



Friday Morning Coffee

Nr. 44 – Why we are flex cap

The CIO of NN invest, Valentijn van Nieuwenhuizen, published an excellent article last week “size matters, as does timing” where he makes two important points. First, he explains why **smaller capitalization stocks outperform their large peers in the long run by a significant margin**. Secondly, he comes to the conclusion that it would add value for investors to time the size premium as small caps can be out of favour over long periods of time. He has developed a more dynamic approach to size the small cap part in portfolios. He is advocating for using option adjusted BBB credit spreads in a strategy overweighting small caps when credit spreads are tightening and reducing exposure to small caps when credit spreads are widening and risk aversion is increasing.

The so-called small cap premium has been well studied and documented in the academic world. According to Eugene Fama and Kenneth French, U.S. small outperformed large caps by over 2% a year between 1926 and 2013. In Europe we do not have the same range of historical data. What we can say however that EUR 100 invested at the end of 2000 would be worth EUR 389 today. The same EUR 100 invested in the European large caps would only be worth EUR 158 today. The main reason why small caps are outperforming is because **investors are being remunerated for higher liquidity risk**. In addition, small companies tend to be under-researched and/or simply overlooked. The opportunity for investors to uncover mispriced assets is hereby higher in that field.



Source: Bloomberg

The following note gives the opinion of the Investment team at the time of the publication. Please refer to important notice at the end of the document.

Friday Morning Coffee - Nr. 44 – Why we are flex cap

So why are we not allocating all our investments into smaller companies? Simply because of the higher volatility. In periods of market stress small caps are being sold first as liquidity is being withdrawn by investors. As seen on the graph, the damage done in 2008, 2011, 2016 and 2018 are clear examples of the pain inflicted to small caps in difficult market conditions. The patient long term investor in smaller companies would stay invested **during such times of stress. He may even invest more money into smaller companies as they are becoming cheaper and cheaper. In the long run, a cool-headed small cap investor has good chances to outperform the broader market.** However, as Nieuvenhuizen correctly points out, the periods of underperformance can be very long: for example, in the 32-year period from 1982 to 2013, the small cap premium was virtually non-existent in the U.S. stock market. Hence the idea of a dynamic allocation as proposed by NN Invest. In a back testing over a time period between 1997 and 2018, this dynamic strategy has achieved an excess return of 3.3% per year compared to 2.2% for a pure small cap strategy in a global universe of 1600 stocks. We simply do not know enough about the inner workings of this strategy to judge the validity of such an approach.

At ECP we run a so-called flexible strategy allowing us to invest wherever we can find investment opportunities independently of the market capitalization of the underlying companies. In our screenings, we apply the same criteria to large and small companies as we are fishing for undervalued earning power. We currently have 20% in small caps with a market cap below 2 bn EUR, 42% in midcaps and the remainder in companies with a market value higher than 10 bn EUR. This allocation is not the result of what a model based on a credit spread but simply the result of where we find the best investment opportunities.

Have a great weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
February 15th, 2019

Important notice

European Capital Partners (Luxembourg) SA ("ECP") is responsible for the publication of this promotional document. ECP is an asset management company based in Luxembourg, registered at JF Kennedy avenue 35a, L-1855 Luxembourg (RCS Luxembourg, B 134.746) authorized as an Alternative Investment Fund Manager ("AIFM") of the Luxembourg law of 12 July 2013 and supervised by the Commission de Surveillance du Secteur Financier (CSSF). This document is published for information purposes only and gives the opinion of the Investment team at the time of the publication. It does not constitute an offer to buy or sell financial instruments or investment advice and does not confirm any transaction unless expressly agreed otherwise. Although ECP carefully selects the data and sources used, errors or omissions cannot be excluded a priori. ECP cannot be held liable for any direct or indirect damage resulting from the use of this document. The intellectual property rights of ECP must be respected at all times; The contents of this document may not be reproduced without prior written consent. Any investment involves risks, such as the risk of loss of initial capital. Please read the Prospectus of Selected Funds, their Key Investor Information Documents (KIIDs) and financial reports before making an investment decision to understand their specific risks, costs and conditions. Those documents are available on www.ecp.lu. Past performance does not guarantee future performance. Please refer to an independent tax advisor for country tax information that can change at any time and analyze the tax impacts of any investment on your personal situation.