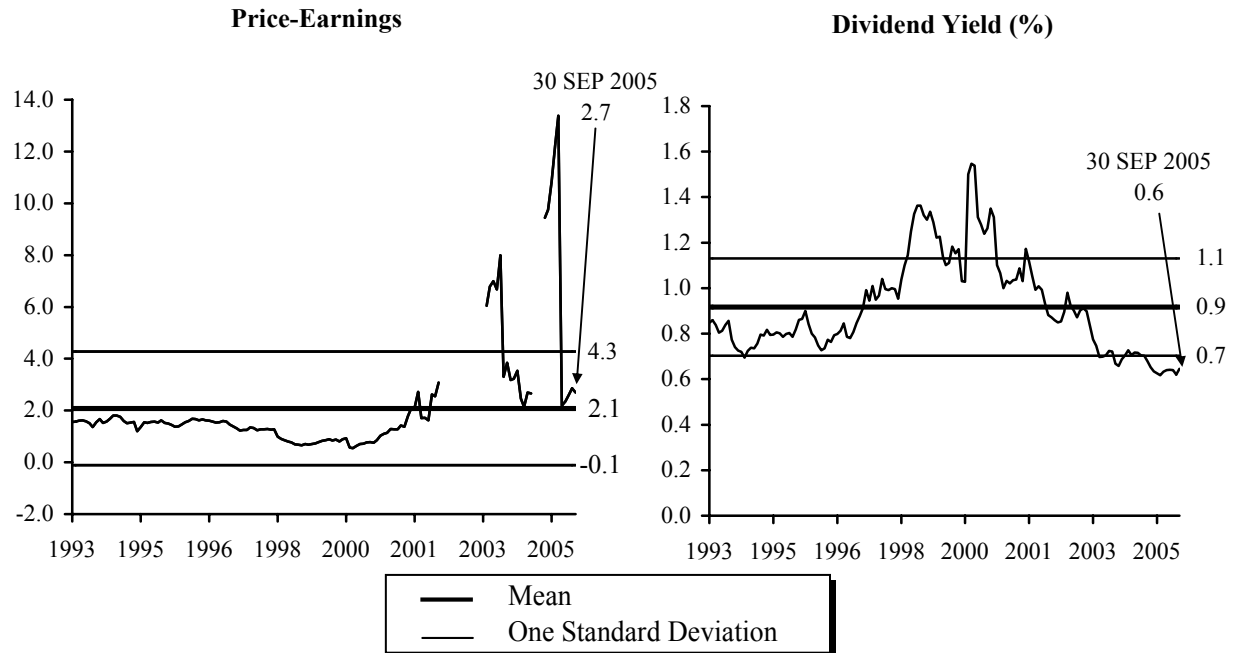
Table E

VALUATIONS OF FTSE SMALLCAP

1 June 1993 - 30 September 2005



FTSE SmallCap Relative to FTSE 100



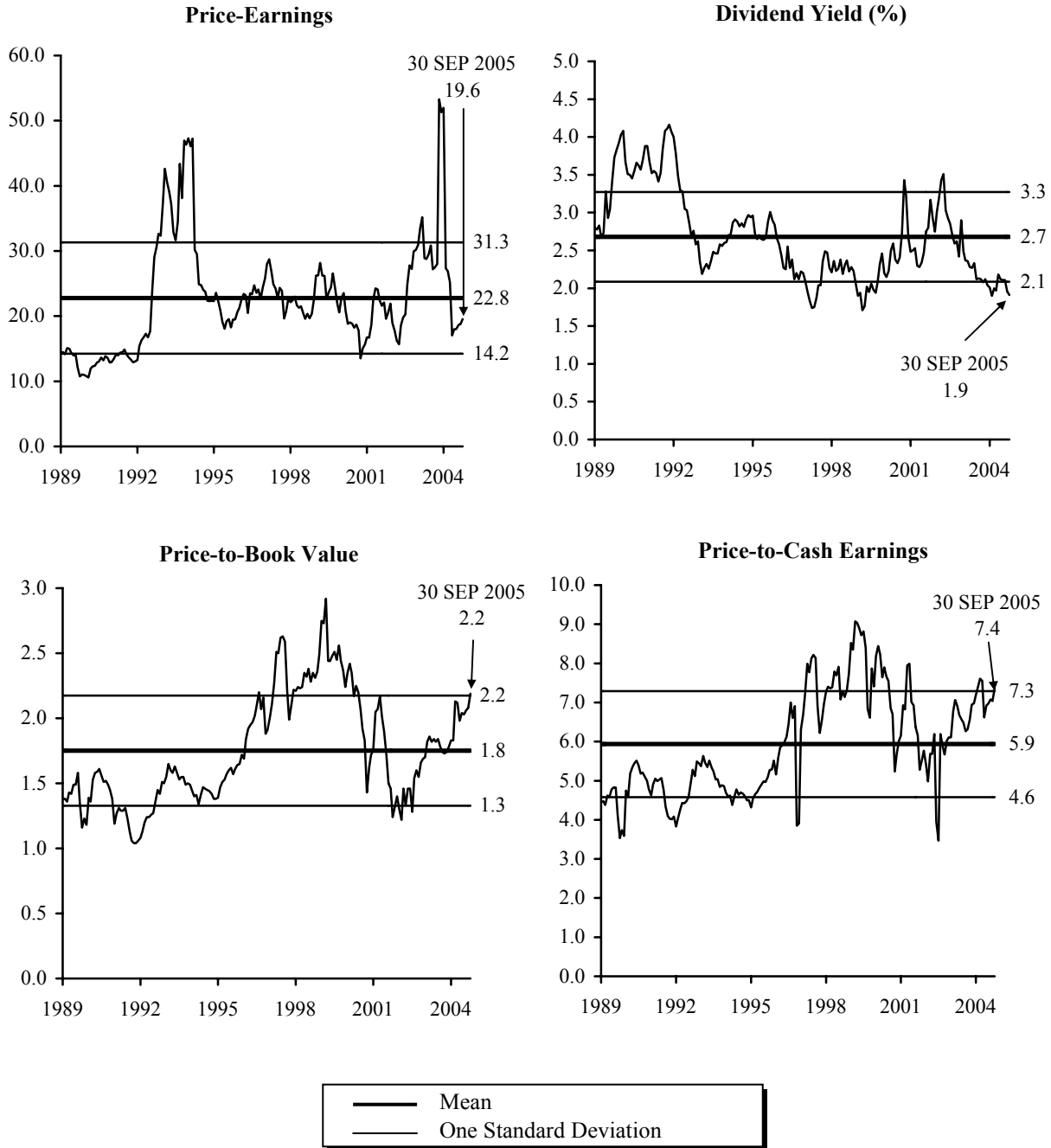
Sources: FTSE International Limited and Thomson Datastream.

Notes: Gaps in the P/E graphs exclude data between 30 June 2002 and 30 June 2003 and 30 September 2004 and 30 November 2004. These periods include negative or extreme earnings, which result in negative or distorted P/E ratios (ranging from -3,400 to 5,200).

Table F

S&P/CITIGROUP EUROPE EX U.K. EMI (SMALL CAP) VALUATIONS

31 December 1989 - 30 September 2005

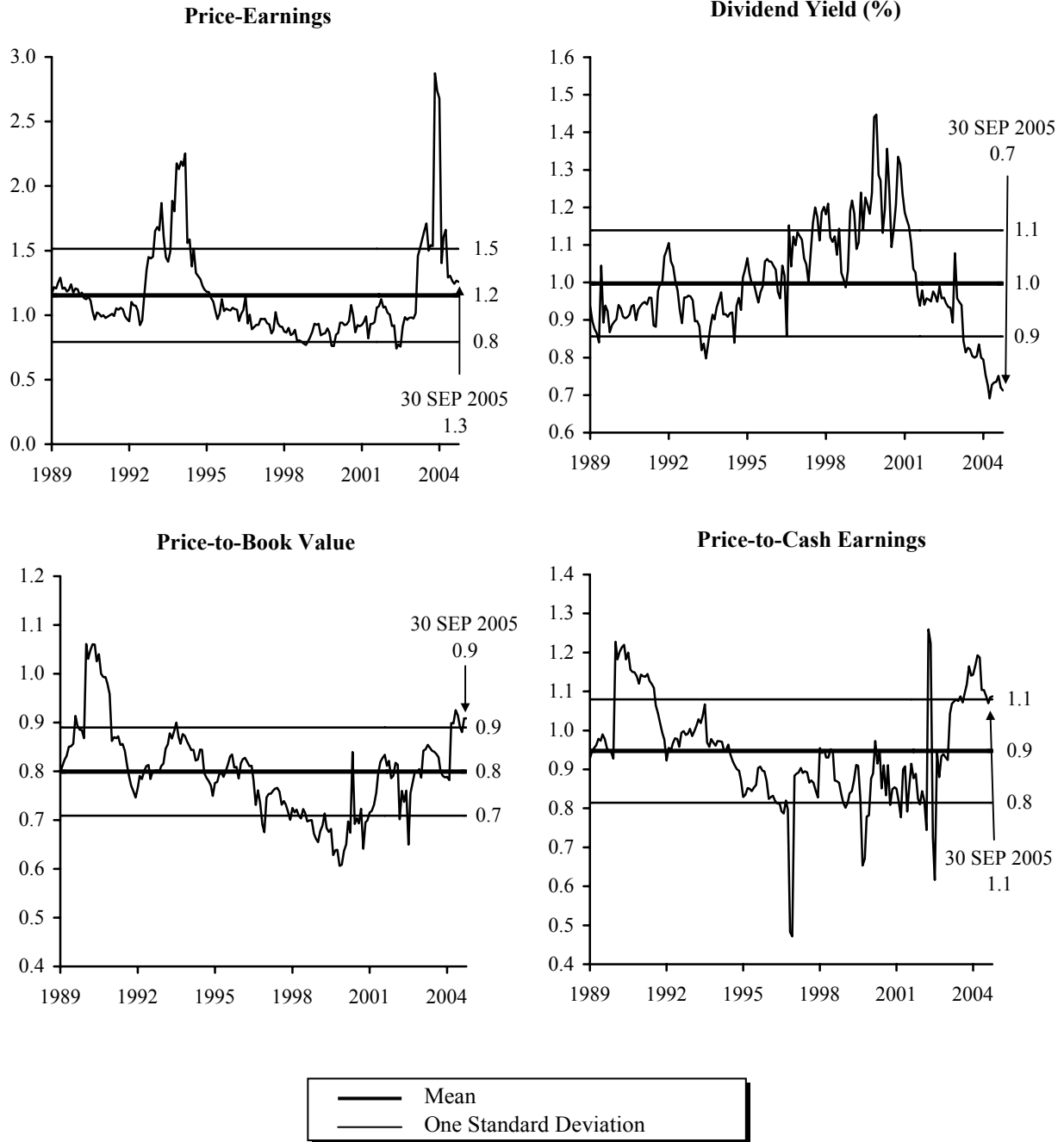


Sources: Citigroup Global Markets and Standard & Poor's.

Table G

**S&P/CITIGROUP EUROPE EX U.K. EMI (SMALL CAP) RELATIVE TO
S&P/CITIGROUP EUROPE EX U.K. PMI (LARGE CAP)**

31 December 1989 - 30 September 2005



Sources: Citigroup Global Markets and Standard & Poor's.