Elston

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Elston Insights

For small caps, active management can pay

- Data shows small-cap funds more likely to outperform benchmark
- Dispersion helps to deliver distinctive results
- Small-caps attractive after outsized de-rating

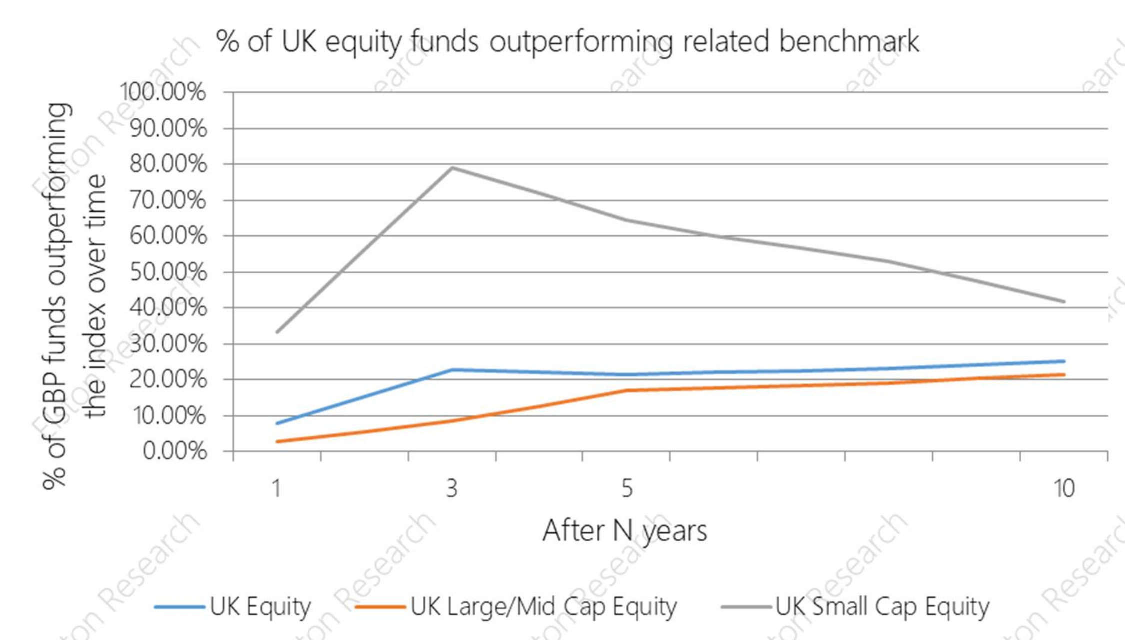
Where does active management make the most difference?

In today's era of technological advancement, where artificial intelligence allows for near-instant execution in automatic reaction to market events, and funds can trade autonomously in line with a particular index, the heydays of active management might seem well and truly over. But while the competition active managers face is certainly stiffer, and the depth and efficiency of markets means price mismatches are rarer, data suggests that there are still pockets of opportunity where active managers have a chance to outperform.

The recently-published annual SPIVA (S&P Indices Versus Active) study for the most part makes gloomy reading for active managers but one trend that emerges is the opportunity in the UK Small Cap sector. Whether equal-weight or asset-weighted, for sterling-denominated small-cap UK equity funds, annualised performance over the past 3, 5 and 10 years has consistently outpaced the benchmark.[1]

[1] S&P, 2023

Fig. 1 Percentage of UK equity funds by segment outperforming related benchmark



Source: Elston research, S&P Dow Jones Indices SPIVA Europe scorecard data for the year ending 31.12.22

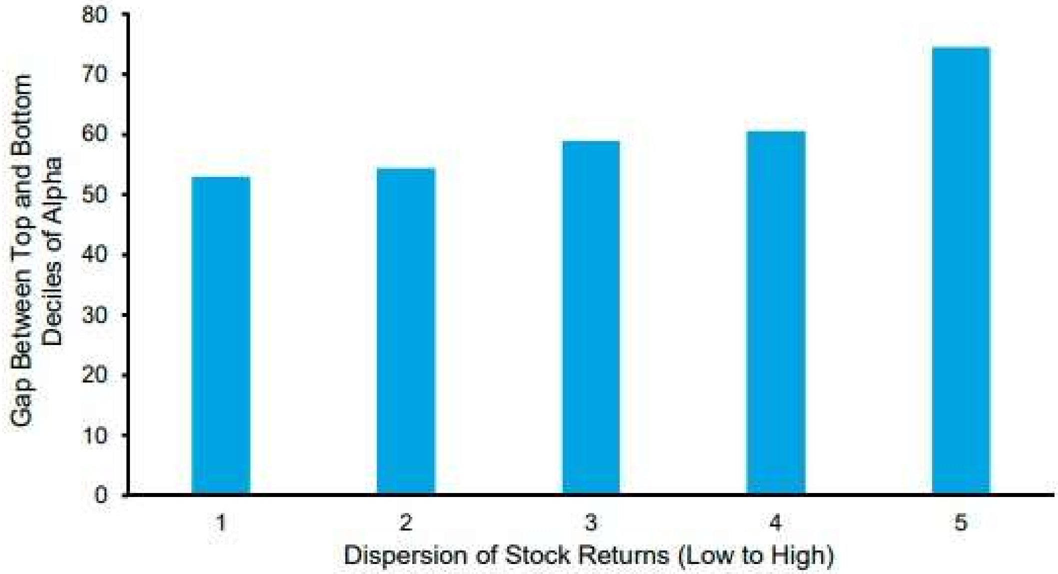
The chart above illustrates the performance gap between large- and mid-cap equity funds and small-cap equity funds. It is within the latter segment that there is greatest potential for alpha, with approximately 80% of active managers beating their benchmark over 3 years.

Dispersion and why it matters

Dispersion measures the range of returns for a group of shares. If gains and losses in the underlying shares of a benchmark are very similar to the gains and losses of the benchmark overall, then it proves hard to generate excess return. If dispersion is high, however, then there is opportunity for a shrewd stock-picker to pick winners, avoid losers and create a portfolio that outperforms.

The chart below shows that the gap in excess returns between the best and worst funds grows with higher dispersion.

Fig 2 Performance increases with dispersion



Source: Journal of Investing, 2010

Between the large-, mid- and small-cap segments of the UK equity market, it is in small-caps that there is greatest dispersion and it is this relative inefficiency in the market that gives active investors the opportunity to add value.

The 2022 de-rating

There was little escape from the near-ubiquitous de-rating of global assets in 2022. In equities, both the small- and mid-cap segments of the market fared poorly with the FTSE Small Cap index down by 13.5% compared to the gain for the FTSE 100 of 4.7%. While this may represent a good buying opportunity, there are certain factors to bear in mind. Small cap holdings by their nature tend to have a growth bias and with high and rising interest rates and the possibility of a recession, the investment environment is likely to remain inhospitable to growth for the medium term. Additionally, volatility is prevalent and is something that investors need to be able to stomach if looking to hold funds for the medium- or long-term. Given the waxing of Value and waning of Growth, it could also make sense to look at small-cap funds with an income focus.

Summary

Active management has not been entirely disenfranchised by automated trading strategies. There are still areas of the market – like the small cap sector – where dispersion is high enough for stock-pickers to find opportunities to beat the benchmark. For investors, it's just a matter of knowing where to focus and finding the manager that can outperform.

Marina Gardiner

Research editor

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