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EUROPEAN MARKET COMMENT: IS THE 'SMALL COMPANY EFFECT' REASSERTING ITSELF?

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Is the 'Small Company Effect' Reasserting Itself?

Over the last 46 years, the bottom 10% of the U.K. equity market has delivered an annualised return 3.5 percentage points greater than that of the FTSE All-Share Index, thereby rewarding investors who have withstood the increased volatility and the lower liquidity inherent in small-cap investing. Although the 1990s were not the best of times for small-cap investors, as poor fundamentals culminated in underperformance for a universe dominated by 'old economy' sectors such as building and engineering, the technology boom proved somewhat of a catalyst for change, bringing forth not only renewed optimism, but also a 'new economy' dimension to a once cyclical play.

As Table A suggests, the trend that saw large-caps outperform small-caps throughout most of the 1990s reversed in 1999, and this was primarily attributable to the tech hysteria that swept through the markets. However, information technology's (IT) prominence in the small-cap universe has been a very recent phenomenon: as of April 1999, IT constituted only 4.9% of the FTSE Small-Cap Index; by the end of February 2000, however, that weighting had ballooned to 12.5% as a result not only of share price movements, but also of a record number of new issues being brought to the market, 40% of which were technology companies. Another paradoxical factor was that the poor performance of technology stocks throughout 2000 meant that several fell into the small-cap arena. Currently, the IT sector accounts for 10.6% of the FTSE Small-Cap Index and has reduced the pure 'old economy' bias that contributed largely to the small-cap sector's underperformance in the 1990s.

Having outperformed the FTSE 100 Index by 33.2 percentage points (53.8% vs 20.6%) in 1999, small-caps continued to outperform in 2000, 5.5% vs -8.2%. In a year to forget for equity markets, small-cap outperformance was a result of minimum telecom exposure at a time when telecom share prices plummeted (although IT equities also plunged, they only constitute 2.8% of the large-cap index).

Table B highlights the fact that the make-up of the small- and large-cap markets are very distinct. The small-cap market has always been very much a cyclical play, with cyclical services (see "FTSE Global Classification System" on page 90 of *Market Update: Returns and Valuations*, March 31, 2001 for economic group definitions) making up 26.7% of the index compared to 11.3% for the FTSE 100 Index. Similarly, general industrials and basic industries combined constitute 15.7% of the small-cap market and only 2.8% of the large-cap market. The weighting of financials may appear quite similar, 25.2% for large-caps and 31.5% for small-caps; however, the underlying content is very different.

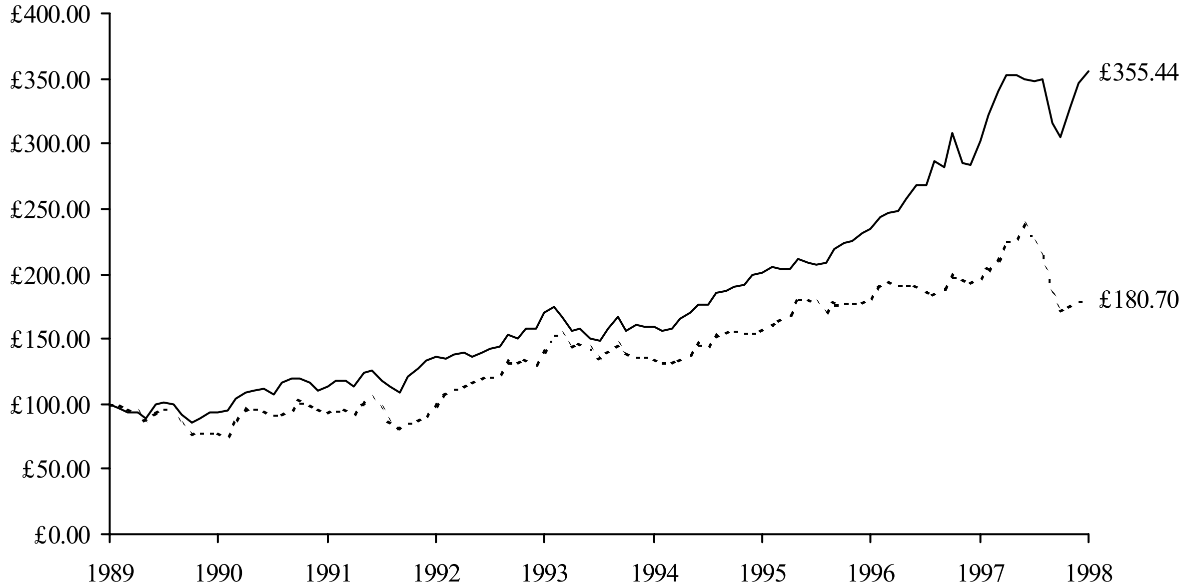
On a valuation basis, the case for small-cap investing remains favourable. Even after two years of solid outperformance, small-caps[1] are still trading at a lower P/E ratio, a higher dividend yield, and better dividend cover than the large-caps. Diversification benefits have also been enhanced over the last decade, with the 36-month correlation between small- and large-cap steadily falling from a peak of 0.93 in August 1988 to 0.72 in February this year. Liquidity in the market is showing signs of improving, but the environment of consolidation within the fund management industry remains a problem, with bigger institutional funds tending to require bigger minimum investments. Finally, investors should always recognise the greater vulnerability of the small-cap market to any serious diminution in economic activity—smaller companies are inherently riskier because they rarely carry much fat that can be cut in lean years and often lack the resources necessary to ride out hard times.

[1] Small-caps as defined by Hoare Govett: the smallest 10% of U.K. companies by market capitalisation.

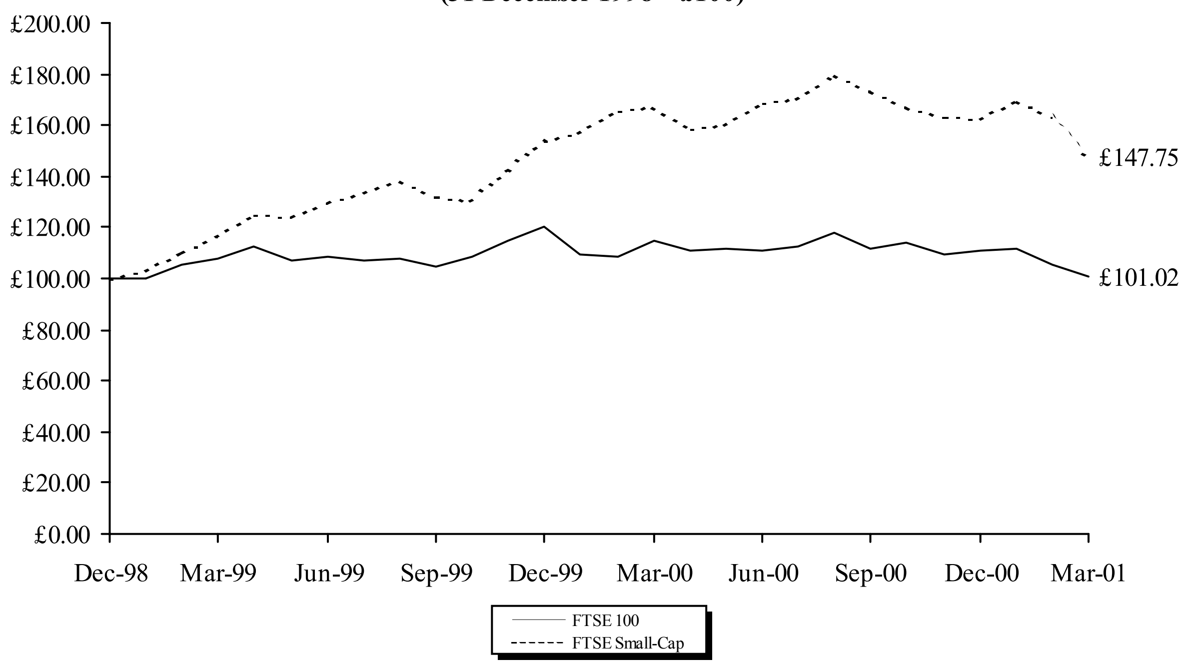
Table A

FTSE 100 VERSUS FTSE SMALL-CAP: CUMULATIVE WEALTH

1 January 1990 - 31 December 1998
(31 December 1989 = £100)



1 January 1999 - 31 March 2001
(31 December 1998 = £100)

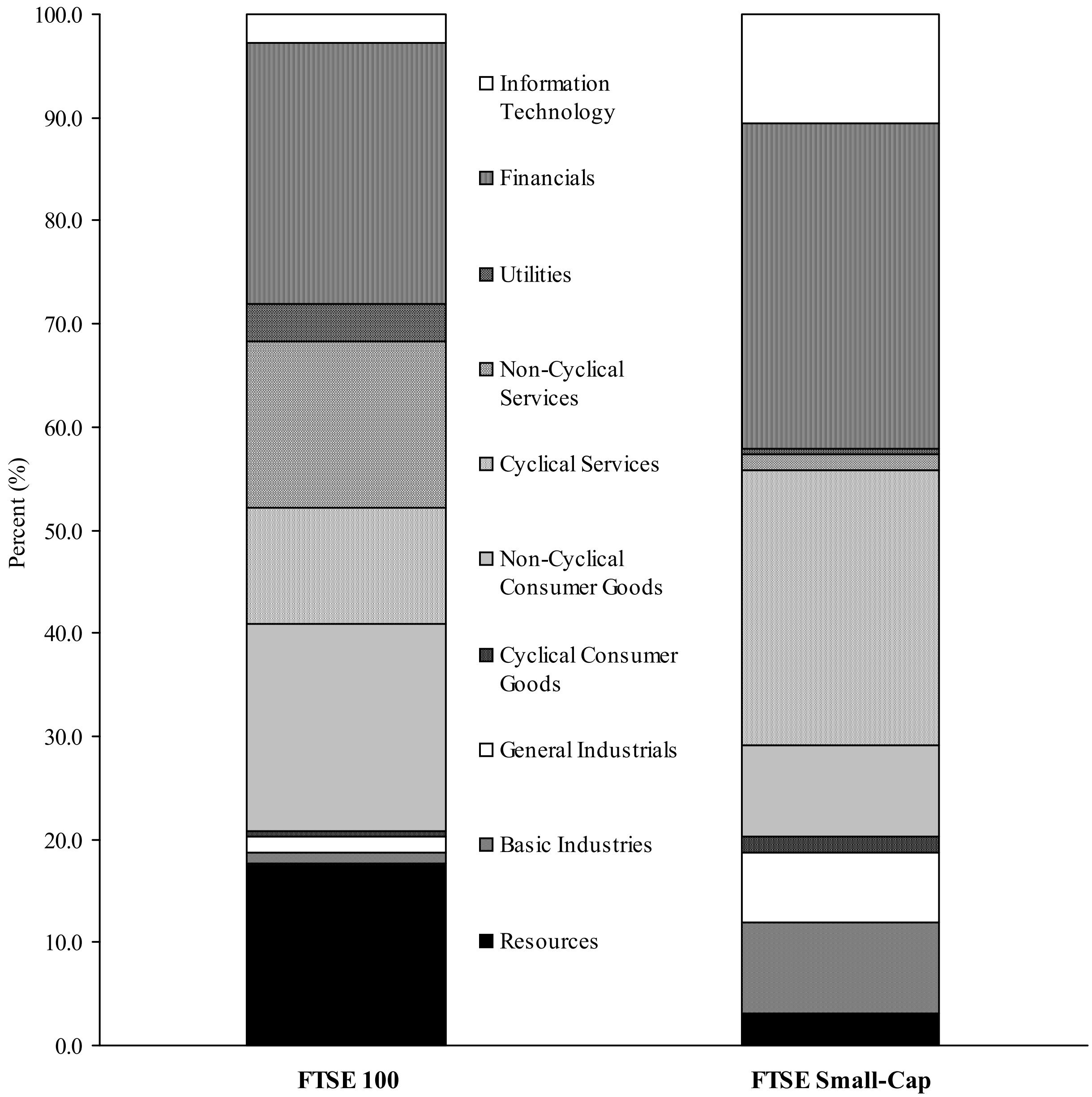


Source: Datastream International.

Table B

FTSE 100 VERSUS FTSE SMALL-CAP: ECONOMIC GROUP ALLOCATION

As of 31 March 2001



Source: FTSE International.