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Stock picking paramount in European small cap market

Managing money in a crisis can be challenging, but our long-term investment approach and valuation discipline have helped us take advantage of the market dislocation

Mine Tezgul, Portfolio Manager

European smaller companies have held up well in the Covid-19 crisis. Over the 12 months to the end of September 2020, the EMIX Europe ex UK Small Cap Index generated a total return of 5.7% in euros, while the sterling return was 8.4%; this compared with -7.3% (in euros) for the MSCI Europe Index, a good proxy for large cap performance.[1]

Perhaps such performance would have not be an obvious outcome from the onset. Smaller companies carry more risk and can get hit more severely by an economic downturn as they are less diversified and may have fewer resources to draw on. So how do we approach this investment space, especially during a crisis?

First and foremost, a crisis stress-tests the strength of the business model and the capital adequacy of a company. Our philosophy of investing in high-quality companies with strong economic moats, attractive returns and healthy balance sheets has helped us differentiate during this time of increased uncertainty. Companies with weak fundamentals can see their equity value disappear in a downturn if they enter it with excessive financial leverage. In contrast, companies with robust business models that generate free cash flow and demonstrate the ability to grow without the need for high debt levels can weather an economic storm much more effectively and come back stronger on the other side. Stock selection is therefore paramount.

More specifically, the global pandemic has accelerated many trends already identified as secular growth drivers for the types of companies we like. For example, digitisation and increasing data consumption have continued to support Moore's Law and investment in semiconductor capital expenditure, which benefit the market leaders in niche semiconductor technologies. Meanwhile, leading European payment companies, which have augmented their pricing power through consolidation, grew strongly with the continued shift from cash to electronic payments, helped by consumer choice and regulation.

Diagnostic testing and medical technology companies have expanded their installed bases significantly, thanks to investments in automation and innovation in healthcare, which will benefit them for many years with the growth in their recurring revenues. Technology platforms with a strong network effect have strengthened their position by gaining new "sticky" customer cohorts with an increased shift to online transactions in e-commerce, online banking, food delivery and online gaming industries. Such trends we believe remain intact, and when combined with competitive advantage will harvest long-term winners.

- On the other hand, companies which we have decided to avoid due to the structural challenges they face from technological disruption and sustainability risks were put under further pressure this year by the restrictions brought on by the pandemic and an increasing focus on ESG factors. The commercial real estate industry, for example, is suffering from deteriorating pricing power due to shifts in demand, exacerbated by working from home and online consumption. Technological disruption in the distribution of film content, meanwhile, continues to present a challenge for cinema operators. Sustainability risks and associated liabilities remain high in pollutive industries, such as oil and gas. Assessing sustainability is a core pillar of our investment process and we remain underweight companies with such material risks.

Finally, our long-term investment approach and valuation discipline have helped us take advantage of the market dislocation provided by the short-term fears arising from the health crisis. During the indiscriminate sell-off in the first half of the year we opened and increased positions in high-quality companies at attractive price levels offering significant upside to their intrinsic value.

Volatile markets are not easy to navigate, but they offer opportunities for the patient investor. Small cap is a universe especially ripe with these opportunities, because the companies are less well researched and understood. This gives an active manager a greater ability to generate alpha by investing in well-researched high conviction ideas. Our quality and growth-oriented investment philosophy, fundamental bottom-up process and long-term approach have served us well in good and bad markets. By remaining loyal to our process we have navigated 2020's wide-ranging market environments and hope to continue doing so in future.

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[1] Morningstar, 30 September 2020.

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