ALL THE SMALL THINGS: An examination of US smaller companies

It's not easy being small. Not only are smaller companies less popular than large caps among investors and public consumers, they also lose the popularity battle among Wall Street analysts.

U.S. election impact: post-haste

Trump's election as the 45th president of the U.S. was considered a surprise election. Despite a lack of details behind his policy plans, the potential impacts of what he could do were immediately reflected in stock prices. Investors quickly identified their perceived winners and losers, which generated large price swings in the market. Going forward, U.S. small caps may grow in popularity if Trump's goal to protect American businesses pans out. Many U.S. smaller companies are domestic-oriented.

U.S. election impact: post-date

Trump's inauguration marked a dramatic shift in views on business, regulation, trade and taxation. Some regarded his views as a refreshing change, while others saw his protectionist views as a reversion to outdated visions.

In either case, Trump's policies will be important components of near-future decisions made by business managers. The details and timing of Trump's proposed plans remain uncertain, so we are cautious about the valuations of companies that have priced in the "best" outcome. These outcomes are what investors believe could be the best-case scenarios for businesses based on the perceived benefits of tax reduction, greater government spending or increased business confidence.

Similarly, the worst-case scenarios may not be as terrible as some investors figure. These rather, more extreme views have provided us with the opportunity to adjust our holdings and take significant binary risks.

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What's most important has little to do with the impacts of the election and more to do with the fundamental health of U.S. smaller companies. We believe that they still have room for continued improvement in earnings power.

Small caps gain traction

We believe many investors have started or increased their consideration to U.S. small caps in search for new ways to diversify. Small-cap companies are typically defined as ones with market caps ranging from $300 million to $3 billion.

They are generally less established than large caps, although some smaller companies have brands that have survived decades. In nearly all cases, small caps have more room to grow than their more mature, large-cap counterparts. While inherently more risky, investing in small caps can be an advantageous extension for equity investors with longer time horizons, and who can handle the risk in exchange for the potential of added income. Valuations have been fair in a historical context (see figure below).

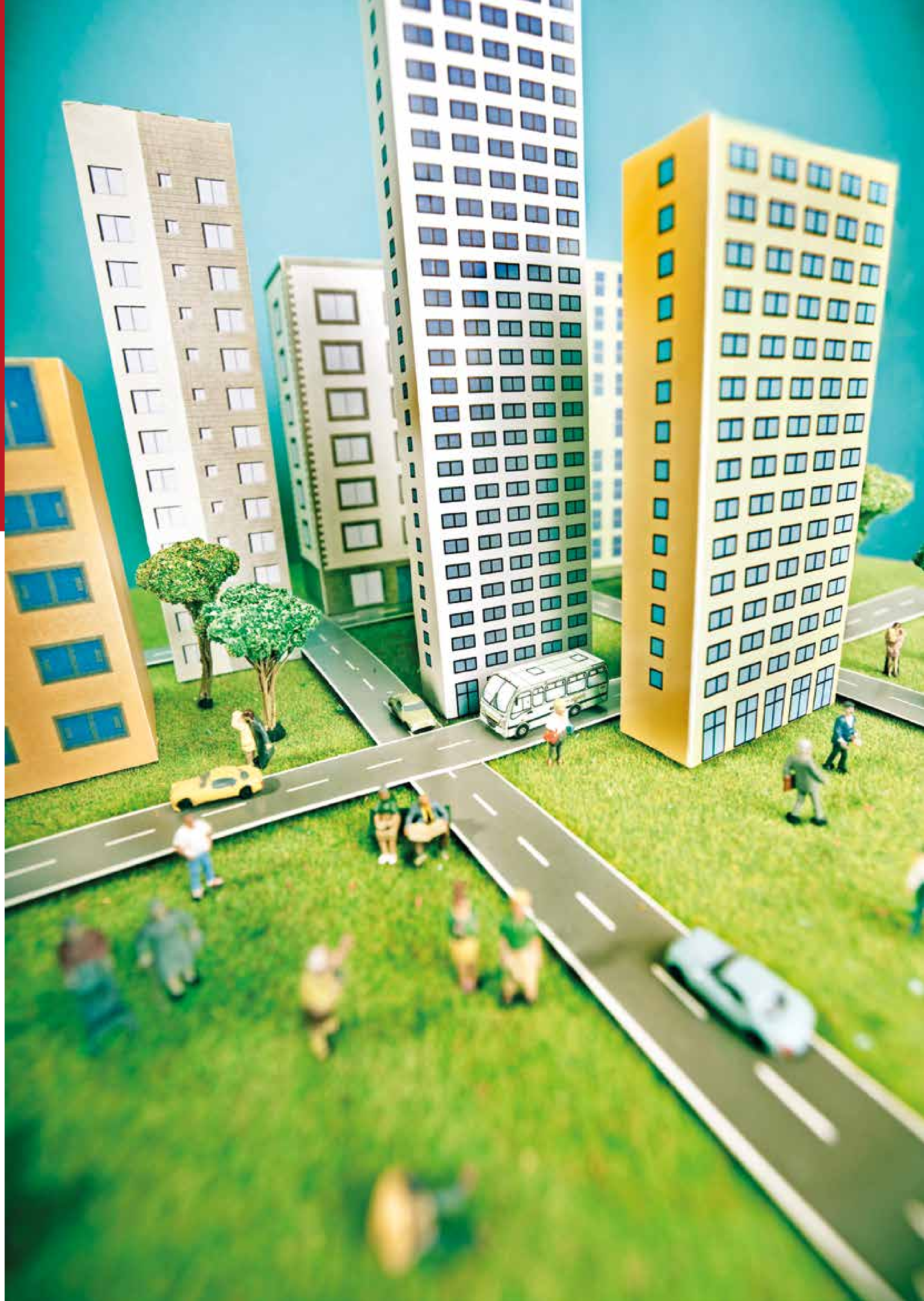
The small cap challenge

Different views, different outcomes

The way investment managers view the market determines the companies they buy. If they view the market as being made up of political events, then the companies could represent a world that is constantly in flux and hard to predict. If they view the market as being made up of companies, then the companies could be less trendy but better able to withstand the long term.

One potential benefit of taking the second view is the ability to invest in opportunities others might have missed. As others devote their attention to what's trending, they can overlook perfectly healthy companies that might be undervalued or in a down cycle but are poised for long-term growth. Such oversight is relatively common when investing in U.S. small caps, an asset class that has gained popularity over the years.

From every angle, a strong and well-rounded small-cap equity portfolio is about companies. Too often, investors tend to narrow their focus on the markets.



This limited view is harder to avoid in times of economic stress. It seems the world today is most concerned with predicting the next steps of global policymakers, whether in monetary, fiscal or political affairs, but when it comes to small caps, it all boils down to companies.

Active stance on risk

With many variables to consider, investors are no doubt more cautious than ever, thinking deeper about where they want to put their investment dollars. Proper diversification* across asset classes and risk areas has helped many investors feel more comfortable about uncertainty. But investors remain concerned about the future of their portfolios.

The merits of active management have been thoroughly debated over recent years following the demand for passive investment vehicles, but we believe there remain benefits to having investments overseen by active strategies.

Actively seeking small

Despite a fairly healthy business sector, many businesses have found it harder to expand margins. This has occurred across many sectors as inflation prevailed over certain areas, including labour. In addition to increased costs, businesses have faced greater stock and sector dispersion amid volatility.

It has therefore become harder for investment managers to distinguish the companies that are well-valued and differentiated without proprietary research.

Active management has become a useful strategy in order to decipher what the data means, and face-to-face meetings have made more of a difference in understanding a company's strategy than reading a press release or company letter.

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For smaller companies, which tend to be less established and have fewer analysts covering them, active management can do more than sort companies. Active management of small-cap assets can help uncover opportunities in a massive universe that remains relatively uncharted.

In order to identify and invest in the right companies, it is critical to ask the right questions. There are many ways to select investment holdings, but we prefer a simple and straightforward process that is used across Aberdeen's equity teams.

Aberdeen's approach

The universe of small-cap stocks is already complicated: many options, different sectors, varying sizes. U.S. small-cap companies make up over 70% of all publicly traded U.S. companies. The number of publicly listed small-cap companies exceeds large-cap ones by three to one. There are more small companies in the market but fewer market analysts doing the work covering them. For managers like us that delve into the world of smaller companies, process is critical.

A research process that is simple to understand can help reduce noise that doesn't matter to a long-term investment. Our first two steps are critical parts of each company visit note. These then lead to the third step, which is the portfolio construction process. The goal of this process is to eventually invest in good quality companies at a sensible price. The iterative work involved can be laborious, but it is necessary to get to the aim of identifying companies that can be successful as businesses and stocks over the term of a holding period.

Small caps for the long term

The unpredictable nature of the markets and the trajectory of a U.S. smaller company should not deter investors from taking advantage of opportunities in the asset class. While a smaller company takes longer to grow, it is during this time when it can add income to a portfolio, perhaps more so than an established and slower growth large-cap company could do.

A long-term allocation to a well-balanced equity strategy may make sense for investors searching for growth and diversification.

Many investors have recently re-allocated to the U.S. market after having moved away for a period of time. Despite the current political or economic environment, we believe many small caps have healthy fundamentals. Companies of all sizes are always trying to grow. Quality small caps with niche products and services tend to be able to achieve organic growth by gaining market share, even during tough environments.

Picking the right ones

While these small caps exist, they are not the easiest to find. Small caps require a greater amount of due diligence and proprietary research because they get less coverage by Wall Street.

Avoiding herd mentality

For every success story in the small-cap universe, there are also many smaller companies that flounder. The numbers tell only part of the story. The people at the company ultimately define its future success, and asset managers need to be adept at diligence and decision-making to separate the right characteristics from those that don't always measure up.

Evaluating companies using ESG factors can also be a helpful strategy in this case because taking stewardship seriously can make it easier to distinguish the smaller companies that care about

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their footprint from the ones that don't. Companies that care about their customers and the world they operate in can attract more loyalty, eventually leading to a stronger business.

There's a lot more to small caps than some investors may have traditionally given them credit for. The opportunities are abundant within U.S. small caps. The challenge is about knowing where to look rather than what to look for. Being picky can make the difference with small caps, but it isn't easy knowing how to be picky. With the help of a professional team, sorting through all the options may not be so tricky after all.

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