



# The return of the SMID cap stocks?

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**Freddie Fuller**  
European & International  
Equity Product Specialist

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**“The last few weeks have seen a renewed interest in small cap investing across various developed markets.”**

There are few gospels in investing. In part because they are upended far too regularly to be so and, as much the industry has tried, it is not a science and therefore rules rarely apply. There are however assumptions, adages, and even things you cannot say, such as ‘this time is different’.

One of those that has lasted for many decades is the size premium, first documented by Rolf Banz in the 1980s, which showed that smaller NYSE firms had significantly larger risk-adjusted returns than large caps over a 40-year period which could not be accounted for by market beta. This analysis has become lore, although as with all analysis, conviction has been degraded as historical records have become weaker over time, suggestions that much of it is explained by illiquidity premiums, or that excess returns are curiously compressed into the month of January.

The last few weeks have seen a renewed interest in small cap investing across various developed markets. This follows a torrid period for small and mid-cap (SMID) investors around the world, sometimes in absolute terms but often in relative terms, as large and mega-cap names led by US technology businesses have continued to reach stratospheric highs. US small caps have had a particularly hard time of it, with record discounts to their larger peers. This has raised the question as to whether SMID stocks are finally about to make a return to long-term outperformance?

To respond to this question, it is vital to examine the myriad of factors that affect the underlying businesses themselves as well as their performance in the market. This can also lead us to ascertain whether the size premium exists at all.

SMID stocks tend to demand a higher premium given their risk profile compared with larger, well-established companies. There are various reasons for this: investors take on different risks including illiquidity risk, credit risk (given the cost of both equity and debt tend to be higher for these companies), inflation risk (smaller companies find it harder to absorb higher expenses and pass on increases to customers) and finally recession risk, given these companies tend to carry more debt, and that debt is of shorter maturity with fewer sources of financing.

However, there are also benefits to investing in these businesses. They typically have higher earnings growth, stemming not only from a small base but also because they are often disruptors and can become monopolies or duopolies in their niche very swiftly. They also tend to have simpler business models versus an impenetrable conglomerate, have less exposure to FX risk given their domestic focus, and are also more stock-specifically driven from a return's perspective. Finally, although on average these companies carry more debt, analysis demonstrates that this debt is concentrated into a portion of lower quality, often unprofitable companies<sup>1</sup>.

The sum of these factors determines the relative performance of the asset class and goes some way to explaining why SMID stocks can outperform in the longer term. However, academia has re-evaluated the analysis of Banz and overlaid it with some interesting research that, to a statistically significant degree, demonstrates that there likely is a size factor at play, but it should be heavily caveated by two determining elements. The first is quality and the second is the interest rate cycle.

Addressing the first: in their natively named study 'Size Matters, If You Control your Junk'<sup>2</sup> the authors demonstrate that when controlling for quality companies – in this instance defined as a strong balance sheet with reliable profitability – and removing those 'junk' stocks with low average returns, often distressed and very illiquid, the size factor returns as a much larger and more stable premium, prevalent across seasons, industries, and geographies. The second is demonstrated in a 2022 paper<sup>3</sup> that builds on the first study, showing that the size factor disappears during periods of monetary tightening and is present during periods of monetary expansion. The authors argue that the reasons for this are likely intertwined with some of the components mentioned above, which are specific to SMID caps, namely i) a stock market liquidity effect ii) a firm-level (balance sheet) liquidity effect and iii) increased access to credit.

As bottom-up, fundamental investors focussed on high-quality businesses, we have never particularly desired or relied upon academic research touting this or that 'guaranteed' premium. Instead, our philosophy has remained that those high-quality businesses, which generate high levels of return on capital employed in the business and can reinvest in their own business, can compound shareholder value over many years and prove resilient in the face of geopolitical and economic disruption.

To some extent, the aforementioned academia does chime with our experience, especially as we have seen higher-quality businesses perform well the further down the market cap scale you go. However, the utilisation of the analysis for investment purposes is extraneous to our process.

Forecasting when a particular asset class might come back into vogue is a thankless task. If there is indeed a correlation between not only the peaking of the interest rate cycle, but also the speed at which that cycle occurred (some research suggests that the faster the rate hikes, the greater the underperformance of SMID caps) then it may be that the headwinds facing these sorts of companies from an investor point of view are abating.

With relative valuations as attractive as they are, one could argue that there is at the very least a cushion with regards to how they may fare in the future if central banks are indeed approaching a period of interest rate cuts as disinflation continues. There is one remaining caveat when it comes SMID cap performance though: time periods matter. The studies mentioned so far have pointed to any premium exerting itself over decades, an important point to note if an investor were looking to exploit the factor.

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The more interesting question perhaps is not when, but how to approach the asset class. There are idiosyncrasies that exist in this arena that do not apply to others. For example, analyst coverage of small caps, particularly since the introduction of the MiFID II regime in Europe, is woeful when compared with larger companies. Therein lies an opportunity for active management that may be lacking when compared with the armies of analysts focussing on the better-known end of the corporate spectrum. This is amplified by the opportunity provided through engagement with company management; not only does the relationship building give insight into the business itself in a beneficial manner, given the less efficient market from an informational perspective, but there is a latent opportunity to build these relationships in the first place, given the businesses themselves are more accessible.

<sup>1</sup> RBC Global Asset Management, Bloomberg, 2024.

<sup>2</sup> Asness, Cliff S. and Frazzini, Andrea and Israel, Ronen and Moskowitz, Tobias J. and Moskowitz, Tobias J. and Pedersen, Lasse Heje, Size Matters, If You Control Your Junk (January 22, 2015).

<sup>3</sup> Simpson, Marc W. and Grossmann, Axel, The Resurrected Size Effect Still Sleeps in the (Monetary) Winter (September 24, 2022).

As much as fund managers like to believe the opposite, you are far more likely to meet the management team of a small local business in the UK than you are the CEO of a multi-national conglomerate. The sheer scale of the SMID cap universe also gives fund managers good opportunities for alpha, even when controlling for quality, and this seems to be particularly prevalent outside of the US, where data suggests that not only is the size premium more discernible, but the opportunity for active management to add value is greater. This could suggest that European and International SMID equities remain a desirable area for fundamental active managers to thrive.

Ultimately, there are no absolutes. Familiarity tells us that the small and mid-cap equity universe is a diverse and exciting area for investment opportunities. There are indications that focussing on the highest-quality companies through stock picking over long investment horizons can be beneficial to investors, even though it is often accompanied by more volatility than larger peers. Our experience suggests that with the right philosophy and process, this asset class can continue to offer up interesting, diversifying businesses, and it remains an asset class unlike others.

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