Strange dislocations in European small caps: what is going on?

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Part One – And what if the tail is wagging the dog?

It’s been tough times recently for managers of small cap equities in Europe. In fact, as at the end of October **no less than *80%* of small cap managers have *underperformed* the MSCI Europe Small Cap index year-to-date.** French and German managers have been particularly hard hit given their propensity to overweight their home markets, which have been amongst the worst performers (the CAC Small CS90 Index is down 10.7% and the Deutsche Börse SDAX Price Index -7.4% at the time of writing).

Painfully - and with an active share ratio of 98% - we are right in the middle of the 80% that have underperformed, and we have been looking at the data behind the movements to shed some light on why so many managers have been suffering.

One thing that is clear is that index funds tracking the MSCI European Small Cap have dominated the inflows to the asset class to the tune of around EUR 1.4bn (mostly into two well-known trackers). This compares with positive flows of only EUR 455m into actively managed European small cap funds.

These flows seem to be causing a distortion in valuations. If we look at the ETF trackers based on European small cap then we see that, on an equally weighted basis, the valuations stand on a P/E of 15.5x earnings for the current year, but if weighted according to market cap then the index valuation rises to an astonishing 27x as the larger companies in the index are more expensive.

Could it be that the index is no longer replicating the asset class it is meant to represent? By its exposure to mostly larger more liquid companies maybe the index is no longer giving real exposure to the universe of around 4,500 small companies across Europe. A quick look shows that the largest company in the index is DS Smith in the UK valued at GBP 8bn, closely followed by Marks & Spencer at GBP 7.4bn. In fact, there are no less than one fifth of the companies in the index that have market caps of over EUR 5bn. Just for reference there are over 4,500 companies quoted in Europe with market caps of less than EUR 5bn which will mostly escape the index and are therefore being ignored.

Beyond the size of companies in the index, it is also interesting to see that **the earnings growth is lower than the asset class as a whole**: across the index there is expected earnings growth of 15% for 2025, which compares with 20% for the small cap universe as a whole (as based on S&P Capital IQ). In valuation terms, it seems that by buying the index one is paying more in terms of P/E ratio for lower earnings growth across the sector than the wider universe.

It seems to us that the index is therefore no longer giving the right exposure to small companies in Europe. Flows into the associated ETFs seem to be driving the performance of the index stocks at the expense of the wider market. At the other end of the scale, valuations are very low: the QCF (Lux) - Argonaut Fund is currently valued at <10x expected earnings for 2025, with earnings growth of approximately 20% for 2025.

Increasingly, in terms of market performance, it seems that the tail is wagging the dog: maybe it is not that 80% of active managers have underperformed the index, but we should be looking from the other side and saying that ***the index* has *outperformed* 80% of active managers**. Investors buying the small cap ETFs to play an out-of-favour part of the market that has low valuations may not be getting what they were looking for.

Part Two – Negative consensus and good news is no news…

One of the things that we have noticed in the past couple of months is that **small cap share prices are no longer reacting to good news**.

We have examined the market reaction to announcement of Q3 earnings for the top ten companies in our portfolio and we have classified five of the announcements as superior to estimates, and five as neutral. In the case of the five earnings "beats", market reaction was minimal and had mostly evaporated by the end of the trading day. The five earnings reports that were "in line" resulted in negative movements by the end of the day.

To have five of the top ten holdings reporting earnings "beats" is good news for the portfolio and a reminder of the health of the companies. To have such anaemic price reaction with no follow-through suggests that (1) nobody is really paying attention and/or (2) small cap funds have no new money to deploy.

Part Three – Valuation as a catalyst?

We are often asked how and when European small caps might come back into favour. Part of the answer lies in valuation, which should be a catalyst in itself. **The current situation seems unsustainable**: small caps typically sell at a 20% valuation premium to large caps, but this has recently fallen to a substantial discount.

Also, looking across the Atlantic, the valuation of U.S. small caps seems to be very stretched, by comparison. Even allowing for a significant favourable growth outlook in the U.S., the Russell 2000 now sells on more than 25x 2025 estimated earnings, which compares with 15x for the MSCI Small Cap Europe and less than 10x for the Argonaut portfolio. It is also worth noting that Private Equity deals continue to take place at much higher EBITDA multiples than the wider quoted sector (cf. deal valuations of 10/11x EBITDA compared with valuation in our portfolio of around 6x).

Part Four – Governments are worried and starting to take action

But what other catalysts might spark interest for a return to small caps in Europe?

On this point, we find **recent discussions of political initiatives to attract interest to the sector very promising**: in recent weeks we have seen public/private initiatives launched in both France and Italy to support investment in smaller quoted companies (in the form of new small cap funds with government seeding). Though details need to be hammered out, the “Megafunds” proposal in the UK is also likely to contain measures to encourage investment in small, listed companies. Germany is likely to follow soon as most European governments will be closely monitoring initiatives being put in place elsewhere.

If one looks back to the 1980s and 1990s, measures like the Loi Monory and Loi Fabius brought substantial flows into the markets. The same was seen more recently with the PIR scheme in Italy. Typically, the markets have tended to anticipate flows from these sorts of measures, and we would imagine the tide could turn fast, bringing positive flows into the market in the first quarter of 2025.

Part Five – Companies, families and founders are buying back their stock

The current depressed prices mean that both companies and families have been buying in stock.

We have calculated that more than one third of the companies in our portfolio have a share buy-back program underway. On top of this family shareholders, founders, and other “insiders” have been using the opportunity to increase their shareholdings by buying in blocks and increasing their ownership.

The market may not find their shares to be cheap, but the *insiders* clearly do…

Conclusion – Dark days bring opportunities

Times are undoubtedly tough for European small cap shares – probably the toughest we have seen since 2008-9.

However, at current levels it is not hard to find quality companies with good prospects and solid balance sheets that are trading on a P/E ratio of around 10x 2025 earnings. In our portfolio, there are many between 6x and 10x.

In our experience, such opportunities do not come often.

Despite the dark days of spring 2009 – when there were similar valuations and a total lack of investor interest – by year-end, our fund had risen 60%.

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