VIEWPOINT

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Is it still worthwhile investing in the European Small and Mid Caps?

The European Small and Mid Caps outperformed over the last decade. Between 2001 and 2010, the Stoxx Small 200 index rallied +36% at the same time the Stoxx Large 200 fell -31%.

Will the next decade be as favourable for the European Small and Mid Caps? Will they continue to outperform?

For Joëlle Morlet-Selmer and Diane Bruno, Small & Mid Cap portfolio managers at Mandarine Gestion, the answer is yes. The decade is starting off in a context of increased volatility, the consequence, among other factors, of commodity prices, exchange rates and regulations. Given their greater flexibility, the Small and Mid Caps have demonstrated substantial capacity to adapt to these conditions. Technological upheavals will continue to favour the emergence of new business models. For example, the Internet has fundamentally changed the retailing sector.

The new rules of the game in the emerging markets are also a factor in favour of the Small and Mid Caps. *"The automobile sector in China is a striking example of this. While the major automobile manufacturers must accept the Chinese government's stringent conditions (obligation to create joint ventures, local brands etc.), the automobile parts suppliers (often small/mid caps) are much freer, as the sector is not yet considered to be strategic"* indicates Diane Bruno.

Finally, the composition of the indices remains more favourable for the Small and Mid Caps. Sectors that are structurally suffering from increasing regulation (telecoms, pharmaceuticals, utilities, bank-insurance) make up over 40% of the Stoxx Large 200 index.

In Mandarine Gestion's view, the Small and Mid Caps therefore represent an essential diversification asset.

"In effect, the risks are more limited than one could think. The volatility of the Small and Mid Caps, so often decried, is in fact similar to that of the Large Cap indices. The liquidity issue, so often raised, is manageable if it remains at the centre of the management process" says Joëlle Morlet-Selmer.

The Small and Mid Caps additionally have strong structural advantages. They are exposed to highly varied and de-correlated economic models: in niche sectors, they are the leaders that offer drivers of growth that are found rarely or not at all among the Large Caps. Finally, the Small and Mid Caps are companies with solid balance sheets that are able to seize strategic opportunities (acquisitions or new markets). Certain of today's Small Caps will therefore become tomorrow's Mid Caps and the Large Caps of the future.

A structural position in Small and Mid Caps in an equity allocation therefore offers multiple advantages. Their business segments and development models provide substantial economic diversification compared to the Large Caps and make it possible to create exposure to world economic growth with less political risk.
The commonly accepted notions regarding their high level of volatility, their small size, their lack of financial stability etc. must therefore be definitively rejected! Finally, their valuation premium compared to the Large Caps (25% on average), a reflection of their higher earnings growth, has in no way prevented them from outperforming over the last decade.