

Different approaches to investing in small caps

In February, Tell Media Group, in cooperation with **Van Lanschot Kempenn Investment Management**, **Principal - Origin Asset Management** and **Schroders**, invited Finnish selectors and allocators to discuss investing in small cap equities.

By: **Niklas Tell** Photo: **Christer Salling**



The discussion started with Niklas Tell asking the participants about their exposure to small caps and whether now is the time to increase the allocation.

TINO SIEVÄNEN: "We've largely stayed away from small caps, which has been a good call. Now the tricky question is whether large caps will continue their run and how much you tactically want to go into small caps. This is probably not the worst time to start building a strategic position in small caps. We added European small caps late last year and we're currently looking at US small caps."

ANTTI PAITULA: "The positioning is similar at OP. We've increased our exposure to small caps and we see it as an early cycle play. The question is whether this is early or late cycle. The consensus is now for a soft or no landing scenario, so I think there's a possibility that we're early cycle and if the Fed is starting to cut rates, that should boost small caps. It's still, of course, a question whether small caps will be able to outperform the mega caps that have done and continue to do very well."

JAN WILLEM BERGHUIS: "When we look at companies in our market, we see that a lot of bad news is already priced in. The economy is not in a great shape right now, so there's a reason why small caps have been depressed. But investors are, of course, looking ahead and if you have a long-term view, then valuations clearly benefit small caps. We see that clients are increasing their allocations and if you expect a soft landing and lower interest rates, then small caps should do well."

CHRIS CARTER: "If you look at small caps broadly on an index level, it looks positive from a technical point of view

and absolute valuations are ok. Relative to large caps, it depends on which region you are looking at. Small caps have done badly relative to large caps in the US but they've done well relative to large caps in emerging markets, for example. So small caps in their own right are doing ok - it's just that US large caps are doing spectacularly well.

LASSI JÄRVINEN: "From a pure valuation perspective, it's probably not a bad time to go into small caps. Just the fact that interest rates are steadying is positive. However, for small caps to really outperform, you probably need the economy to improve as well."

JANNE LÄHDESMÄKI: "If we look at historical data, it has always been a good idea to own stocks when central banks starts to cut rates - regardless of how the economy is doing. If we look at the relative performance of Nordic small caps to Nordic large caps, we share a similar challenge to the US. In the US, the large caps have outperformed thanks to the magnificent seven and in the Nordic region, we have Novo Nordisk that has helped the performance of the large cap index."

TINO SIEVÄNEN: "Many small cap managers say that the change in the rate cycle will be the catalyst for performance. However, if it's really a duration bet, as an asset allocator I'm probably better off taking that bet in fixed income rather than in small caps. It would be interesting to hear what the managers have to say on that."

JANNE LÄHDESMÄKI: "From my perspective as a bottom-up stock picker, I don't really see a big direct impact from interest rates as balance sheets for Nordic small caps are in a good shape. There can, of course, be an indirect

impact from increased inflows to small caps when interest rates come down."

CHRIS CARTER: "I'm not convinced that interest rates are a driver for small cap performance versus large caps. I'm sceptical of most macro-economic explanations and if you run a regression analysis between small caps and treasuries, it will be a very weak relationship. If you want to take a bet on duration, you're probably better off doing that in treasuries."

JAN WILLEM BERGHUIS: "I'm not an asset allocator but if you're investing in small caps, then time in the market is more important than timing the market. When we're talking about interest rate sensitivity in small caps, it depends on the individual company. We saw an example of that in Q4 when the smallest and riskiest companies with the most leverage did the best. If you look at our portfolio, the leverage is half of the benchmark. There are a lot of opportunities in small caps but it's all bottom-up. One example from our portfolio is Brunswick, which is the maker of Mercury outboard motors. The stock trades at 11 times earnings and the company warned that it's a weak economy but that's already in the price. Earnings could grow by 30 per cent but the multiple could also grow by 30 per cent. We don't know if that were to happen this quarter or if it will take 18 months but if you're a long-term investor, that shouldn't matter and that's also why I think it's difficult to time an entry into small caps because you risk missing these opportunities."

CHRIS CARTER: "We know that beating the market in large cap US equities has at least historically been very difficult but you may more have more confidence in the alpha creation abilities of a small cap manager."

NIKLAS TELL: AS INVESTORS, DO YOU PREFER TO KEEP THE EXPOSURE AS A LONG-TERM HOLDING OR DO YOU VIEW IT MORE AS A TACTICAL ALLOCATION WHERE YOU GO IN AND OUT DEPENDING ON YOUR MARKET OUTLOOK?

TINO SIEVÄNEN: "We've been largely out of small caps but that has not really been a bet against small caps - rather the overall risk appetite. Overall, we do like to view small caps as a strategic asset and a long-term holding."

PARTICIPANTS

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- **TINO SIEVÄNEN**
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ANTTI PAITULA

Portfolio manager in the asset allocation team at OP Asset Management. He is a member of the investment committee forming the house view and deciding the asset allocation. He manages several discretionary multi-asset portfolios for wealth management and institutional clients and is also responsible for the open-ended, long-only fund research and selection.



TINO SIEVÄNEN

Portfolio manager and responsible for equity manager selection at Aktia. He is also a member of the bank's ESG committee with responsibility for third party fund products. Before joining Aktia in 2020, he spent close to five years at SEB as a senior analyst in the portfolio solutions team and as a client executive in the investment products team.



LASSI JÄRVINEN

Head of allocation products at Mandatum Asset Management. Before joining Mandatum in 2021, he spent about four years at Taaleri, first as a portfolio manager and then as head of solutions and allocation. Prior to that, he worked close to seven years in different positions at Nordea in Helsinki.

ANTTI PAITULA: "Small caps, especially in the US and Europe, have underperformed for a long time now but as we know, it's almost impossible to time the perfect entry point. If you believe that the small cap premium exists, you should of course keep a strategic position in small caps. Then how much you allocate I think depends on where we are in the economic cycle."

NIKLAS TELL: WHAT DO YOU SEE AS THE MAIN DRIVERS FOR CREATING VALUE AS A SMALL CAP MANAGER?

JANNE LÄHDESMÄKI: "For me and my co-manager, it comes down to growth. Both top-line growth but it also needs to lead to growth of EPS and EBIT. We typically like companies that have some sort of operating leverage in their business and we tend to focus on companies with above average margins and recurring revenues. We talked about loss-making companies earlier and we of course have these in the Nordic region as well. It's an area that we've stayed away from but we've now actually started to look at these companies. That's not to say that we will focus on loss making companies for the portfolio but given the sentiment change in market, there can be companies that will grow into profitability and mispricing is the biggest among these companies. This is, of course, also the most dangerous space because if things don't work out, they can't refinance themselves - especially in the equity market because the dilution would be too big."

JAN WILLEM BERGHUIS: "We have more of a value bias. We typically buy quality companies that for some reason is out of favour at the moment. The market last year brought a lot of companies onto our screen where we saw some companies down by some 50 per cent because investors worry about a slowing economy. We see ourselves as contrarian and these events create attractive opportunities for us as long-term investors. We could, of course, be too early into these companies but we would rather position ourselves in the right companies and wait for the economic turnaround. It's also a great time to be an active owner because company management will have a lot of time to talk to you as many others are staying away."

CHRIS CARTER: "It sounds as if we have some things in common - we also want to buy quality, which we define as companies that earn well above average cashflow return on investments. The average for the small cap index is 8 per cent and the average for companies in our portfolio is 25 per cent. We typically don't buy when companies are out of favour but focus on companies where the market is discounting much lower profitability in the future. We will only buy into companies where the share price is already rising relative to the market - so a classic approach to momentum - and we also want to see positive earnings revisions."

JANNE LÄHDESMÄKI: "What's the average market size in your portfolios?"

JAN WILLEM BERGHUIS: "For us, the average company in the portfolio is EUR 4.4 billion in market cap."

CHRIS CARTER: "It's very similar for us. We are EUR 4.3 billion on average."

JANNE LÄHDESMÄKI: "For our small cap strategy our average company is EUR 700 million and for our micro-cap strategy the average company is EUR 150 million."

NIKLAS TELL: WHAT ARE THE MAIN CHALLENGES FOR YOU AS ALLOCATORS AND ARE THERE ANY SPECIFIC CHALLENGES RELATING TO SMALL CAPS VERSUS LARGE CAPS?



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- Antti Paitula, OP Asset Management

ANTTI PAITULA: "I think we first need to realise that it's too broad to talk about small caps as we've seen from this discussion. We have US small caps, which is probably more liquid than Finnish large caps and then we have Nordic small caps. Those are very different markets. With that said, I think one of the first thing to look out for is that the manager really is investing in the part of the market that you're looking for. Also, when it comes to small caps, we think it's very important that the manager is controlling the AUM and that they are ready to close the strategy if needed."

TINO SIEVÄNEN: "Another thing to look out for is styles and factors as there are different approaches to investing in small caps. We've also noticed that there's a limited number available small-cap funds in the US while the situation is slightly better for European small caps. When you do a search, you want the universe to be as big as possible."

JANNE LÄHDESMÄKI: "Why is that do you think?"

JAN WILLEM BERGHUIS: "There are probably several reasons but as discussed earlier, you need to be prepared to close a fund if you're successful and that of course limits the revenue potential. If you're a very big manager, it might therefore not be worth it to launch a small-cap strategy. We manage EUR 2 billion in our global small cap strategy and for us, that's huge and it's our flagship fund."

JANNE LÄHDESMÄKI: "I think you're correct. We actually had this discussion before joining Schroders and we asked ourselves if they realise that the Nordic micro-cap universe is not very big compared to the total AUM of Schroders. We did the capacity calculation on our end and Schroders did a similar exercise and we actually ended up at roughly the same number. So before we even joined, we all knew that the capacity for the micro-cap fund is EUR 300 to 400 million."

CHRIS CARTER: "As allocators, you also need to decide what it is that you're looking for. Are you looking for small-cap beta with some alpha potential on top? Then you're probably looking for a lower tracking-error fund. Or are you looking for a manager that has the potential to outperform the benchmark by 30 per cent - and then will risk underperforming the benchmark by the same amount?"

LASSI JÄRVINEN: "Yes. As an asset allocator you, of course, need to decide what it is that you're looking for because if you simply want small-cap beta, then you're probably better off selecting an ETF. On the other hand, I do think it's probably more likely that there are alpha generation opportunities in small caps compared with large caps."



JAN WILLEM BERGHUIS
Head of small caps at Van Lanschot Kempen Investment Management. He joined the company in 1999 and launched the Kempen global small-cap strategy in 2014. He is currently responsible for company analysis and portfolio construction.



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Partner and portfolio manager at Principal - Origin Asset Management. He was previously a senior investment manager at Investec Asset Management, where he was one of the architects of the company's investment process and managed global equity and balanced portfolios. Prior to that, he was head of the global investment strategy team at UBS.



JANNE LÄHDESMÄKI
Portfolio manager at Schroders. He joined the company in January 2022 and manages the Nordic smaller companies and Nordic micro-cap strategies. He joined Schroders from Aktia where he spent some eight years, managing funds covering the Nordic all cap, small cap and micro-cap space. He has previously also worked as a portfolio manager at Nordea Asset Management.

NIKLAS TELL: AS SMALL CAP MANAGERS, ARE THERE BEHAVIOURAL TRAPS THAT ARE EASY TO FALL INTO AND HOW DO YOU AVOID THAT?

JAN WILLEM BERGHUIS: "We have, as I have mentioned, a value bias and for us it's important not to fall into value traps. A lot of companies can look inexpensive when you run your screens but the important question is whether it's a quality company. The discussions we have in the team is not about valuations - it's about quality. Also, when you have a value bias, you tend to buy into companies too early and one way to mitigate that is to take a smaller position when you enter a new name. We're aware of these biases and it's something we discuss continuously in the team."

JANNE LÄHDESMÄKI: "If you look at historical data for Nordic small caps, you will find that it's very few companies that contribute to most of the returns over time. As a micro-cap manager, you try to pick up the best compounding ideas. However, sometimes you will have a company that is constantly under-delivering, even if it's a strong management team, and then you must realise that it's just the wrong business and you need to kill your darlings. It can be painful because you've met the management teams several times and with few institutional owners, it could be game over for them if you sell."

CHRIS CARTER: "The obvious behavioural trap in finance is that people sell their winners too early and hold on to their losers for too long. Fortunately, with a momentum approach we tend to avoid that. Another potential trap is in meeting management teams. We have all the data we need to find the companies we want to invest in. If you meet management teams, you might become more positive on that company compared to if you haven't met the team."

TINO SIEVÄNEN: "I think a lesson from a fund selection point of view when listening to these three managers is that we need to stay open-minded because there are different ways to be successful in small-cap equity investing. We, as selectors, probably also have biases and we might personally like a specific style over another and we need to be aware of that."

JAN WILLEM BERGHUIS: "I think what's important is that you select a manager that is consistent in his or her approach. Different approaches can work but you don't want a manager that is value this year and momentum next year."

CHRIS CARTER: "I think with the development we've seen in data and technology, investors today will be able to dig very deep into the historical performance and they can see if we've been consistent in what we do. As we see from this discussion, there are several ways you can approach small-cap investing and if you screen small-cap funds, you will probably end up with enough funds that fulfil the historical alpha generation that you're looking for. These will probably be very different and I therefore think investors should focus their research and due diligence on the input to the process because none of us can control the output."

NIKLAS TELL: DO YOU HAVE A STRICT LIMIT ON COMPANY SIZE WHERE YOU SELL OR ARE YOU ABLE TO KEEP COMPANIES IN THE PORTFOLIO?

JANNE LÄHDESMÄKI: "We don't have a strict limit but what we typically do is top slice the holdings and allocate that to smaller companies. We say that we always want to have seed potatoes in the portfolio, which might be a very Finnish saying."

ANTTI PAITULA: "This is a very important topic from a fund selection point of view. On the one hand, you want the manager to be able to keep names that continue to perform but on the other hand, you also want to ensure that the portfolio maintains its small-cap characteristics because that's what you have invested in."

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– Janne Lähdesmäki, Schroders

NIKLAS TELL: WE TOUCHED ON ENGAGEMENT WITH MANAGEMENT TEAMS EARLIER. HOW IMPORTANT IS ENGAGEMENT WHEN IT COMES TO YOUR ESG WORK?

JAN WILLEM BERGHUIS: "We, of course, have exclusions and we've carried the Belgian Febelfin label since 2019 but where I think we can really make a difference is through engagement. We, for example, regularly engage with the most carbon intense companies in the portfolio in order to encourage them to take extra steps. However, we must also recognise that we're a small firm so there's only so much we can do. On the social side, we've done a lot of work with Abercrombie & Fitch, which is a company that we've been invested for a long time and we're finally seeing results after many years. Then on the governance side, a lot of positive things are happening in Japan and here you can really help smaller companies as they're looking to become more shareholder friendly."

JANNE LÄHDESMÄKI: "As we're only investing in the Nordic region, that's already a good starting point when it comes to ESG. Also, our investment process typically leads us to companies with very low CO2 emissions. When it comes to engagement, we've focused mostly on human capital management. The companies in our portfolio typically have light balance sheets and it's really about the people and we've therefore encouraged companies to report more on workplace and employee satisfaction."

CHRIS CARTER: "We're very much driven by data, also when it comes to ESG. The way we've addressed it is to look at the universe of companies and ask what the impact from a carbon tax would be and then we rank it from the least impacted to the most impacted. As you would expect, we hold very few companies that would be very impacted from a carbon tax." ●

