QUARTERLY COMMENT - I 2016

In 2016 the stock market saw one of the worst starts to a new year in a very long time. The reasons were almost purely sentiment driven because of oft-cited issues such as slowing growth in China or falling oil prices neither of which were really new information.

The larger universe of European shares, embodied by the MSCI Europe index, plunged by -16.9% by 11 February but then recovered to -7.7% at the end of the first quarter ending March. Contrary to conventional assumptions, the MSCI Europe Micro Caps index, which is not investible, lost less value with a maximum drawdown of -13.2% (11 February) and -6.1% for the first quarter. But wait, aren't smaller companies supposed to be more volatile and susceptible to market gyrations?

I regularly get this question, so I thought it might help to shed some light on causal relations between large and micro caps.

In the large cap arena, passive investment products like index ETFs have increasingly taken market share and have been heavily used by asset allocators for quick risk on / risk off tactical maneuvers.

As a side effect, overall volatility for large caps has climbed above past averages. In contrast, micro caps don't offer cost effective passive ETF vehicles because it would require building, in the case of the MSCI Europe Micro Cap index, a portfolio of 1385 individual companies. Sampling and synthesizing a micro cap portfolio to provide the same index exposure would be quite challenging. After all, micro caps don't work well for the asset allocation game.

On the other hand, actively managed products like large cap mutual funds often track benchmark indices very closely. Some of them have ventured into smaller company sizes but there is a limit in terms of market cap where mutual funds stop investing. It largely depends on the trading liquidity of individual companies and starts happening below EUR 300m in market cap. Traditionally, mutual funds rarely invest in companies with less than EUR 100m in market cap. Yet, it is largely the mutual funds (and institutional investors behind them) that permeate top down market fluctuations in equities, sometimes with a time lag for smaller entities. The traditional investors in micro caps have been comparatively steadier hands with longer-term investment horizons. Usually, they are not asset allocators nor prone to market sentiment. Therefore, there is a gradual transition from EUR 300m to EUR 100m in market cap during which the large cap ripple effects somewhat fizzle out. However, to a certain extent they always trickle down.

These structural conditions explain the lower correlations between large and micro caps than one might expect. In addition, correlations among micro caps have also been weak and offer further diversification benefits. Special investment strategies can further exploit this potential.

As a matter of fact, our portfolio has had very little correlation with the overall market in the past. It therefore has the potential to once again post positive returns despite a contracting valuation environment.

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