



Finding opportunities amid the small caps

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After a strong first half of the year equities markets have been falling seemingly precipitously in the second half. The FTSE Small Cap (ex Investment Trusts) Index has fallen nearly 20% from the July peak, taking the index return to -15% for the year so far.

Inevitably in a period of decelerating global economic growth and falling stock markets, most share prices are lower now than they were at the start of the year, but certainly not all. Indeed, around 30% of the holdings in the Royal London UK Smaller Companies Fund have recorded positive absolute returns year to date.

So why have these stocks performed so much better than the wider market? The fund's focus is on investing in financially strong companies with structural growth drivers to their business models. This ensures a solid investment platform from which the management can drive the company forward. Even in a period of economic slowdown there are operators or technologies or industries that are less mature and can buck the wider slowdown.

If management can capitalise on their strong platforms one of three things will happen; they will carve out a strong growth path in a new field almost independent of the wider economic backdrop, they will benefit from the relative weakness of competitors and grow market share - the "survivor bias"- or their success will attract the attention not only of equity investors, but also of other operators in their industries and the companies will be taken over.

The fund's investment strategy has borne fruit in all three of these categories as holdings such as EMIS, Babcock, Genus and Dignity all continue to carve out their own growth paths; Fuller, Smith & Turner and Galliford Try have cemented superior relative positions to their peers and Axis-Shield, Holidaybreak and Prostrakan have all attracted attention from peers and been bid for at significant premia to the prevailing share prices. As a result of capitalising on strong platforms and sound finances, all of these stocks have generated double digit positive returns in 2011.

Source: rlam as at 7 October 2011 unless otherwise stated.

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