Markets

Can small caps prosper in a world of deflation and disruption?

The recent underperformance of small caps in a number of markets has prompted some to suggest that they may have lost their particular investment advantages. We disagree.

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As we enter a period of unprecedented disruption and deflationary growth, we argue that small caps can bring a number of unique characteristics to a wider portfolio.

Can nimble small caps avoid cannibalisation?

Traditional companies face handicaps when it comes to developing or adopting a disruptive innovation, such as the fear of cannibalising existing revenues.

These are less evident at smaller and newer companies, which are not tied to an established product and have more incentive to direct resources to the next disruptive innovation.

With innovation and technological advances moving at an unprecedented pace, companies that are nimble and less burdened by layers of management may be better equipped to keep up with these changes.

Being small brings its advantages

In this environment, having a strong brand, a large installed base and a wide distribution network are not necessarily assets anymore.

Instead we are seeing a new generation of winners that are "capital light" and have a strong online presence.

As industries evolve in this direction, barriers to entry are reduced and innovations progress faster, creating increasing opportunities for small companies.

Beyond these general characteristics, there a number of specific areas where smaller companies enjoy advantages not necessarily shared by their larger rivals.

Unfilled niches

Success can come by moving into a gap in the market that others may be too large to occupy profitably. Normally, it is larger companies with commanding market shares that enjoy the advantage here. However, smaller producers can often dominate a niche, giving themselves the ability to set prices and thereby providing some protection against deflation.

Better balance sheets

Surprisingly, quoted small caps may boast sounder finances than large listed stocks. Certainly, they are less likely to undertake share buybacks, which tend to increase financial gearing.

Investment impact

Smaller companies may offer investors a better way to tap into changing consumer trends. While these changes can benefit large companies as well, they are likely to have a greater impact on smaller companies which specialise in producing a few products.

Lower profile

The good name of a well-known company is easily tarnished by bad publicity, as Google, Starbucks and Volkswagen can testify from recent events. By contrast, smaller companies often operate under less media and market scrutiny than their larger rivals.

Given the outlook for low economic growth and increasing technological disruption, we believe smaller companies are well placed to gain market share, dominate niches and grow faster than the market.

However, investors should not rely on the assumption that this small cap premium will operate universally. Investors need to be able to sort the wheat from the chaff, so having a knowledgeable manager looking after a small cap portfolio will be all-important to success.

Read the full report

The case for small caps in a world of deflation and disruption 5 | 642 kb