Big caps are back

Over the last few years the salient feature of equity investing has been the outperformance of the small and mid-cap stocks at the expense of large cap shares.

The simplest way to demonstrate that is to contrast the 25.3% total return of the FTSE 100 over the last five years to 31st May with the 63.5% return of the FTSE 250 over the same period. During that same time the FTSE Small Cap index increased 59.2% so it is not a straight forward case of saying the smaller the company the better the performance. Even so, it is clear that the big blue-chip companies that so dominate the stock market in terms of valuation, cash generation and news flow have lagged behind their smaller listed brethren.

Some of that has been a result of re-rating. Larger companies are often seen as dividend paying cash-cows while the mid-caps might be viewed as nimbler and more agile competitors able to exploit niches in their markets. As a consequence the valuation measures applied to larger companies have drifted lower while the mid-caps have edged upwards. Nevertheless, earnings have probably grown a little faster for the constituents of the 250. It is important to remember though that the 250 companies in that sector only account for about 17% of the market capitalisation of the FTSE 350 Index.

Even before the sharp moves triggered by the surprising result of the EU referendum there were signs that change was in the air as the 250 lagged the 100 index over the first five months of the year. In June that difference increased with a near 6% fall in the 250 in contrast to a 2% rise in the 100 so that in the first six months mid-cap shares have lagged the big caps by 11.8%. That may not sound very dramatic but when markets are doing little, or declining, it makes a huge difference to relative returns. Nowhere is that more obvious than in the discrepancies between the performance of active funds and passive funds where, among many differences, probably the largest is the overweighting to smaller companies in the majority of active funds.

Maybe active managers feel that this group is less well researched than those in the FTSE 100 or perhaps it is function of active funds selecting less liquid stocks to benefit from a scarcity premium as their own activity moves the market. Who knows? But this year the downside of smaller companies, their higher risk, is becoming more evident.

It is clear from recent years that the high-beta (i.e. higher volatility) of mid and smaller sized stocks is a benefit in rising markets but a disadvantage when stock markets fall. An example of the two most extreme years in the UK stock market over the last 10 years illustrates the point. In 2008 the FTSE 100 fell 28% but the FTSE 250 dropped 38%. However, in the following year the mid cap index gained 51% against a rise of “only” 27% for the big cap index.

No one knows how this year will pan out but it is clear from the movements in June that the higher risk from mid-cap shares cannot be separated from returns. In the long run, there should not be a discernible difference in the risk adjusted returns between large and mid-sized stocks. But when markets are volatile the higher risk in smaller stocks might help on the upside but it does hurts on the downside. Both get to the same destination eventually but the larger companies give a smoother ride.