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WHY INVESTING IN SMALLER COMPANIES IS NOT ONLY RESPONSIBLE CAPITALISM BUT BETTER FOR INVESTORS TOO

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Reconnecting the natural instincts of savers with the allocation of their capital appears to address the problems of the credit boom. Mary Ziegler's enthusiasm and skill has helped to bring these ideas together.

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Looking back at history, a neat thread of actions and consequences can be seen as a straightforward narrative. But for those living though the period, the line of action and consequence is not so clear. The relative importance of the different elements can be obscured by social 'noise', so the main trends are often overlooked at the time. Even if they are not, then there are always several potential outcomes, so the future generally remains clouded. In general, key actions and outcomes are not recognised until well after the event.

However, occasionally – just occasionally – a trend becomes so over-extended, and the ending of the trend so clear, that it is possible to identify a major turning point contemporaneously. For me, 2011 was one of those moments.

Changing orientation in the credit boom

Over the last 25 years, debt has been used in increasingly large amounts. Debt has special qualities. It draws upon our collective savings ahead of them having been accrued. So the use of debt boosts demand ahead of another period in the future when we must consume less and repay the borrowings. It is all about timing, bringing forward economic growth from the future.

Prior to 1985, debt had expanded at a rate broadly in line with GDP for a period of almost 50 years. So while economic growth may have been boosted a little by debt, it was increasing no faster than our ability as a nation to repay. However, from 1986 the trend changed.

Deregulation, combined with innovation in the credit markets and the emergence of more marketable debt securities, contributed to a much greater availability of debt. Credit booms are normally associated with faster wage rises and inflation, and therefore are normally choked off fairly quickly by interest rate increases. However in this case, low-cost imports offset inflationary price rises in service and wage costs. Although there were some interest rate rises in the UK while we sought to shadow the European exchange rate mechanism (ERM), other countries found little need to do so. Following its withdrawal from the ERM in 1992, the UK gradually reduced interest rates, given that inflation continued to moderate as the volume of cheap imported goods grew.

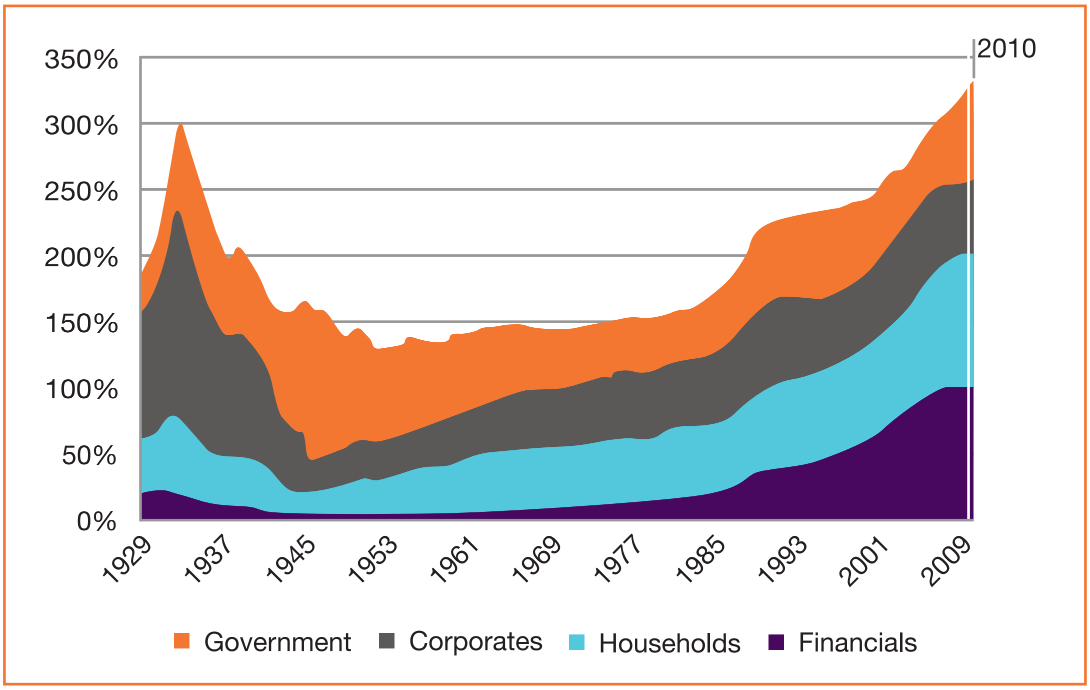
Higher wages and greater credit availability tend to drive up asset prices, and the late 1980s were no exception. House prices moved sharply higher for a newly wealthy 'Loadsamoney' generation. The rise in asset prices caused investor preferences to change. Those who bought houses in the UK in the early part of the boom were able to book very sizable capital gains within a few years, and these gains were even more substantial for those who geared up with debt. Speculative behaviour was rewarded disproportionately, and those who were most imprudent were rewarded the most.

Long-term investment strategies can look pedestrian, when compared with the sizable capital gains that can be made on short-term speculation as asset prices rise. Research by cognitive psychologists suggests that most people are predisposed to accept gains now, rather than to sit still and wait for what could be larger benefits in the future (Kahneman 2011). This is problematic, because evaluating capital appreciation in isolation, ignoring the compounding effect of reinvesting income, underestimates the real return by some margin. As a result, well-established investment strategies, like patient capital[1], have fallen by the wayside during the credit boom, replaced by impatient investors looking for fast gains.

1 'Patient capital' denotes capital invested with no expectation of a rapid return in the short term; greater benefits are expected to accrue over a long timescale.

In the financial world, greater trading volumes and more widespread use of information technology led to an increase in financial sophistication. In particular, a more quantitative and mechanistic approach to financial risk encouraged the view that risks could be specifically identified, accurately modelled and efficiently managed (see Berry 2010, Fama and French 2004). While the shortcomings of this approach are now clear, they were not immediately evident; this allowed the credit bubble to be sustained for an exceptionally long period and be played out worldwide.

Figure 1
The scale of the credit boom: US credit market debt, 1929–2010 (% nominal US GDP)



Source: Morgan Stanley Research/Bloomberg/IMF

The scale and duration of the credit boom has distorted expectations, and altered what is perceived as 'normal'. It led to the strongest phase of economic development that the world has ever seen.[2] A generous flow of credit allowed businesses to expand more quickly, take over rivals and book large profits along the way. Our financial institutions funded these changes with larger loans to consumers and businesses. Overall, this allowed the accumulated debt to become 'supersized'. More alarmingly, the duration and scale of the credit boom has led speculative investment preferences to become embedded, and portfolio allocation by our savings institutions to be optimised for a credit boom world. The cyclical effect has persisted for so long that slow-moving institutions like pension funds have mistaken it for a secular trend.

The credit boom: implications for institutional asset allocation

In this way, the credit boom has led to major changes in the allocation of assets by pension funds and equity savers. Assets in home markets have been sold to increase participation in the rapid rises of emerging economy stock markets. In addition, new asset classes have also attracted sizable allocations for the first time, and it is these that comprise those which have benefited most from the credit trends. Private equity returns

2 Professor Charles Goodhart, cited House of Commons Treasury Committee 2009: 32, para 65

have been heavily enhanced by the use of much higher-than-usual debt levels, while hedge funds are most successful when there are high levels of trading volumes, as this allows them to speculate frequently in size at tight spreads.

So while around two-thirds of all UK pension assets were invested domestically 25 years ago, that figure had dropped to less than 40 per cent by 2009.[3] Today, well-known high street names like Marks & Spencer and the John Lewis Partnership have around only 8 per cent of pension assets invested in UK equities (NAPF 2011). For John Lewis, this is less than the scale of its hedge fund investments.

Asset allocation in the coming period

Now that the credit boom is coming to an end, premium economic growth rates can also be expected to come to an end. The key question is how this will affect asset allocation by UK pension funds, which control around £1 trillion[4] of investment. Is the asset allocation of institutional investors optimised to reflect the trends established during the credit boom?

With the arrival of austerity in the developed nations, there is some hope that the economic growth of emerging economies will decouple from the adverse trends elsewhere. During the credit boom, pension funds allocated capital to emerging markets because it was believed that their faster GDP growth rates would translate into swift capital gains. Even at a time when growth rates in the developed market are slowing, this argument still appears compelling. So despite disappointing returns from some emerging markets in the last year or two, as well as in other markets, many still feel that they hold the key to economic expansion in the coming years. Arguments to increasing allocations to the emerging markets could be supplemented by the advantages of diversifying portfolio risk further, given that institutional funds are already well represented in UK, US, continental European and Japanese equities.

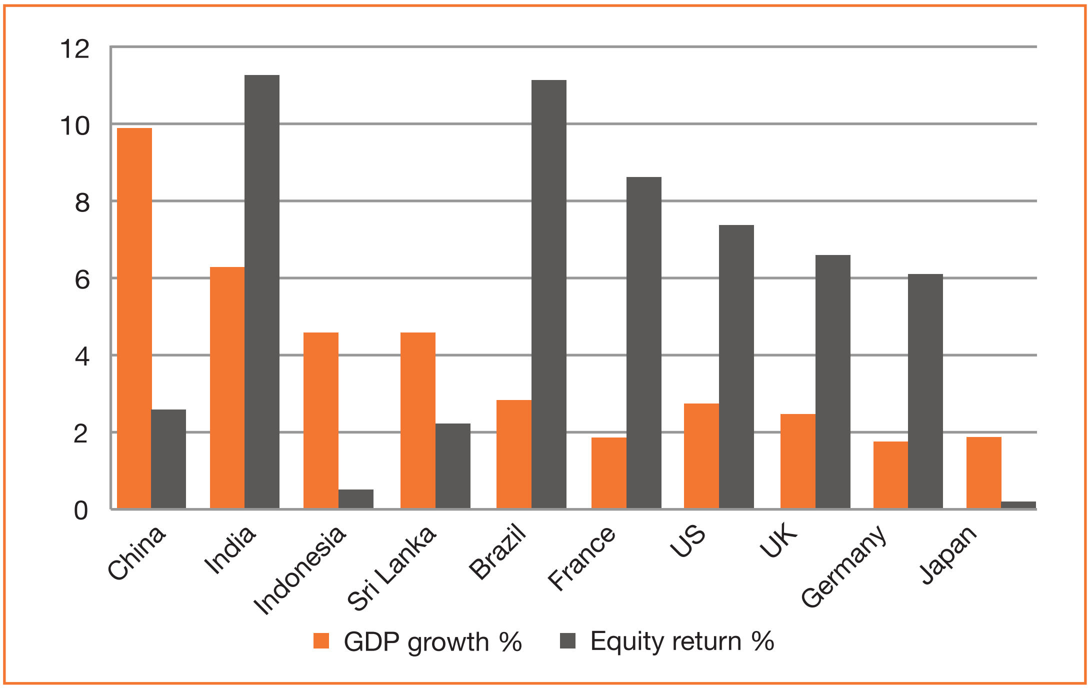
However, these arguments are not supported by the facts. Although several emerging markets have indeed generated eye-catching capital gains at times, overall returns are frequently disappointing over the longer term (Dimson et al 2010). Researchers from London Business School (LBS) have highlighted, quite clearly, the *lack* of a simple link between GDP growth and overall equity market returns.

The reasons are subject to debate, but principally thought to relate to the well-established trend whereby investors tend to overpay for growth stocks (Arnott et al 2009). It seems that asset allocators have a similar blind spot regarding overpaying for growth countries. So while some of the emerging markets did indeed record very good capital growth in the late stages of the credit boom, many of the more developed markets performed better over the longer term when dividend income is also included.

3 WM All Funds Universe, State Street Investment Analytics Asset Allocation 1985–2009, provided to author

4 Joanne Segars, chief executive of NAPF, cited Reuters, 28 November 2011: http://uk.reuters.com/article/2011/11/28/uk-infrastructure-funds-idUKLNE7AR01G20111128

Figure 2
Annualised real GDP growth and equity returns, 1985–2009



Source: Dimson et al 2010

LBS data demonstrates that a persistent strategy for generating premium return is by investing in those stocks with a premium yield (Dimson et al 2011: 18). The power of compounding, where the investor reinvests the dividend payouts back into the stock market each period, is consistently successful. Through this process, the investor not only gains the benefit of an escalating stream of dividends over time, but also enjoys this benefit on an increasing number of shares as the dividend increases, given the reinvestment each year.

Perversely, as well as offering premium returns a strategy based upon dividend compounding also appears to carry lower risks (ibid: 20). Shares with higher yields naturally tend to fall less sharply in falling markets, given the attraction of their yields, and hence tend to have lower volatility than other stocks. The combination of lower risk and better return is puzzling to academics, since this seems to be contrary to the widely accepted wisdom that risk is proportionate to return in equity markets. Even so, the effect has been very widely recorded.

Premium dividend strategies are not only successful in terms of individual stock selection. It seems they are also successful in terms of national stock markets too: markets with higher dividend yields tend to outperform those with lower yields (ibid: 21). This may partly explain why, even during the credit boom, many stock markets in the developed world have continued to deliver better returns than high-growth emerging markets.

Other sectors that saw rapid increases in pension fund allocation over the credit boom are also delivering less than expected. Hedge funds and private equity tend to charge much higher fees than other strategies, so even if they match the returns on other asset classes, their clients will be disadvantaged. However, with the end of the boom, trading volumes have already started to reduce. Speculative strategies that were so favoured over the last two decades are recording poor returns, with hedge funds in particular suffering. Equally, in an era of slow economic growth, and at a time when companies with the greatest levels of debt are most vulnerable, we can anticipate some credit rationing. Banks will become more selective over those they lend to, and indeed over the scale of that lending. Companies funded by private equity are particularly vulnerable in this regard. Many can be expected to go into liquidation; even those that manage to issue more equity capital to bring debt down to more conventional levels will dilute returns in the process. Overall, both hedge funds and private equity strategies appear at risk of disappointing with the ending of the credit boom.

Why smaller domestic businesses may continue to lose out

It seems that most investors have indeed over-optimised their allocation of their assets, and are poorly positioned for the coming period. With the end of the credit boom, there are good reasons for institutions and pension funds to reallocate capital back to developed markets. The key question for Britain as a nation is where the capital released from unfavoured asset categories should be allocated in the future. This is far from a trivial matter, since the UK economy is likely to see little demand growth in the coming years. Importantly, most agree that one way out of our current crisis is to see our domestic economy becoming more productive; this can be accelerated if our collective savings are allocated to those businesses best placed to achieve this.

During the credit boom, domestic institutions reduced their holdings of UK quoted businesses to fund increased holdings of overseas quoted companies, private equity and hedge funds. The true scale and impact of this have not been fully recognised. It has led to a sharp reduction in domestic support for both large and small quoted companies. This factor has not affected the ability of the largest companies to raise additional capital, since these are widely traded among international investors. However, in the case of the smaller quoted companies, the position has been radically changed. Smaller quoted companies are typically only of interest to domestic investors, so with many institutions withdrawing together, it has been unusually difficult to raise additional capital.

Data from the Investment Management Association (IMA) underlines this point. The IMA publishes data regarding the net purchases and sales of OEICs[5] each year. During the period of the credit boom, almost all OEIC strategies have seen a large increase in invested capital. In contrast, the UK smaller company category has failed to participate in the growth in invested capital and, quite uniquely, has suffered net withdrawals for every year of the last 10![6]

Other factors have exacerbated this trend. With the rapid appreciation of stock market indices during the credit boom, fund managers face criticism and commercial damage if they fail to keep up. As a result, they have tended to narrow their focus to stocks within their specific benchmarks, hoping to outperform by beating their competitors to those index stocks on the rise. This trend has also worked against investment in smaller quoted companies. After all, few smaller stocks are represented in the major indices, and even those that are tend to have very small weightings.

Finally, the inclination to invest in smaller companies has been reduced further by the way the rules for inclusion in the indices have been 'gamed' by brokers and large companies.

5 Open ended investment companies

6 Annual figures provided by the IMA; monthly figures available at http://www.investmentuk.org/fund-statistics/full-figures

In the mid-1980s, the FTSE100 was dominated by UK businesses that had grown to become the largest domestic businesses. However, over the period of the credit boom, other international companies have sought a primary listing in London specifically in order to be included in the FTSE100. Good examples are Kazakhmys, Essar Energy, Fresnillo, Vedanta Resources, Glencore, Eurasian Natural Resources and Xstrata. Together they are valued at around £100 billion.[7] More names like this are expected to move up from the FTSE250 shortly; CRH is also moving its primary listing to London to stay on the institutional radar.

Given the close interest that institutions have in the constituents of the major indices, stocks appearing in the FTSE100 are purchased with the capital raised from other stocks at the smaller end of the spectrum. The overall effect is that capital is typically withdrawn from smaller UK stocks to be reallocated to larger international companies that happen to have their primary listing in London.

Smaller businesses have a much better chance of doubling in size through organic growth, when compared to very large businesses that are naturally constrained by global limits. On the stock market, it has been observed that smaller businesses outperform larger ones. The effect is widely recorded, and is inversely proportionate to size (Dimson et al 2011: 41). The very small company typically outperforms the small company, which often outperforms the medium-sized business, and so on. But during the credit boom, withdrawal of capital from the smaller quoted businesses in London has been so severe that these natural trends have been overwhelmed. The FT Smallcap Index has underperformed those of the most-liquid companies on a progressive basis since 1988.

The effect has been to reinforce the inclination for institutional investors to avoid smaller quoted companies. From their point of view, larger businesses have the advantage of being the most liquid, and therefore easy to monitor and trade within a portfolio. They are also the best represented in the indices, and therefore will deliver returns that shadow those of the industry benchmark. Finally, they have delivered long-term outperformance, so the fiddly task of investing in the smallest companies can be avoided entirely. Most now consider smaller companies to be effectively unsuitable for institutional portfolios. Since they lack scale and are numerous, they require extra resource to monitor, compared with a smaller number of large stock holdings.

Lack of liquidity also means that speculative strategies seeking quick capital gains are incompatible with investing in smaller quoted companies. During the credit boom investment professionals have grown accustomed to the convenience of plentiful liquidity and holding a short list of major businesses with the ability to change the weightings of holdings in a portfolio at will. This 'flexibility' gives the illusion that fallout from unexpected events can be accurately managed through subsequent portfolio adjustments.

Finally, it is self-evident that smaller companies don't really participate in the globalisation trend.

Institutional prejudice against smaller companies has become endemic. Institutions are exceptionally wary of illiquid investments, and this concern is heightened further by a particularly challenging economic outlook with increased stock market volatility at present. So, all things being equal, it seems that institutions and pension funds will persist with a

7 James Bishop, Investec Securities, correspondence with author, 5 December 2011

strategy of prioritising strategies that offer good liquidity, even after the credit boom comes to an end.

The impact on prospects for domestic growth

The effects of this investment prejudice extend well beyond adverse impact on future investment performance.

Job creation and long-term domestic growth are heavily dependent upon smaller businesses. Small and medium-sized enterprises (SMEs) create at least 70 per cent of employment opportunities,[8] perhaps more.

Smaller businesses tend to have a high percentage of their turnover and stronger connections in the domestic economy than larger companies. Therefore an increased capital allocation to smaller businesses tends to have a much more direct effect on the UK economy that an equivalent sum allocated to the mid and large capital sector.

So there are excellent reasons for the wider public, and the government, to break the downward trend of institutional allocation to smaller quoted businesses. Currently, smaller companies are constricted in their ability to invest and this is holding back the ability of the UK economy to rebalance after the excesses of the credit boom. The problem is that even if pension funds and institutions do reallocate capital back to developed markets, including the UK, they are likely to persist with strategies that offer good liquidity. So much of the capital reallocated back to the UK will boost the holdings of larger quoted companies, which have little direct effect on the wider domestic economy.

There are good arguments suggesting that a strategy focusing purely on the most liquid companies may disappoint. Large companies are unlikely to expand much in the absence of world economic growth. An increased allocation to these companies is understandable during a period when world growth has been rapid, but if growth is indeed moving towards sub-normal levels, then a strategy focused on larger stocks might be expected to underperform. The key problem is that institutional mindsets are unlikely to change in the absence of government action. This is a priority, since the continued reluctance of pension funds and other institution investors to support the small companies 'universe' has a very profound impact on the ability of the UK economy to respond to our current period of austerity.

Fiscal options

The current balance of fiscal incentives favours the speculator over the long-term investor. Speculative trading using spread betting, for example, is entirely tax-free, even for the individual. Derivative trading has a broadly similar tax treatment, although individual investors may be subject to capital gains tax.

Some air has been given to a new tax on financial transactions, to address excessive speculation. The concept, first set out by the economist James Tobin in the early 1970s to constrict excessive currency speculation, has been suggested in an extended form in the eurozone to cover interbank trades in stocks and bonds. The proposal is to set the tax at a rate of 0.1 per cent of the transaction value, with 0.01 per cent for macro products like derivatives. This proposal has caused some alarm in the financial sector, given the risk that the trade in these products simply decamps to other territories outside of the EU.

8 Institute of International Finance (IIF) cited in ACCA 2011

Compare these proposals to the fiscal regime for those already investing in UK equities. The exchequer routinely taxes 0.5 per cent on each purchase, a level that is five or even fifty times higher than that suggested for the 'Tobin tax'. In addition, individual investors who support domestic businesses with their own capital are liable for capital gains tax beyond a modest annual limit. On top of this, they are also liable to pay income tax on dividend income, even if they reinvest their dividends back into the company to compound the investment over time.

The current fiscal regime encourages speculation, which favours larger liquid companies over smaller, less frequently traded businesses. The fiscal regime also imposes the greatest taxes on patient investors in our domestic businesses. There is a golden opportunity for government to change the adverse investment trends afflicting our smaller company sector.

If stamp duty was removed from all quoted company transactions outside the largest 350 listed companies, then the loss of stamp duty to the exchequer would be around 5 per cent. The current tax take on stamp duty from quoted share transactions runs at £3 billion per annum, so the cost of this proposal is around £150 million per annum.

A second policy change would be to make dividends from stocks outside the largest 350 listed companies free of income tax if reinvested. This would encourage shareholders of smaller companies to reinvest dividends and participate in the long-term success of many of these businesses. This policy would have negligible effect on ultimate income tax revenue. But together, these policies would begin to address the problems of market failure for the smaller quoted stock universe.

However, to reverse the previous trend most effectively, these tax benefits would need to be offered to investment funds that invest *solely* in the smaller company universe, namely those small enough to fall outside the FT350 index.[9] While these measures might appear modest, they would give asset management companies a platform from which to actively promote this area of the market. Most income investment trusts stand at a premium to assets, given that these funds tend to exhibit less volatility and are best placed to benefit from the premium returns offered on compounding of dividends. If fund management companies were able to offer similar funds with the benefit of no income tax on reinvested dividends, and without a stamp duty charge at purchase, then these should attract capital amounting to many multiples of the capital raised by venture capital trusts. And such funds could be promoted to institutional clients and pension funds, enabling this group to consider reallocating capital to this strategy as soon as they recognise the previous trend has ceased. After all, once capital is allocated to smaller businesses again, the previous trend of outperformance of the bottom end of the market is likely to be re-established.

Conclusions

Smaller companies have scope to deliver, enhanced by their very smallness. Their flexibility is more valuable in challenging times and, somewhat ironically, they are particularly well placed, given that they have not had banking support to over-borrow during the credit boom. Over long timescales, small UK companies have gained investor support by offering diversification and performance benefits during normal market conditions.[10] But this pattern has been broken by the credit boom. In this period, speculative behaviour

9 Representing the largest 350 London-listed stocks by market capitalisation

10 Over the period 1955–2010, £1 invested in 'small value' returned £20,885; £1 invested in 'big growth' returned £245 (Dimson et al 2011: 49). See also the annual report of the RBS Hoare Govett Smaller Companies Index 2011.

has been rewarded disproportionately; those who have borrowed the most have been exceptionally rewarded. Patient commitment to illiquid companies over the long-term has been replaced by impatient investment in search of fast capital gains.

The credit boom has been so large, and has persisted for such a long time, that it has led institutions and pension funds to progressively allocate sizable balances to those strategies that have been optimised for credit booms. Allocations to overseas equity markets have increased, as they have to novel asset classes like private equity and hedge funds. But as the credit boom comes to an end, these strategies face new challenges. They are poorly positioned for lower trading volumes and the risks of carrying high debt at a time of economic uncertainty. And data reveals that many developed markets have actually performed better than the emerging markets over the last 25 years when the compounding of dividend income is also included.

Capital for these boom-led allocations has been funded by a reduction in UK assets, particularly UK smaller companies. The negative trend for UK smaller companies is so well established that investment professionals have grown accustomed to the convenience of plentiful liquidity, holding concentrated portfolios of major businesses with the ability to change the weightings at will. Institutional behaviour is so deeply rooted that the trend is unlikely to change in the absence of government action. This is a priority, since investors' continued reluctance to support the small companies universe has a profound impact on its prospects and its ability to respond to austerity.

Removing stamp duty on quoted stock transactions and the income tax liability on dividends solely on those stocks outside the largest 350 listed companies is estimated to cost less than £300 million per annum.[11] But such a change would begin to address the impact of market failure to fund these types of companies. Extending the same benefits to funds that invested solely in this universe would reignite fund management interest in this area and, in time, ultimately bring in more serious capital allocations from institutions and pension funds. Ensuring our smallest quoted companies gain fair access to capital will boost domestic economic growth and job creation at time when both are sorely needed.

11 Calculated with guidance from the London Stock Exchange, with reference to London Stock Exchange trading statistics and data on stamp duty receipts from the Office of National Statistics. See http://www.londonstockexchange.com/statistics/trading/trading-summary/trading-summary.htm, http://www.hmrc.gov.uk/stats/stamp_duty/table15-1.pdf

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