

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

U.K. SMALL-CAP INDICES: SIZE MATTERS

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U.K. Small-Cap Indices: Size Matters

To index or not to index, that is the question. Actually, for investors in U.K. small-cap equities, the question is also *which* index to use, the FTSE Small-Cap Index (FTSE SC) or the Hoare Govett Smaller Companies Index (HGSC). While the performance of the indices has been remarkably similar, they do differ greatly in terms of number and size of companies included. The HGSC, for example, gives investors a comprehensive view of the U.K. small-cap universe, but also includes many smaller, illiquid companies that are difficult and more costly to trade. The FTSE SC, on the other hand, only includes companies that meet certain guidelines for size and liquidity, but represents a narrower subset of the market. Investors looking to choose one or the other should first decide exactly what they consider to be small-cap shares, then select whichever index best covers that universe.

Methodology

The FTSE SC is made up of companies too small to be included in the FTSE All-Share Index, but larger than those included in the FTSE Fledgling Index, and typically makes up about 2% of total U.K. equity market capitalization. Changes to the index are made quarterly and governed by strict rules, with size, liquidity, and free float all considered. For example, a company whose market cap is more than 0.2% of the FTSE SC automatically graduates to the All-Share (provided it meets all other requirements), while a company that makes up less than 0.05% of the FTSE SC is "demoted" to the Fledgling Index.

The HGSC, devised by Triumph of the Optimists authors (and London Business School professors) Elroy Dimson and Paul Marsh, is far simpler to administer: the index simply tracks the performance of the companies representing the smallest 10% of the U.K. equity market, rebalanced annually.

Viva la difference!

As stated earlier, the major difference between the two indices is in the number of companies included and the range of market caps represented. As of January 31, the FTSE SC was made up of 347 companies with market caps ranging from £26.9 million to £375.1 million; the HGSC was made up of 1,181 companies with market caps from £100,000 to £908.2 million. However, while the median market cap differs significantly (£130.1 million for the FTSE SC and £53.7 million for HGSC) the average market cap of constituents was more comparable (£145.1 million for the FTSE SC and £120.7 million for HGSC) as both indices have a relatively heavy weighting in the largest shares. (See Table A.)

The top ten companies, for example, make up 6.4% of the FTSE SC and 5.4% of the HGSC; the top 20, 12.0% and 10.2%; and the top 50, 26.5% and 22.3%. In addition, the volatility of the indices are similar, with an annualized standard deviation since 1988 of 20.9% for the FTSE SC, and 19.5% for the HGSC.

In terms of economic sector representation, the indices are more similar than they are different, with no more than a percentage point or two separating most sector weights between the indices. The largest gaps are in information technology,

which makes up 9.0% of the FTSE SC but only 6.4% of HGSC, and non-cyclical consumer goods, which makes up 8.0% of the FTSE SC and 5.6% of HGSC. (See Table B.)

The valuations provided by the index vendors are strikingly different; however, they do not allow for a true comparison of valuations as they use significantly different calculation methodologies. For example, while the FTSE SC includes all companies in its price-earnings (P/E) calculation, the HGSC excludes those with negative earnings, as well as those with a P/E of less than one or more than 200, making it appear as if the HGSC is much more attractively valued.

The Bottom Line

The two indices have put up remarkably similar long-term performance numbers: over the 16 years ended in 2003, quarterly returns were 99% correlated, with the FTSE SC posting an AACR of 7.6% and the HGSC returning 8.1% a year. Looked at another way, £100 invested in the FTSE SC in 1988 would have grown to £343.33 by the end of 2003, while £100 invested in HGSC would be worth £365.88. Moreover, all of the HGSC outperformance has come in recent years: as recently as 2001 the two indices' historical performance was roughly even. (See Table C.)

While long-term returns may be comparable, however, short-term differences between returns are also to be expected. In 1998, for example, the FTSE SC lagged the HGSC by more than four percentage points, returning -8.1% versus -4.0%, while two years later, the FTSE SC handily outperformed its counterpart, returning 5.5% to the HGSC's 0.8%. (See Table D.)

In sum, while the two indices appear similar in many ways, they do have differences that investors and managers should take into account. While we do not have a particular preference for one or the other, investors should understand these differences and use them to select the index best suited to meeting their needs.

Table A**MARKET CAP RANGES OF U.K. SMALL-CAP INDICES****As of 31 January 2004**

	FTSE Small-Cap <u>Index</u>	Hoare Govett <u>Smaller Companies Index</u>
Number of Companies	347	1,181
Total Market Cap (£ Millions)	50,336.7	142,537.7
Largest Market Cap (£ Millions)	375.1	908.2
Smallest Market Cap (£ Millions)	26.9	0.1
Median Market Cap (£ Millions)	130.1	53.7
Average Market Cap (£ Millions)	145.1	120.7

Sources: ABN AMRO, FTSE International, and Thomson Datastream.

Table B**FTSE SMALL-CAP AND HOARE GOVETT SMALLER COMPANIES ECONOMIC GROUP WEIGHTS****As of January 31, 2004**

<u>Economic Group</u>	<u>Percentage of FTSE Small-Cap</u>	<u>Percentage of HGSC</u>
Resources	3.5	3.8
Basic Industries	5.8	6.9
General Industrials	5.9	7.9
Cyclical Consumer Goods	3.5	2.3
Non-Cyclical Consumer Goods	8.0	5.6
Cyclical Services	27.0	29.0
Non-Cyclical Services	1.8	2.5
Utilities	0.2	0.8
Financials	35.3	34.9
Information Technology	9.0	6.4
All Economic Groups	100.0	100.0

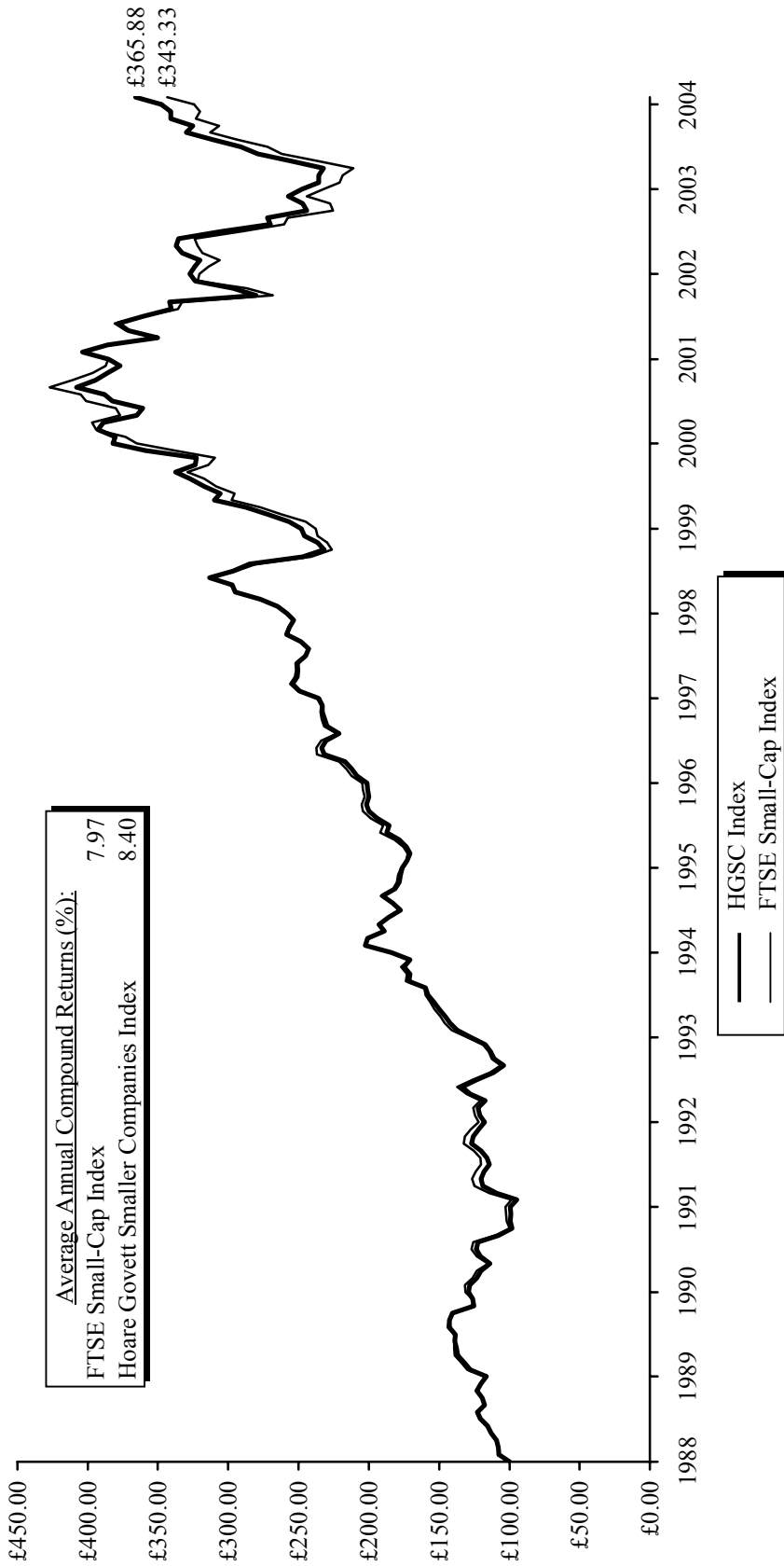
Sources: ABN AMRO and FTSE International.

Note: Percentages may not total due to rounding.

Table C

CUMULATIVE WEALTH OF THE FTSE SMALL-CAP INDEX AND THE HOARE GOVETT SMALLER COMPANIES INDEX

1 January 1988 - 31 January 2004
 (31 December 1987 = £100)



Sources: ABN AMRO and Thomson Datastream.

Table D**FTSE SMALL-CAP AND HGSC INDEX PERFORMANCE****1 January 1988 - 31 January 2004****Sterling (£)****Annual Total Returns (%)**

<u>Year</u>	FTSE Small-Cap <u>Index</u>	Hoare Govett Smaller Companies <u>Index</u>
1988	17.0	16.5
1989	12.3	10.8
1990	-21.7	-23.1
1991	18.6	18.5
1992	6.5	8.5
1993	41.6	44.0
1994	-3.6	-4.1
1995	15.4	14.4
1996	15.7	17.0
1997	9.1	9.5
1998	-8.1	-4.0
1999	53.8	54.2
2000	5.5	0.8
2001	-16.9	-15.1
2002	-27.6	-24.3
2003	39.7	40.4
2004	5.9	5.3

**Average Annual Compound Returns (%)
Periods Ended 31 December 2003**

16 Yrs	7.6	8.1
15 Yrs	7.0	7.6
14 Yrs	6.7	7.3
13 Yrs	9.2	10.1
12 Yrs	8.5	9.4
11 Yrs	8.7	9.5
10 Yrs	5.8	6.6
9 Yrs	6.9	7.8
8 Yrs	5.9	7.0
7 Yrs	4.6	5.7
6 Yrs	3.9	5.1
5 Yrs	6.4	7.0
4 Yrs	-2.9	-2.3
3 Yrs	-5.6	-3.4
2 Yrs	0.6	3.1
1 Yr	39.7	40.4

Sources: ABN AMRO and FTSE International.

Note: Cumulative returns for 2004 are through 31 January.