# MARKET INSIGHT

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Redmayne Bentley

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# Think Small


IN THIS ISSUE

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## IN THIS ISSUE




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### RISK WARNING



**Stock markets are used by many as a real-time bellwether of the health of an economy. We have become so used to the rolling tickers on news channels, giving us either a sense of comfort if the market is up, or dread if it is down. Though, in reality, we are only hearing about the largest 100 companies here in the UK and often are only told about 30 of the largest in the US. Yet, between these two markets, there are over 6,000 companies listed, so what about the rest?**

It's an underserved majority of the investment universe that many overlook when dipping their toe in buying stocks, yet it's often a source of great financial returns (**See: Small & Mid-Cap Stocks The Key to Long-Term Returns?**). Small and mid-cap companies are aptly named for their market capitalisation (aka market value) and are a little-known hunting ground for savvy stock pickers, looking for an edge over the normal return profile of blue-chip companies. They are less mature and often give an opportunity to get in early before they enter their growth phase.

Further benefits can be reaped from smaller company investing. AIM, the London Stock Exchange's market for small and medium cap companies, offers its investors business relief on qualifying shares, meaning investors can shield their wealth from inheritance tax (**see: Scoping AIM**). There's also plenty of exciting opportunities to invest in, which are certainly not unknown. Jet2, Fevertree and Boohoo all offer compelling investment cases that can save you tax too.

Although most stocks in this sphere are real life companies with operational assets, it is a good hunting ground for investment trusts (investment funds under the guise of a listed company). One asset class that often uses this structure is Private Equity, which was the theme of our Winter edition of *1875*. The nature of a company structure lends itself to packaging up a diverse private equity strategy (**see: The HG Capital Trust: Small & Mid-Cap Private Market Resilience**), while allowing the fund to run like a company and set up consultancy support to the businesses they invest in. In other words, running the fund much like a parent company, without meddling in the strategy of your businesses!

As with anything, these are not easy pickings; best left to an experienced manager with a diverse strategy. Small cap companies can be fruitful, but risky (**see: Artificial Intelligence in the Small and Mid-Cap Space**), requiring more careful due diligence before committing any capital. Mostly under the radar, these companies will often come with the baggage of more thorny nuances in their accounting, and it can be hard to find key information or research. What's more, they rely heavily on capital, and it may take some time before you see your investment grow. A bit of patience, diversification and careful stock selection should give ample rewards over the long term.

# AN INTRODUCTION TO SMALL AND LARGE-CAPS


The terms 'small cap' and 'large-cap' are well known in the investments sphere and, at first, their definitions and how they impact investors and their portfolios may seem clear cut. However, the difference between small and large-cap companies extends far beyond their actual market capitalisation.

To begin, a company's market capitalisation is calculated by multiplying the total number of shares by the share price. For example, a company with 10m shares valued at £10 each would have a market capitalisation of £100m. This figure represents how valuable the investing community views a company to be and can, of course, be impacted by factors including popularity, performance and hype. Loosely speaking, small cap stocks are companies said to have market capitalisations of less than £350m while mid-caps have capitalisations of less than £2.5bn. Although the share price (or number of shares available) tends to be lower than that of mid or large-cap companies, small caps have historically outperformed larger firms.

Large-caps, meanwhile, often operate in more mature, but still growing industries such as banking and big tech. Many large-cap companies which feature on the Cboe 100 Index are household names and include the likes of Astrazeneca, BT Group and Coca-Cola, while some of the largest in the world include Apple, Alphabet and Microsoft. One of the key differences between small and large-caps is their volatility. Generally speaking, large-caps often experience lower stock value fluctuation, in part due to their stronger financial resources. Their position means that they may recover from these fluctuations quicker than smaller companies, some of which may not have the resources to survive tougher market conditions. Larger companies may also be more likely to award dividends to their shareholders than smaller companies, which may not be in as strong a position.

Despite their potential to perform strongly, small cap stocks have an entirely different risk profile. As small caps may still be in their growth period or are simply smaller firms, they may operate with less financial resource than their larger counterparts. Similarly, they may also have fewer assets to borrow against and, as many tend to still be in their development stage, this means they can have greater volatility. As a result, small caps sometimes offer greater risk, but also the potential for higher returns.

What we in the UK and those in the US would describe as small or large-cap companies differs dramatically. On the UK Cboe 100, the largest market capitalisation is £173.97bn at the time of writing. Yet, on the S&P500 in the US, it's top company, Apple, has a market cap of US$2.38tn.
There is a perception that the difference between small and large-cap companies is clear, yet the gulf between the two, albeit extreme, examples of Apple and Shell demonstrates that although both are defined large-cap companies, some operate in a league of their own.

# STOCK FOCUS

## THE HG CAPITAL TRUST:
## SMALL & MID-CAP PRIVATE MARKET RESILIENCE

**The HG Capital Trust (HGT) is a FTSE 250 listed investment trust managed by private equity company HG Capital. The trust provides UK investors with diversified exposure to HG's private institutional funds that focus on private small and mid-cap businesses in which HG has taken a controlling stake.**

Our reasons for choosing to write about the HG Capital Trust are twofold. Firstly, in line with the focus of this issue, the investment vehicle provides exposure to a diversified portfolio of high-quality small & mid-cap businesses domiciled in the UK, Europe and the US. Secondly, we believe the approach HG takes to investing in private markets to be rather distinct, focusing specifically on technological businesses with support going beyond supplying financial capital, as HG utilises its controlling stake to provide consultant like support.

To begin on the second point, the focus of the strategy has not always been on technology or, more specifically, industrial software and services businesses. This change was decided upon around a decade ago when HG recognised the likely future dominance of these businesses, and the value HG could offer by specialising within a particular discipline. The belief in the future success of technology businesses was driven by Moore's Law which states we can expect the speed and capability of computers to increase every couple of years, while the general cost of computers simultaneously falls. Gordon E. Moore, the co-founder of Intel, made this observation in 1965 and through the rapid development witnessed over recent decades it cannot be disputed.

By focusing on businesses set to benefit from technological progression, HG has been able to build a portfolio of resilient compounding businesses. Over the past decade, the Trust has delivered a total return of c.350% with relatively low levels of volatility, highlighting both the upside potential and resilient nature of the portfolio.

While HG has demonstrated a strong ability to select businesses with significant upside potential, the true value added is provided via the development support it provides. By specialising in industrial software and service businesses HG has been able to build significant expertise and experiences from which investment partners can benefit. Managing Partner Matthew Brockman likens the HG infrastructure to an investor ecosystem where businesses can learn from one another through "copying each other's homework." This focus on identifying synergies and facilitating strategic partnerships is what HG believes makes it such an effective owner as it provides businesses with scale-up opportunities that would otherwise not be possible.

When evaluating investment opportunities, HG is not constrained by top-down asset allocation. Instead, the focus is purely on those investments that offer the most attractive potential for performance improvement. A core focus for HG has been on businesses that provide low spend business-critical software that has high levels of subscription/repeat revenues. In other words, businesses that deliver software that may be considered relatively mundane when compared to the emerging technologies of today, but once integrated within a business become mission-critical in delivering upon strategic goals. These businesses tend to be characterised by high levels of customer retention, low levels of customer concentration and the ability to scale up rapidly.

The mission-critical nature significantly reduces its sensitivity to economic cycles as, even during recessionary periods, the integrated nature of this software means they are costs a business cannot simply forgo. As we have witnessed over the course of this year, uncorrelated resilience is a vital tool for investors to protect against unexpected volatility. The resilient nature of the portfolio can be witnessed in the year-to-date performance figures where the portfolio delivered reduced downside risk relative to the MSCI World Index, highlighting that even during periods of uncertainty and high inflation, such software remains critical to business operations. ■

Please note that this communication is for information only and does not constitute a recommendation to buy or sell the shares of the investments mentioned.

Investments and income arising from them can fall as well as rise in value. Past performance and forecasts are not reliable indicators of future results and performance.

# INSIGHT

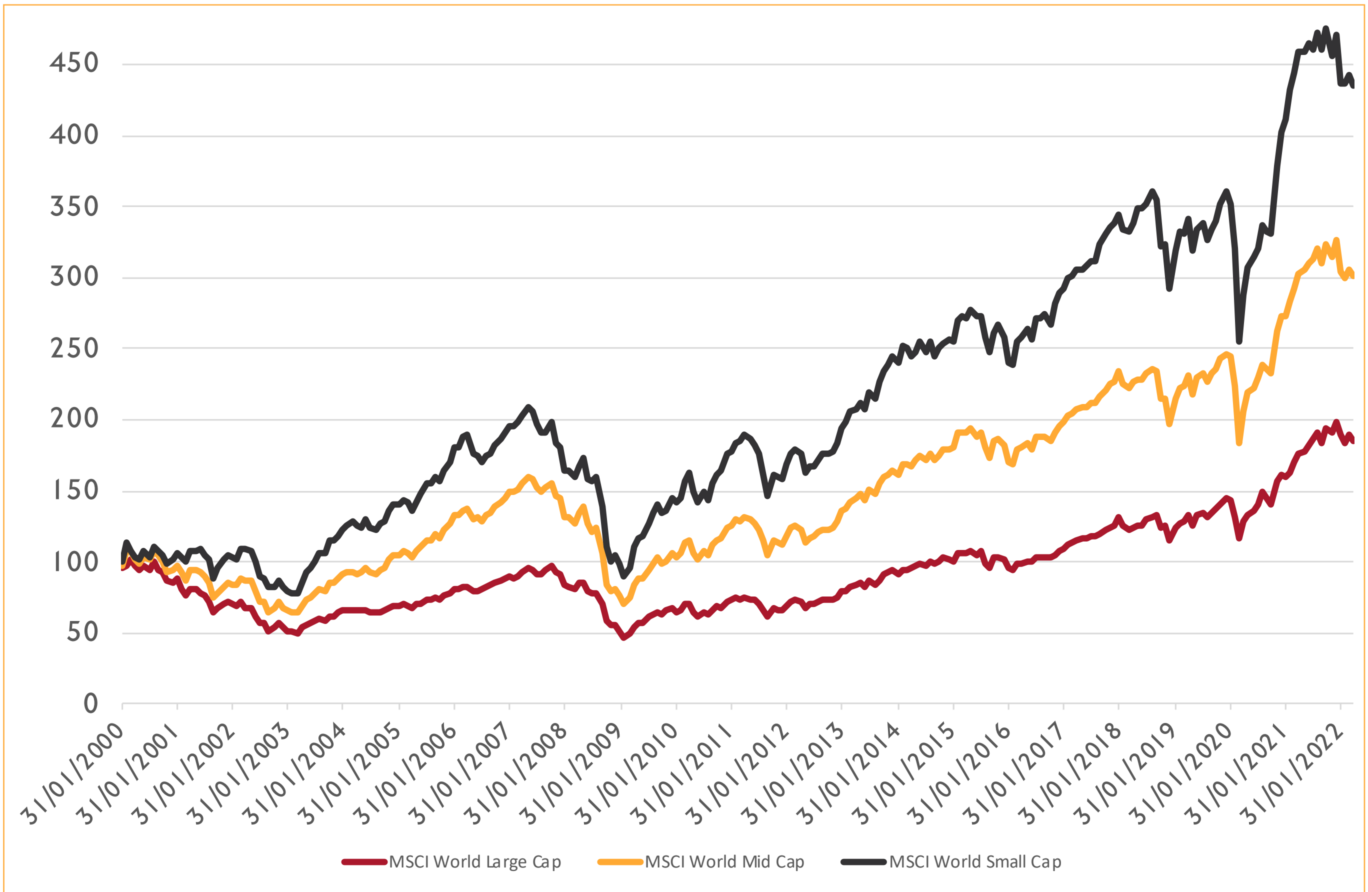
## SMALL & MID-CAP STOCKS

### THE KEY TO LONG-TERM RETURNS?

**Small cap stocks are often misunderstood. Many people have watched The Wolf of Wall Street or seen an advert for a penny stock trader, attempting to sell a revolutionary trading course that can make you millions each month. This reinforces the idea that small cap stocks are simply there to be traded and not suitable for long-term investors. While trading is certainly made easier by the heightened volatility in small cap stocks, the investment case for long-term investing in the asset class remains strong.**

There has traditionally remained a negative correlation between company size and long-term performance, with smaller stocks often outperforming their larger and medium sized counterparts. The majority of this outperformance occurs during bull markets when markets are rising and momentum is strong, as investors risk appetite steadily increases and they seek out riskier assets with greater upside potential. Small cap stocks suit this scenario perfectly as investors inscribe additional weighting to future earnings potential versus large-cap companies with immediate cash flows.

SMALL CAP STOCKS HAVE OUTPERFORMED OVER THE LONG-TERM




*Source: Factset*

While this is the case over the long-term, short-term volatility and drawdown will likely impact the range of investors who wish to access such markets. Likely, such an asset class will be appropriate only for those with elongated investment horizons and higher risk appetites. In fact, from peak to trough during the 2007/08 financial crisis, the MSCI Small Cap index fell by -61.4% compared to -55.5% for its larger cap counterpart, both devastatingly low levels, but with small cap investors suffering an even worse fate.

*"Companies and individuals are now demanding more user friendly, connected and targeted products and services to meet their needs, with smaller companies able to exploit niche areas of the market, offering exactly what their customers require. Their larger competitors require significantly more funding and time to create new products and are often prepared to rest on their laurels as their large market share provides a steady stream of income."*

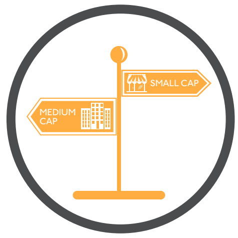
However, despite such drops, small cap stocks tend to bounce back more rapidly, owing to their high levels of innovation, growth and flexibility. In fact, the recent development of so called 'unicorns' (a privately held company with a valuation of US$1bn or more) has given rise to new-age technology companies, many of which have gained significant market share in short periods of time thanks to their innovative products and solutions that have been replacing legacy providers at a rapid rate, and leaving their larger competitors scrambling to find a way back to the top. Perhaps one of the best examples of this is the UK banking industry. Fintech (financial technology) companies such as Monzo and Starling have gained rapid adoption since their inception, thanks to lower fees in areas such as international spending, innovative apps that help consumers more effectively manage their money, as well as payment notifications that help customers better recognise fraud on their account. Digital challenger banks now control 8% of the personal current account market in the UK, up from 1% in 2018 as customers, in particular millennials, grow tired of the lack of innovation and functionality of legacy providers such as Barclays, NatWest and Lloyds, amongst others.

Companies and individuals are now demanding more user friendly, connected and targeted products and services to meet their needs, with smaller companies able to exploit niche areas of the market, offering exactly what their customers require. Their larger competitors require significantly more funding and time to create new products and are often prepared to rest on their laurels as their large market share provides a steady stream of income.

This has meant that smaller companies have traditionally grown at much faster rates than their larger counterparts. In fact, the Cboe UK 100 has averaged an annual sales growth of just 0.03% compared to 3.19% at the Cboe UK 250 over the past ten years, a stark difference that showcases the long-term strength of small and medium sized companies.
These days especially, smaller companies are often better prepared than ever to compete with the incumbents thanks to the rise of private equity capital and firms' willingness to remain private for longer. Private markets have seen an explosion of capital thanks to a large increase in the number of market participants willing to invest in new up and coming technologies. Companies such as Google as well as collective investments such as Baillie Gifford US Growth Trust have increasingly looked to allocate towards private markets as a way of diversifying their revenue streams and widening their investable universe. This has ultimately meant that when such companies decide to list on public markets, they are well positioned in the market in which they operate and often well-funded also to aggressively take market share.

For those investors with longer-term time horizons, looking to tap into the often-fruitful small cap market, there has emerged a large number of funds in recent years with which they can access the area. This ranges from tracker funds which replicate an index at low cost, to more interesting actively managed funds targeting specific geographies and sectors. Selecting a fund and by association a manager that you can rely on, remains of paramount importance when looking to invest in small caps, as avoiding companies at risk of failure often remains a much more difficult job than at larger cap focused funds. ■

# TOPIC OF THE MONTH




## SCOPING AIM

**In a world where stock markets are online and shares are available at the click of a button, it's easy to forget that there is not just one 'stock market', but many. In the UK, many smaller companies are listed off the so-called 'main market', and instead listed on AIM, formerly known as the 'Alternative Investment Market'.**

Launched in 1995, AIM is a sub-market of the London Stock Exchange (LSE) designed to help growing companies access public markets. On its launch, AIM consisted of ten companies with a combined market cap of £82m, which has grown to 850 companies today with a combined market cap of £104bn. The market has much looser listing requirements than the main market, with no trading record, pre-vetting of admission documents by a regulatory authority, or minimum proportion of shares in public hands required. Instead, admission documents are checked by an authorised nominated advisor, or NOMAD, who is responsible for continuing to monitor the company post-initial public offering (IPO). These are intended to attract smaller companies at an earlier stage of growth to list, and the under-researched nature of the market makes it a good source of outsized returns for investors willing to put the work in. Increased competition from the likes of private equity financing may help explain why the number of companies listed on AIM has fallen from a high of 1,694 in 2007.

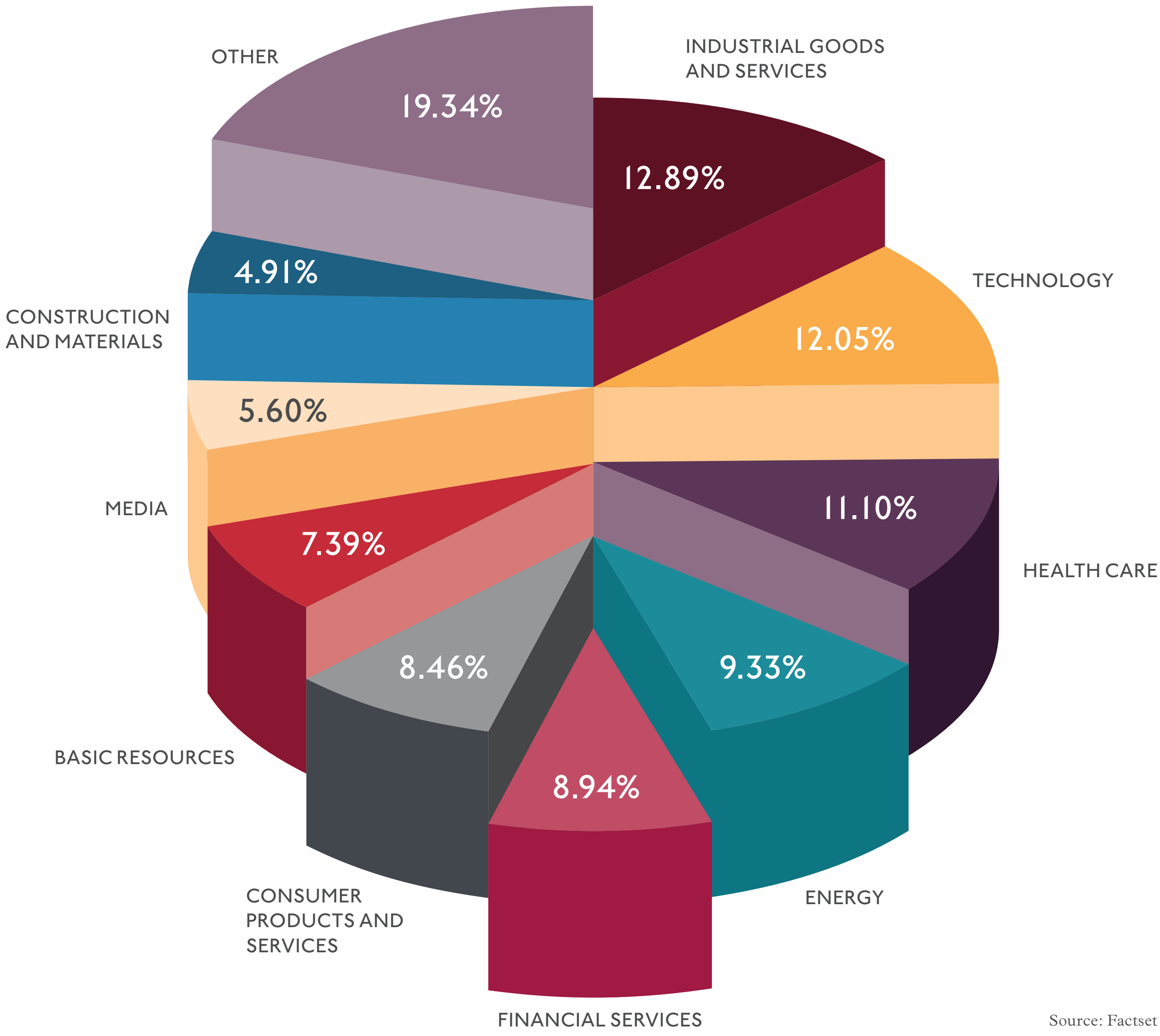
For investors, the lower standards of governance and regulation make AIM riskier as a market, as the main authority in NOMADs monitors companies using a set of guidelines rather than strict rules. This increases the likelihood of fraud with Quindell, an insurance software provider, being one example, which overstated its pre-tax profits to £107m when it had in fact made a loss of £64m.

Evidently, governance is a key risk, and investors should place extra care on verifying its quality. Research has shown that AIM firms that pay a dividend achieved an average five-year return of 156.5% compared to 12% for those that don't. This isn't to say that companies that don't pay a dividend perform poorly, some of its most successful companies like ASOS and Boohoo don't, but a sustainable dividend can be a barometer for strong corporate governance by showing management is conscious of shareholders. A good way of spotting fraud and aggressive accounting is to compare a company's earnings generation with its free cash flow across time. Though some differential is acceptable, significant disparities over time could suggest management is too quick to recognise revenues. Also notable is the fact that free cash flow can be manipulated by companies delaying their bills into the next financial year, cutting investment, and selling their debtors at a discount to credit companies. Poor cash management can also be seen through large or steadily growing receivables and payables, though all numbers can ultimately be window dressed. The manipulation of figures makes it imperative to check long-term trends.

One of the key benefits of AIM shares is that many of its companies offer their holders up to 100% relief from inheritance tax when passing the shares over, so long as they have been held for at least two years and are held on death. Qualifying businesses must be trading, or 'real', businesses. Some businesses on AIM may also qualify to offer shares through the Enterprise Investment Scheme which gives relief to investors on their income and capital gains tax, as well as tax relief on any losses made on the shares – though they must be held for at least three years. ■

Please note, there is an extra risk of losing money when shares are bought in some smaller companies.

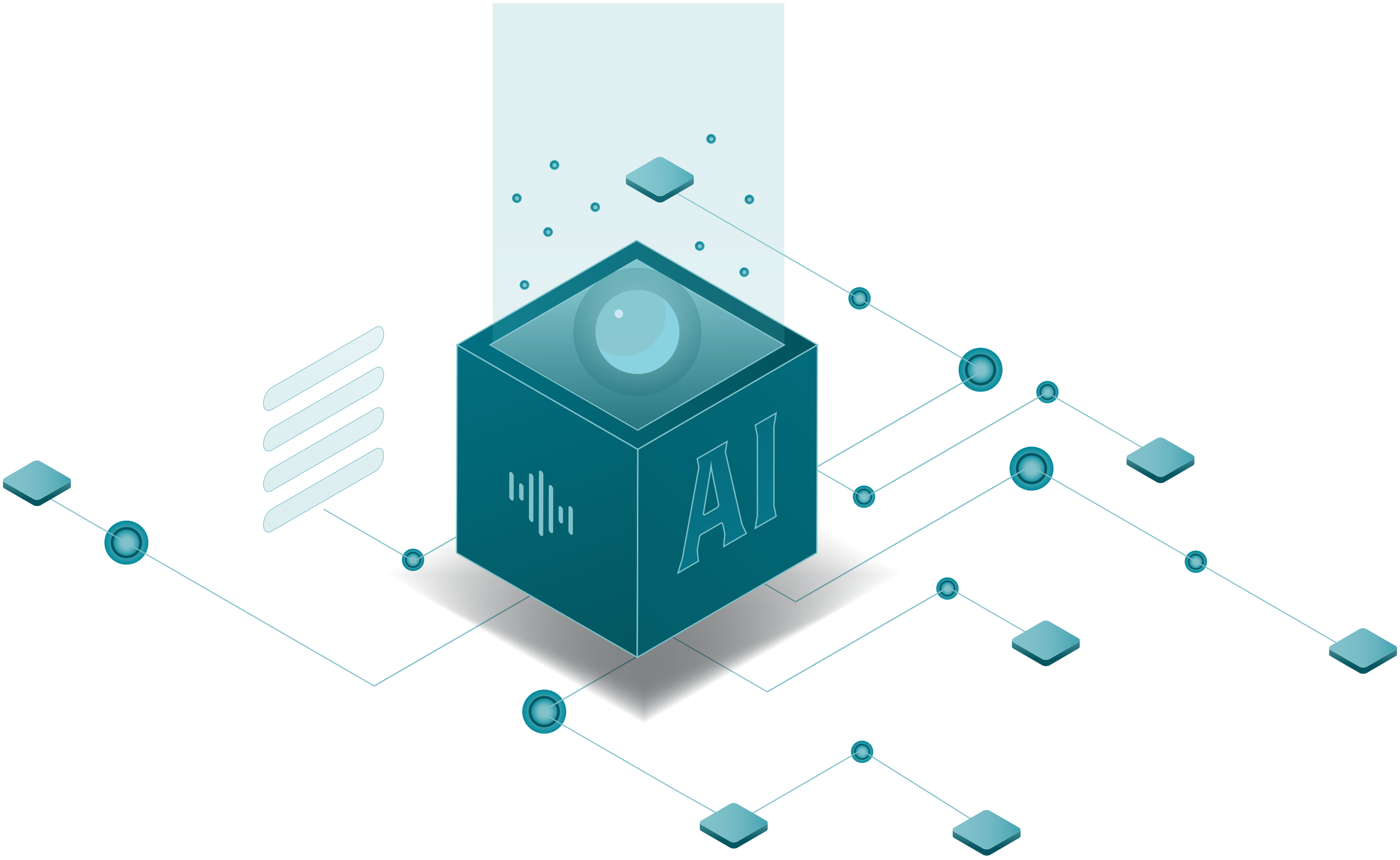
## BREAKDOWN OF AIM BY SECTOR




Source: Factset

# ARTIFICIAL INTELLIGENCE IN THE SMALL AND MID-CAP SPACE

HAL MILLER | HEALTHCARE AND SOFTWARE ANALYST
MONTANARO ASSET MANAGEMENT




**Artificial Intelligence (AI) is still in its infancy, yet low hanging fruit applications are now in reach for one healthcare software business that fits Montanaro's stringent high-quality requirements.**

There has been a boom and bust in valuations for AI businesses touting moonshot opportunities. Of note, a host of 'symptom checker' companies have raised capital with a promise to revolutionise primary healthcare by replacing or augmenting GP check-ups. Efficiency gains are much needed in western healthcare systems, especially now given that huge numbers of appointments were delayed due to Covid-19 – the NHS waiting list recently hit an all-time high of 6.1 million patients.

Symptom checker poster child Babylon Holdings (BBLN US) has AI tools which seek to prioritise ('triage') patients for review by a human doctor, or even to diagnose disease by itself. Its enterprise value has now fallen to less than USD 400m having reached over USD 4.2bn in October 2021, a decline of >80% in equity value in 6 months.

In the pharmaceutical space, other AI companies are developing solutions which seek to accelerate the rate of new drug development and approvals. Again, this is a worthy cause – the development time and cost per successful drug candidate has been rapidly increasing in recent years, partly as a result of increasingly stringent regulatory requirements. A 2020 peer-reviewed article in JAMA found that between 2009 and 2018 it cost companies an average of $1.4bn to bring a drug to market.

An example of an AI company in drug discovery is **BenevolentAI (BAI NA)**, whose shares officially listed in Amsterdam on 25th April. Their stated mission is to discover novel drug candidates with a higher probability of success than those developed using traditional techniques. Benevolent's most publicised success story to date was when they used their AI platform to recommend Eli Lilly's small molecule rheumatoid arthritis drug 'baricitinib' for treating Covid-19 patients. The FDA issued emergency authorisation for it in November 2020.

We aren't yet convinced these kinds of AI moonshot opportunities are investable in our funds. Symptom checkers appear to suffer from a perception of limited clinical evidence, which when combined with regulation and the inherent inertia in complex healthcare systems may mean that they end up producing lower growth and requiring larger investments than investors expect. Early-stage drug discovery is doubtless a rich vein for AI applications, but it is very hard to pick winners at this point. Whilst baricitinib showcases the potential, in a way it is disappointing that the most successful treatments for Covid arose through alternative more traditional channels.

To paraphrase Peter Lynch, who ran the Magellan Fund at Fidelity (previously home to our very own Head of Research Mark Rogers), in a gold rush it is generally a surer path to profits to sell tools to the miners rather than to pick up a shovel yourself. We have employed this strategy successfully with other healthcare companies, notably **Sartorius Stedim Biotech (DIM FP)** in the area of biologic drugs - so are there opportunities for a similar play in Artificial Intelligence?

We believe one such opportunity may be **Pro Medicus (PME AU)**, which is a top 15 holding in our Better World Fund. PME's core product is called Visage, which is software used by radiologists to quickly view CT, MRI and ultrasound scans. This product was developed by two German software wizzes, Detlev Stalling and Malte Westerhoff, before PME acquired it for just USD 4m in 2009. Detlev and Malte are still with PME today, and they are currently working on a new project – AI applications in medical imaging.

Imaging is low hanging fruit as far as AI is concerned. Crucially, the data inputs (i.e. the scans) are highly standardised, making it a much more simple task to use them to train an algorithm. Compare this to a company like Benevolent, who uses Natural Language Processing (NLP) to trawl internet publications for insights into which drugs could be relevant to which diseases. MRI scans all look roughly the same (there are only three companies in the world who dominate the MRI market). Conversely, useful data contained in internet publications is extremely difficult to digest.

Not surprisingly then, a very large amount of money is chasing AI applications in radiology. Of note - Viz.ai just raised $100m at a $1.2bn valuation, Qure.ai raised $40m in March and Aidoc raised $66m in July last year. PME are also developing their own AI algorithms internally. In February 2021 they received FDA approval for their first software program, which measures breast density in women to assist in diagnosis of breast cancer.

However, the real opportunity in our view comes from their emerging opportunity to become an 'app store' for AI algorithms developed by third-party companies.

The really hard part for any emerging healthcare business is often winning customers – hospital purchasing departments are notoriously complex and resistant to change. PME therefore has an asset that is of great value to companies like Viz, Qure and Aidoc – radiologist eyeballs. If PME can partner with (or acquire) companies like this, then they will be able to charge a 'per click' fee every time a radiologist wants to use a certain algorithm.

In the same way that Apple's c$80bn revenue Apple Store business enables them to further monetise iPhone owner eyeballs, will PME's position in the daily workflow of radiologists give them a large new opportunity over the next 5 years? It won't be $80bn (sorry), but it could still be transformational for a $4bn market cap business. Right now, PME charges hospitals about $1.50 per exam. How much more would their product be worth if it were not only an efficiency tool but also crucial to ensuring an accurate diagnosis? $5 per exam? $10 per exam? It's hard to say, but that additional revenue would be pretty much pure bottom line for PME – the future looks good. ■

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