Generating alpha with Eurozone Small & Mid-caps

The case for Eurozone Small & Mid-caps

When considering small & mid-cap companies and stocks, investors often favour them at the start of a period of expansion in the economic cycle. 2003 saw for instance a sharp rebound of stock-market gains for small & mid-cap companies in Europe, outpacing that of the Euro Stoxx 50 blue chip index.

This is rather unfortunate as mid-caps are actually less dependent from macro-economic information and market cycles than large caps - they often have specific drivers of growth for instance - and present interesting characteristics for investors.

For instance, the Eurozone mid-cap universe posted, over time and certainly since 2003, far better performances than the large caps universe (Euro Stoxx 50 index, see graph below) and even fared better than the small caps universe.

Furthermore, listed small & mid-cap companies are often considered as outperforming large market capitalisation companies due to the fact that they display better earnings growth figures.

Though a higher growth rate can partially be explained by the fact that these are smaller companies with smaller numbers, evidence seems to support this fact: the cumulative earnings per share (EPS) growth of small and mid-caps stocks in the Eurozone over the past 13 years has clearly outperformed that of the large capitalisation reference index (see graph below).

Cumulative EPS growth – (February 2002 – February 2017)

Performance of Eurozone small, mid and large caps (December 2003 – February 2017)

Source: FactSet as of 28.02.2017
With the above features, mid-cap stocks are certainly good diversifiers within an overall asset allocation or a standalone equity portfolio, alongside larger market capitalisation companies - especially as their volatility levels are lower than that of large caps, as the below graph shows.

Volatility Large Cap Vs Mid Cap (January 2007 – December 2016)

This is further illustrated when considering the historical dispersion of performance between small/midcaps and large caps: having the expertise to assess and select the most promising companies is paramount, and so is the ability to discard the companies delivering poor performances.

In order to achieve this, our equity portfolio managers typically focus on companies with a solid track-record, with a business model which is both predictable and clearly identified. The team therefore meets more than 300 companies per year, mostly through one-to-one meetings and during Capital Market days.

Furthermore, while large caps tend to be global when considering their sources of revenues, mid-caps tend to be, on average, more domestic: a deeper knowledge of how companies operate and in which conditions they operate also makes the difference over time.

The portfolio managers in charge of the Generali Investments SICAV (GIS) Euro Equity Mid Cap sub-fund (AUM of EUR 465 m)\(^1\) have a clear focus on the companies’ growth perspectives and whether that growth is relatively decorrelated from economic cycles. At the same time, they focus on those companies that, they believe, are really able to generate cash over time.

The team uses its valuation model and inputs (Discounted Cash Flows) to determine a target price for every single stock, selecting the ones with a significant potential increase in their value in the next 3 years.

This investment process has been tried, tested and has proved successful for 10 years now: wherever it is as a standalone equity investment or within a diversified portfolio, recent history shows that it always makes sense to invest in Small & Mid-Cap companies.

\(^1\)Source: Generali Investments Europe S.p.A. Società di gestione del risparmio, data as of 28.02.2017

Understanding companies’ businesses, with valuation being key

At Generali Investments, our small & mid cap portfolio managers conduct thorough strategic analyses of companies in the universe, day in and day out, and for many years now.

Understanding companies’ business models, their management and strategies is indeed key, to avoid pitfalls and generate alpha through careful and focused stock picking.

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