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EUROPEAN MARKET COMMENTARY

EUROPEAN SMALL CAPS: IS THERE MORE LEFT TO RUN?

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European Small Caps: Is There More Left to Run?

The market turmoil over the spring/summer of 2006 had many analysts declaring the long-awaited change in market leadership from small- to large-capitalization companies had arrived, as large-cap shares outperformed small caps over the May-July period. Yet small-cap shares across Europe continue to defy analyst predictions, with the S&P/Citigroup Europe Extended Market Index (EMI) rallying 27% since August 2006 and 6% so far this year, compared to 15% and 3% for large-cap shares, respectively.[1] Indeed, when viewed from a rolling 12-month return basis, small caps in Europe have consistently outperformed large caps since October 2001 (a five-and-one-half-year run), while since European markets bottomed in March 2003, continental small caps have earned an average annual compound return (AACR) of 35.5%, compared to a 25.9% AACR for large caps (31.2% and 18.4% for U.K. small and large caps, respectively, see Table A). While a small-cap run of this magnitude is not unheard of (at least not for U.S. small caps, for which we have a much longer return history), the rally is long and relative valuations are high by historical standards. This raises the question of whether investors should "stay the course" in hopes of further small-cap outperformance, or reduce small-cap exposure given an unfavorable risk-reward trade-off for maintaining a small-cap overweight in Europe.

Valuations

The strong market rally over the past four years has left European small caps (on both sides of the Channel) overvalued, both in absolute terms and relative to large caps (Tables B through E). While price-to-earnings (P/E) ratios are roughly in line with their average since our data begins in 1989, P/Es of 21x reported earnings for both U.K. and continental small caps could hardly be considered fairly valued. Other valuation metrics (dividend yield [DY], price-to-book [P/B], price-to-cash flow [P/CF], and price-to-sales [P/S]) are at, or well above, 1 standard deviation from their historical mean over the same period. What is most striking today is the extreme level of *relative* valuations. Unlike in 2000-02 when small caps were neglected and noticeably cheap relative to large caps (and thus supportive of outperformance), today continental small caps trade over 2 standard deviations away from their relative historic averages on most metrics, save for P/E ratios, which are still relatively expensive at 1 standard deviation above the norm. In the United Kingdom, relative to large caps, small caps are more expensive by 2.7 standard deviations based on P/Es, 2 standard deviations based on DYs, and over 3 standard deviations based on P/S ratios. On P/B and P/CF, U.K. small caps are also above 1 standard deviation from the mean. In other words, no matter how you slice it, European small caps are expensive, especially compared to large caps.

A noticeable difference between large caps and small caps over the current cycle has been the relatively lackluster improvement in small-cap return on equity (ROE). While small-cap ROEs have risen in

[1] We use the S&P/Citigroup Global indices, rather than the more familiar FTSE or MSCI indices because of their combination of a relatively long valuation history, discrete small- and large-cap universes that do not overlap, and consistent definitions applied to both U.K. and Europe ex U.K. equities. Throughout this paper (unless otherwise noted) "small caps" refer to the S&P/Citigroup EMI while "large caps" refer to the S&P/Citigroup Primary Market Index (PMI). S&P/Citigroup defines small caps (the EMI) as the bottom 20% of market capitalization, while large caps (the PMI) covers the top 80% of market capitalization.

absolute terms, they have failed to match the sharp rise enjoyed by large caps, particularly in the United Kingdom, even considering that large-cap ROEs may be overstated by share buyback programs. In addition, European small-cap valuations may now reflect a "takeover-premium" as merger and acquisition (M&A) activity has been heavily concentrated in the sector over the past two years or so, with feverish deal speculation helping to drive share performance. Should M&A activity dry-up and/or profit growth undergo a cyclical downturn, it is highly unlikely that the current high premium small caps enjoy over large caps will remain.

Mid Caps and M&A?

While small-cap shares generally outperform during the early stages of an economic recovery, the continued vast outperformance of smaller company shares into the later stages of the business cycle is certainly tied to the record level of M&A activity and leveraged buyouts taking place globally, and especially in Europe, as smaller companies are deemed to be more digestible for strategic buyers and buyout firms. According to Morgan Stanley, the words "speculation" and "rumor" recently have appeared more often in major financial newspapers than at any time during the past decade, exceeding levels seen during the last M&A spree in the late 1990s, with share prices rising on any hint of takeover activity for related companies.

It is widely believed that most of the M&A mania has benefited mid-cap shares more than small caps, which seems to be confirmed by the FTSE indices in the U.K. market, but is more uncertain based on S&P/Citigroup indices for both U.K. and continental equities. In the United Kingdom, the mid-cap FTSE 250 Index returned an AACR of 32.8% since March 2003, compared to 25.2% for the FTSE SmallCap and 18.8% for the large-cap FTSE 100. Table G shows the dramatic rise in U.K. mid caps since 2003; while the FTSE 100 and FTSE 250 began the current rally at similar levels, mid caps have risen three-fold from a cumulative wealth standpoint. Indeed, over the period for which we have historical FTSE data, large caps and small caps (as defined by FTSE) have posted comparable AACRs since 1989 (roughly 11%), whereas mid caps have done considerably better (14%), with all of this outperformance occurring over the past four years.

There is no widely recognized benchmark for mid-cap shares on the Continent.[2] Looking at the S&P/Citigroup PMI/EMI, the small-cap EMI is clearly more of a small- to mid-cap index than a pure small-cap benchmark, with companies ranging in size from $20 billion down to $30 million. Indeed, the mid-/small-cap split is somewhat arbitrary given the lack of an industry standard for identifying what is admittedly a nebulous break point (not too big, not too small). For example, based on returns provided by Russell for their new global indices, European small caps, both in the United Kingdom *and* on the Continent have outperformed large caps *and* mid caps since March 2003. The only clear trend that can be distinguished is that large caps, no matter how defined, have substantially underperformed smaller-capitalization shares

[2] This gap in capitalization sector coverage is being addressed by a series of new indices being released by both MSCI and Russell, as investor demand for international small-cap investing has grown briskly over the past few years. Indeed, such product developments by index providers could perhaps be viewed as a contrarian signal that small caps and mid caps are overbought and overloved by institutional investors.

over the past six years or so across Europe, and whatever relative valuation discount small caps enjoyed back when the rally began, has now disappeared.

Does the Cycle have More to Run?

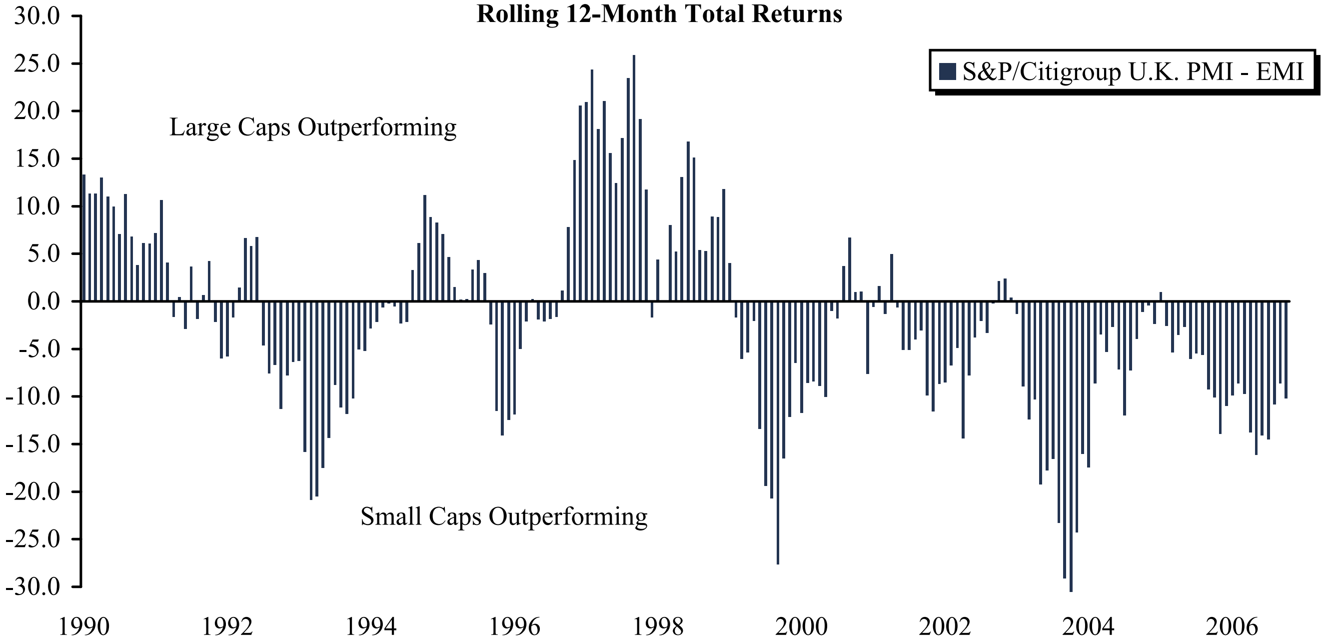
No one ever knows and the current environment provides no exception; the wayside is littered with market commentators who have "called" the change in small-/large-cap leadership over the past two years. That said, liquidity seems plentiful, M&A activity stronger than ever, and appetite for risk among investors appears insatiable; what are all in all conditions supportive of continued small-cap outperformance. In theory, an argument can be made that given the recent cyclical upturn in European economic growth, the macro environment still favors small-cap companies. While economic growth has slowed appreciably in the United States, resulting in lower profit growth, Europe seems to have "decoupled" from the United States, with increased intra-European trade (United Kingdom, Eurozone, and emerging Europe) and strength in Asia and elsewhere in the emerging world offsetting slowing U.S. growth thus far. However, the decoupling thesis has yet to be truly tested as the slowdown in U.S. economic growth has been moderate and it remains to be seen whether this soft patch will remain a mild "mid-cycle slowdown" or develop into something more troubling. Furthermore, European equities, and especially small caps, face the growing headwinds of rising interest rates (both policy rates and bond yields) as economic growth is pushing up inflation pressures and central bankers remain hawkish. Finally, small caps may have become victims of their own success; sky-high prices may be pushing M&A activity up the capitalization spectrum in search of value (a trend we are currently witnessing with the Barclays/ABN-AMRO/RBS consortium deal, and the leveraged buyout of FTSE 100-company Alliance Boots). A rash of "mega-mergers" (whether real or simply rumored) has the potential to spark a speculative surge in large-cap shares; investors underweight in large-cap names would surely underperform the broader market, especially in the concentrated U.K. market, should the buying momentum move from small caps to large caps.

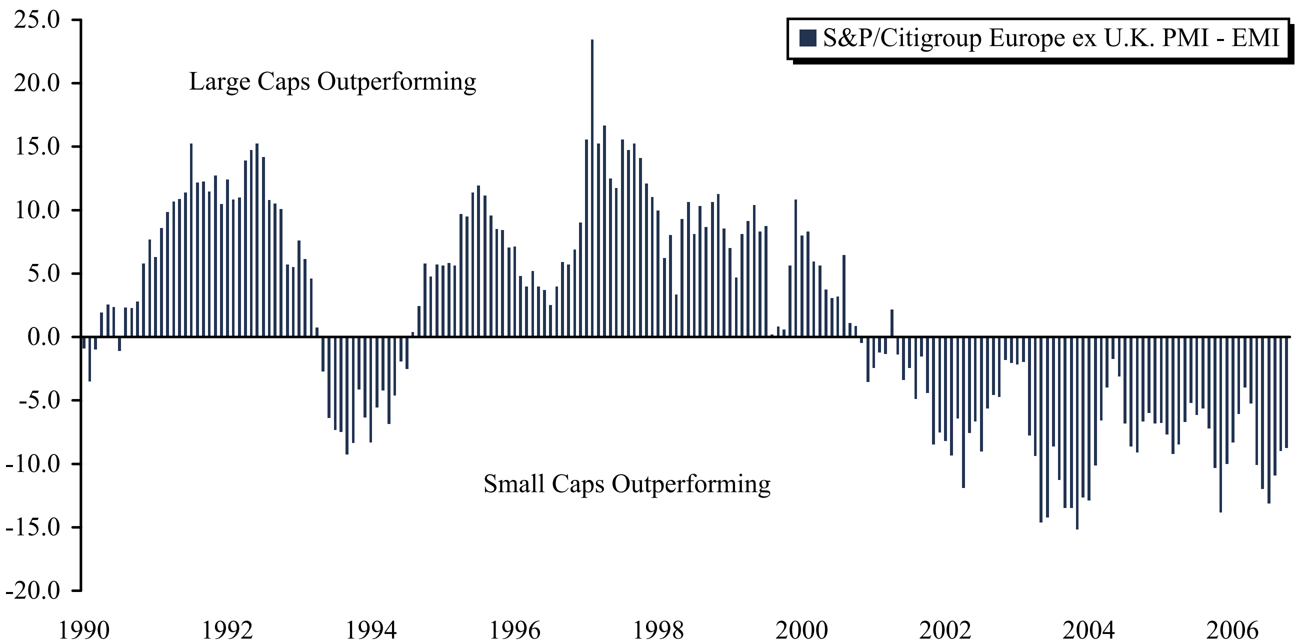
Economic predictions and M&A activity aside, given the stretched nature of valuations, the risk-reward trade-off for small caps does not seem compelling to us. Certainly small caps could continue to run hard, but trying to time the "top" perfectly is a fool's errand, and should equity markets turn downward, small-cap shares will feel the brunt of any sell-off and underperform large caps, as they have done during every market tremor over the past four years. Overall, investors would be well advised to use the renewed rally to rebalance away from small-caps shares, reducing small-cap allocations to at least a "neutral" weight in the European equity portfolio (roughly 5%). In short, to tweak a tired investing adage, now is the time to sell high (small caps) and buy relatively low (large caps).

Table A

EUROPEAN LARGE-/SMALL-CAP CYCLES
S&P/CITIGROUP PMI RELATIVE TO EMI

31 July 1989 - 31 March 2007
Rolling 12-Month Total Returns





Sources: S&P/Citigroup Global Equity Indices, Standard & Poor's, and Thomson Datastream.

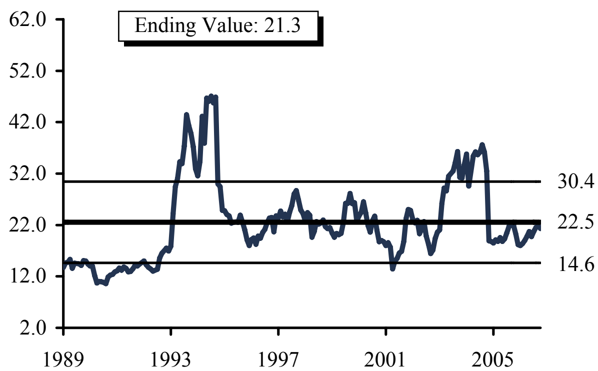
Notes: The S&P/Citigroup Primary Market Index (PMI) represents large-cap shares (defined as the top 80% of market capitalization), while the Extended Market Index (EMI) represents small-cap shares (defined as the bottom 20% of market capitalization). Graph represents rolling 12-month PMI returns minus rolling 12-month EMI returns.

Table B

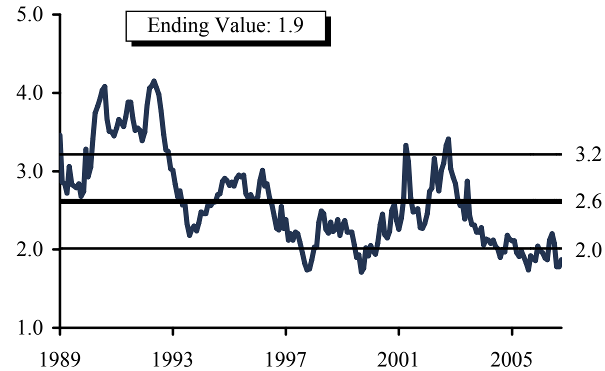
S&P/CITIGROUP EUROPE EX U.K. EMI VALUATIONS

30 June 1989 - 31 March 2007

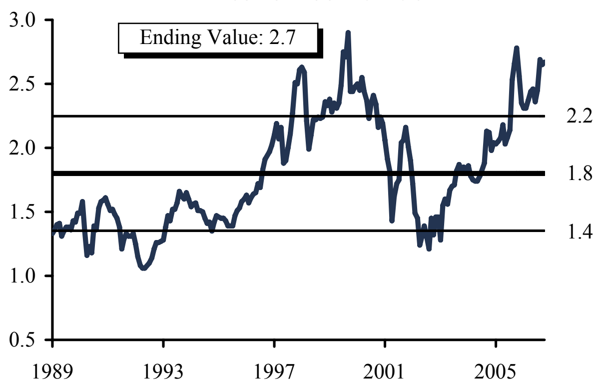
Price-Earnings



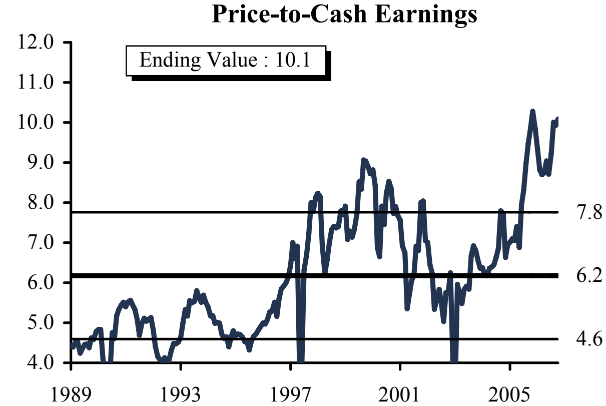
Dividend Yield (%)



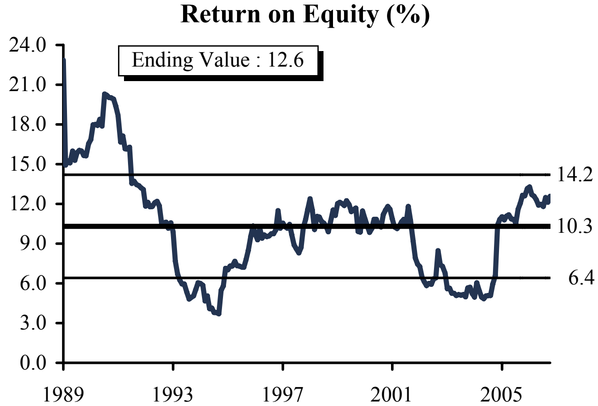
Price-to-Book Value



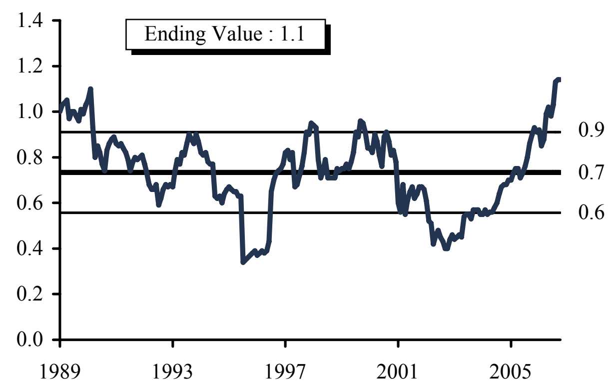
Price-to-Cash Earnings



Return on Equity (%)



Price-to-Sales



Source: S&P/Citigroup Global Markets.

Mean
One Standard Deviation

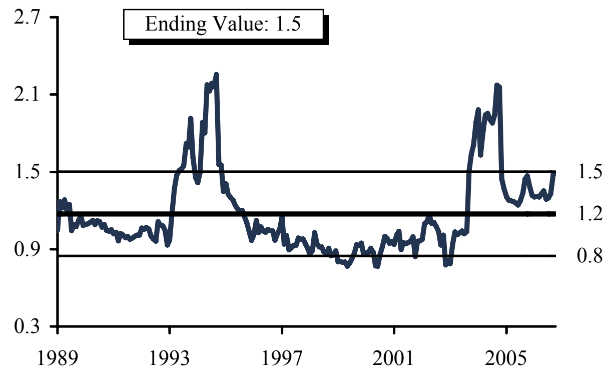
Notes: The S&P/Citigroup Europe ex U.K. EMI represents Europe ex U.K. small caps. Price-earnings ratios are based on last reported annual earnings per share.

Table C

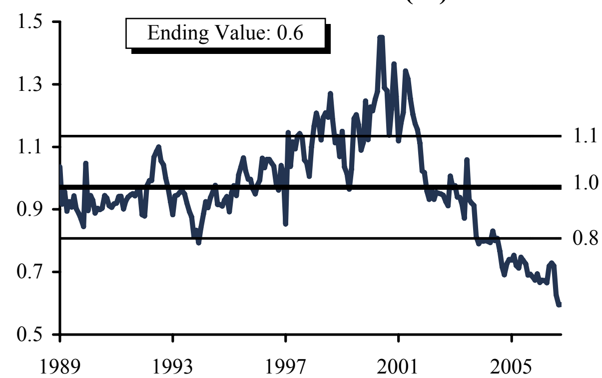
S&P/CITIGROUP EUROPE EX U.K. EMI RELATIVE TO EUROPE EX U.K. PMI VALUATIONS

30 June 1989 - 31 March 2007

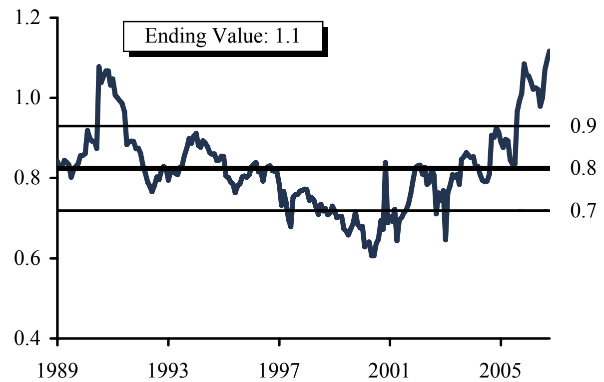
Price-Earnings



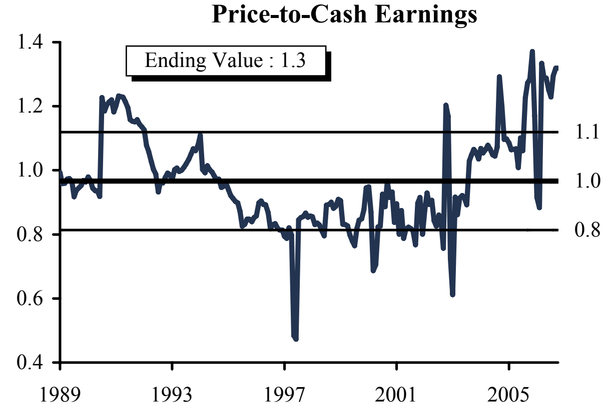
Dividend Yield (%)



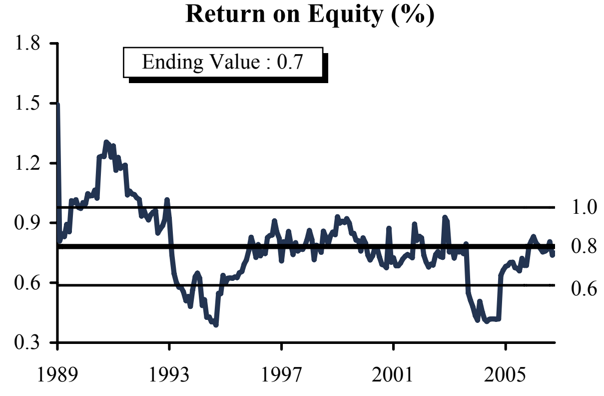
Price-to-Book Value



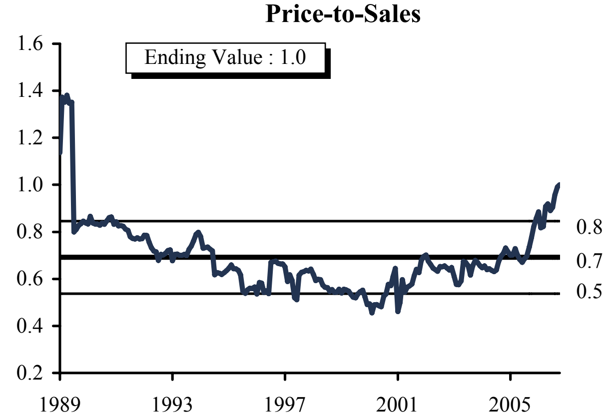
Price-to-Cash Earnings



Return on Equity (%)



Price-to-Sales



Mean
One Standard Deviation

Source: S&P/Citigroup Global Markets.

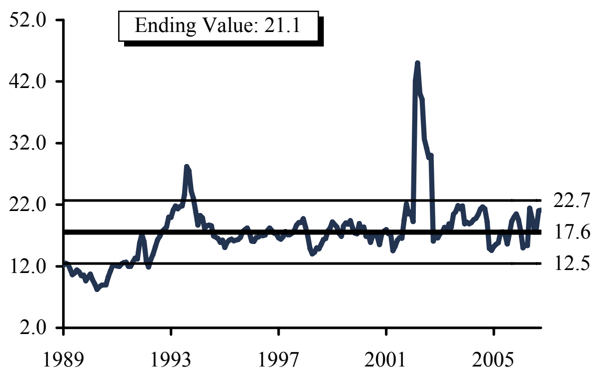
Notes: The S&P/Citigroup Europe ex U.K. EMI represents small caps and the Europe ex U.K. PMI represents large caps. Price-earnings ratios are based on last reported annual earnings per share.

Table D

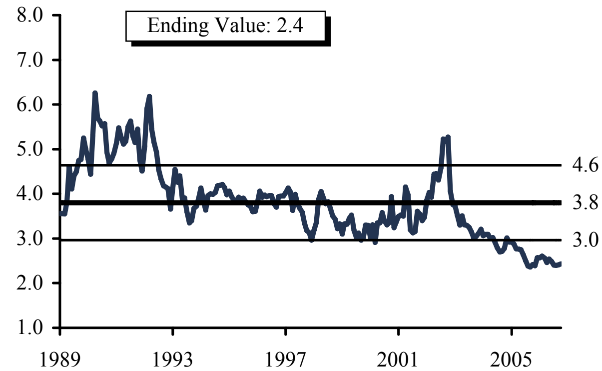
S&P/CITIGROUP UNITED KINGDOM EMI VALUATIONS

30 June 1989 - 31 March 2007

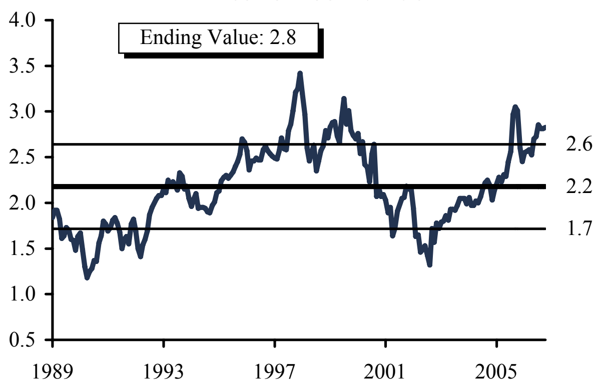
Price-Earnings



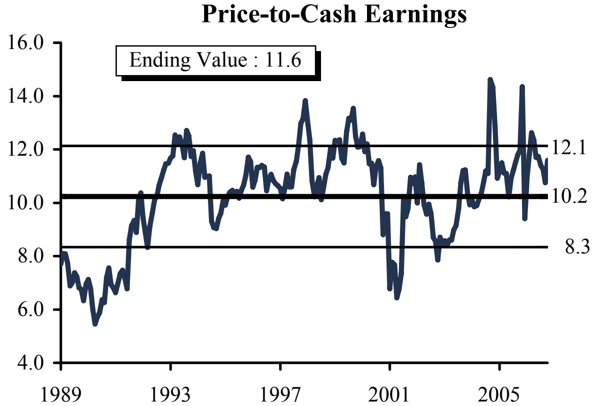
Dividend Yield (%)



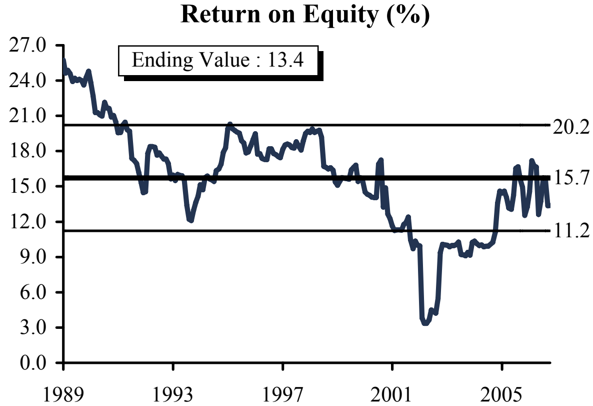
Price-to-Book Value



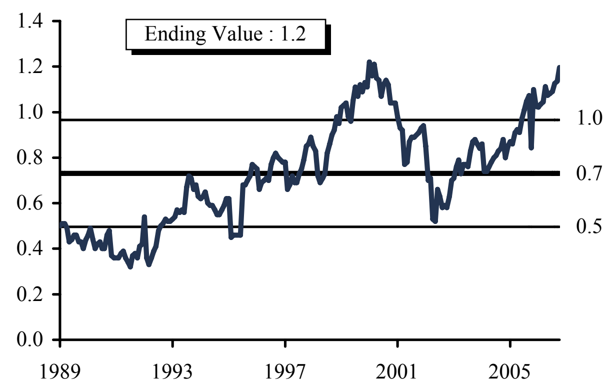
Price-to-Cash Earnings



Return on Equity (%)



Price-to-Sales



Source: S&P/Citigroup Global Markets.

Mean
One Standard Deviation

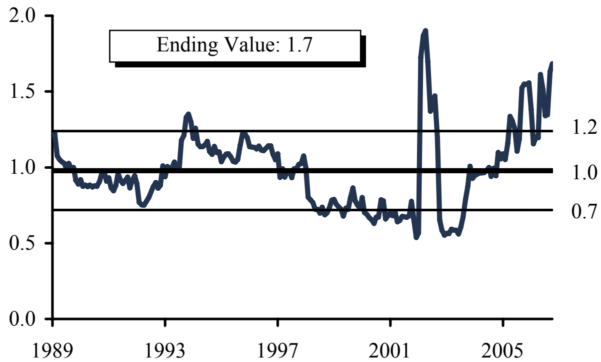
Notes: The S&P/Citigroup United Kingdom EMI represents small caps. Price-earnings ratios are based on last reported annual earnings per share.

Table E

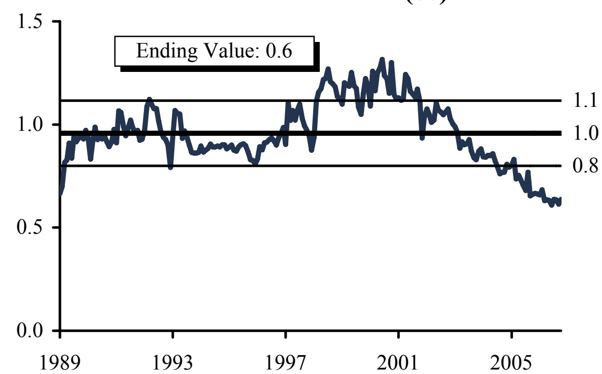
S&P/CITIGROUP UNITED KINGDOM EMI RELATIVE TO UNITED KINGDOM PMI VALUATIONS

30 June 1989 - 31 March 2007

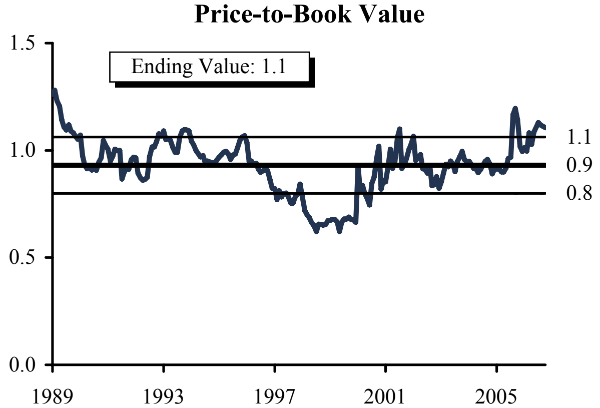
Price-Earnings



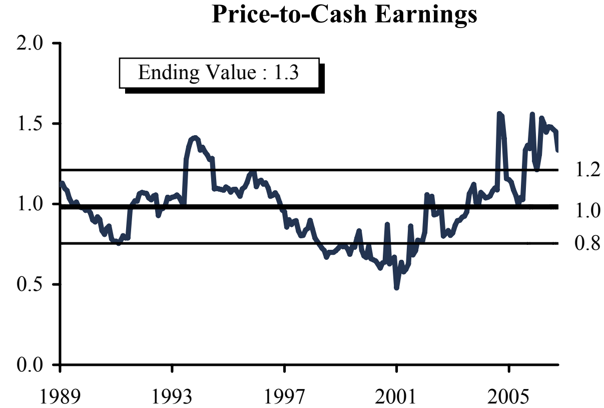
Dividend Yield (%)



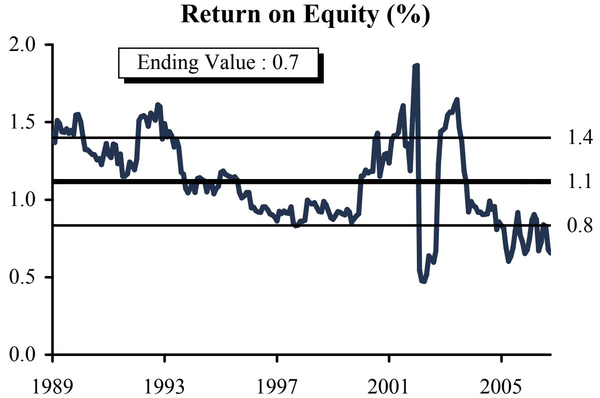
Price-to-Book Value



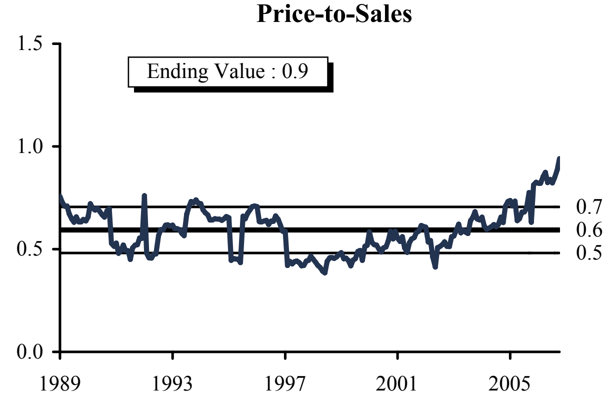
Price-to-Cash Earnings



Return on Equity (%)



Price-to-Sales



Mean
One Standard Deviation

Source: S&P/Citigroup Global Markets.

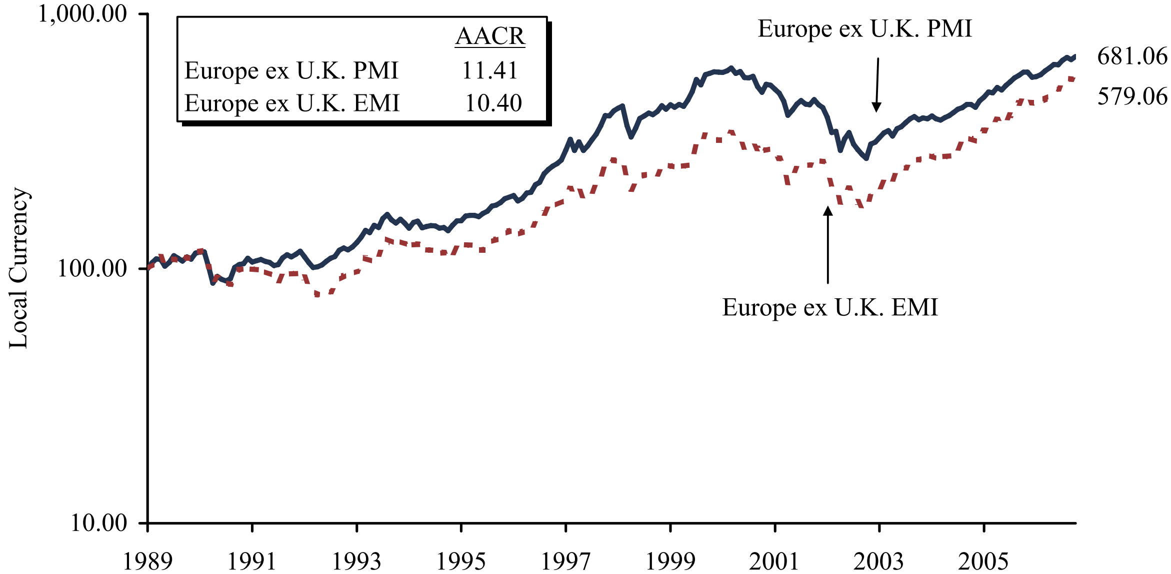
Notes: The S&P/Citigroup United Kingdom PMI represents large caps. Price-earnings ratios are based on last reported annual earnings per share.

Table F

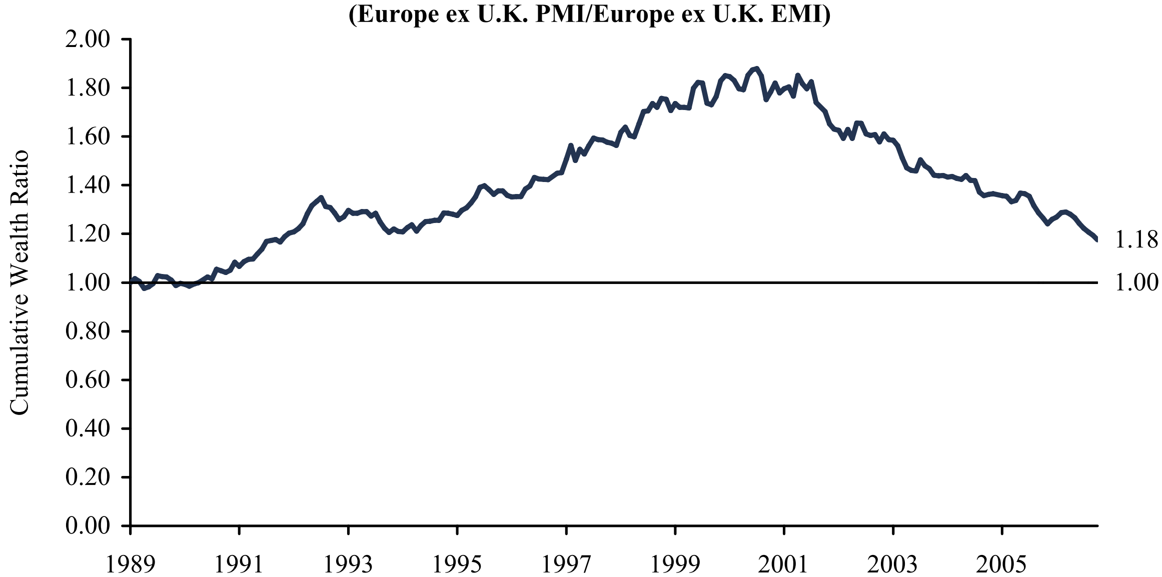
RELATIVE PERFORMANCE OF THE S&P/CITIGROUP EUROPE EX U.K. PMI AND EUROPE EX U.K. EMI

1 July 1989 - 31 March 2007

Cumulative Wealth Index
(Logarithmic Scale)
(30 June 1989 = 100)



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



Source: S&P/Citigroup Global Equity.

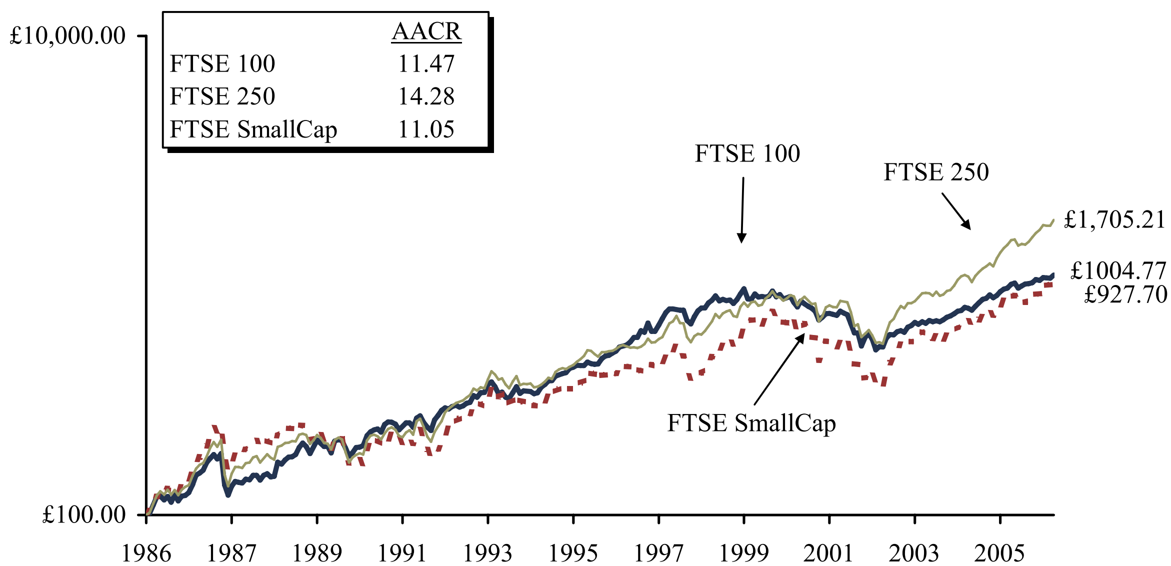
Note: The S&P/Citigroup Europe ex U.K. EMI represents small caps and the Europe ex U.K. PMI represents large caps.

Table G

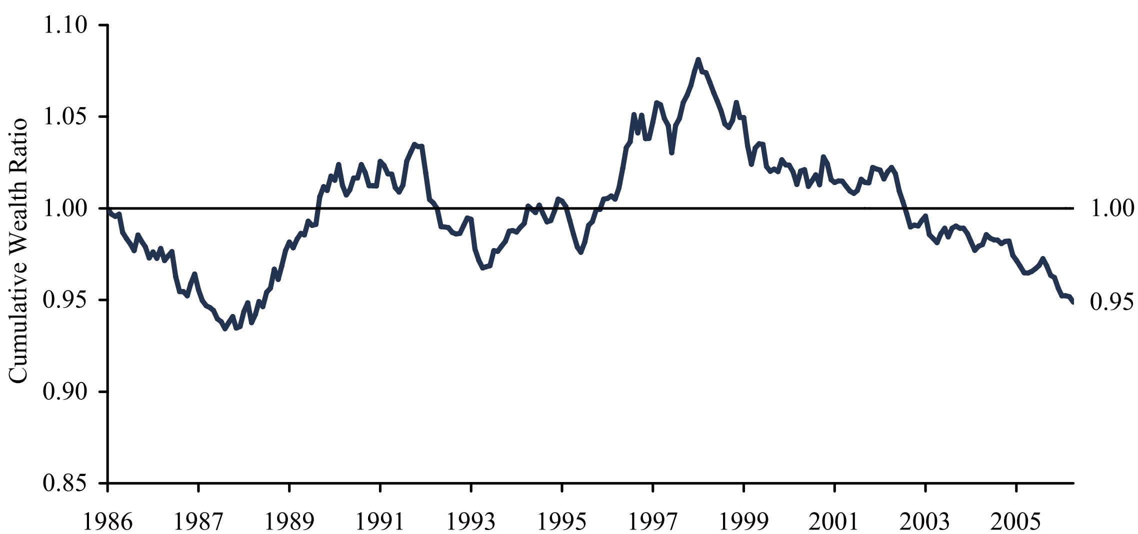
RELATIVE PERFORMANCE OF FTSE CAPITALIZATION SECTORS

1 January 1986 - 31 March 2007

Cumulative Wealth Index
(Logarithmic Scale)
(31 December 1985 = £100)



Relative Cumulative Wealth Index
(FTSE 100/FTSE All Share)



Sources: FTSE International Limited and Thomson Datastream.

Note: The FTSE 100 represents large caps and the FTSE 250 represents mid caps.