Balancing opportunity and risk in small and mid-cap equitie

abrdn

The small and mid-cap universe offers the potential to invest in tomorrow's large companies today. In this article, we'll look at ways to navigate this huge global market while balancing the opportunities and risks.

Given a backdrop of conflict in Ukraine and a lingering pandemic, investors face a lot of uncertainty at the moment.

Due to concerns about inflation, interest rate rises and tightening monetary policy in early 2022, investors in small and mid-cap equities have been favouring "value" stocks with lower price-earnings (P/E) valuations over higher P/E "quality" companies recently.

We also saw small and mid-caps underperform large caps in 2021, based on the (not always accurate) perception that big equals safer.

All this means there is now an opportunity to invest in quality small and mid-cap companies with the potential to weather economic cycles.

These companies are available at compelling valuations. But in today's unpredictable environment, is it possible for investors to buy tomorrow's potential large caps without taking high risks?

Narrowing the search

The global small and mid-cap equity investable universe is vast. Two thirds of the world's listed corporates are small or mid-cap companies. That's 7850 stocks.[1]

Very few analysts cover the sector, which means experienced investors can exploit market inefficiencies.

With such a huge opportunity set, where do investors begin to look? At abrdn our starting point since the late 90s has been our stock screening matrix. Our information feeds measure the quality, growth, momentum and valuation factors that our continuous backtesting has found to be predictive of share price performance.

The above illustration shows the select companies we look for; those with strong quality, growth and momentum characteristics.

Our screening matrix highlights a shortlist of companies which look attractive from a quantitative perspective. Small and mid-cap specialists carry out rigorous fundamental research on these top-scoring companies, including meeting with senior management, financial analysis, an assessment of ESG risks and opportunities, as well as a peer review process.

The result is a 'best ideas list' which comprises of regional analysts' highest conviction names. Each list typically contains 15-20 stocks.

Our portfolios have high weights to these strongest conviction companies, while ensuring a sufficient level of diversification as well as clear, deliberate and persistent style tilts to quality, growth and momentum.

Factors in focus

We've talked about the factors that we believe are important when selecting companies with the potential to enlarge their market capitalisation over the long term. But what are the key indicators of these three characteristics?

[1] Source MSCI 28 February 2022

Balancing opportunity and risk in small and mid-cap equities

Growth

In our view, it's important to look for companies with profitable, sustainable, growth. Small and mid-cap businesses with supportive end markets, as well as the ability to gain market share and expand profit margins, have the greatest potential to become tomorrow's large caps.

Momentum

We also look for signs that companies are exhibiting momentum, such as seeing upward earnings revisions and a history of consistently beating earnings forecasts.

Growth and momentum characteristics have the potential to be sustained for many years, which partly explains why small caps have outperformed large caps over the long term.[2]

Quality

The graphic below shows what we believe are the key indicators of company quality:

Measures such as balance sheet strength, management pedigree and sustainable competitive advantage allow companies to successfully navigate changing economic cycles. Of course, investing in quality is also about avoiding loss-making, blue sky or highly leveraged businesses, as well as those with extremely cyclical earnings or a history of dividend cuts. Because of this, we believe, 'quality' companies have the potential to deliver higher returns over the long term with less volatility. This results in a more favourable risk-return profile.

[2] Source: Morningstar, Total Return, GBP, 01 January 2000 to 31 March 2022

ESG – a key indicator of quality

One indicator shown above is ESG (environmental, social and governance). For us, ESG factors are financially material and can affect any company's performance both positively and negatively. A strong record on ESG issues is a key sign of company quality and can potentially help to reduce risk. Therefore, in our view, understanding ESG risks and opportunities should be an intrinsic part of any small and mid-cap research process, alongside other financial metrics.

We also think informed and constructive engagement with company leaders can help investment managers to encourage and share positive ESG practices – potentially protecting and enhancing the value of investments for years to come.

Well-resourced investment managers have the confidence to rely on their own ESG research, investing in companies which meet their own criteria, even when not covered by external ratings agencies. You can read more about The Importance of ESG in Small Cap Investing in our recent article.

Risk and opportunity

Looking forward, the outlook for higher interest rates, potentially sustained high inflation, and a lower growth environment suggest uncertain times are ahead.

Companies selected using a quality, growth and momentum process combined with ESG analysis are potentially well-placed to weather economic downturns. Far from being dependent on externally-driven cycles, these companies are likely to expand in a predictable, sustainable way.

They are also more likely to be market leaders able to pass on inflationary costs in the form of higher prices, as well as having strong margins and robust balance sheets. Furthermore, portfolios constructed in this way are more likely to be diversified across products, markets and geographies.

We also believe that in a changing world, smaller, nimble, well managed companies that can pivot their businesses more quickly than mega caps are well placed to take advantage of evolving opportunities.

Final thoughts

Many high quality small and mid-cap companies with the potential to expand and grow are currently available at attractive valuations. In today's uncertain world, we believe a robust, repeatable investment process focusing on quality, growth and momentum can help investors select the large cap leaders of the future with favourable risk-return profiles.