Monthly Newsletter

'Car trouble' March 2019

"I'M ED CLARK IN SMALL-CAP FUNDS. YOU MUST BE MONTY SIMS IN LARGE-CAPS."

My car blew up last summer. One minute it seemed to be running fine and the next minute it ground to a halt with an ugly banging noise. A futile attempt to repair the vehicle revealed there had been a very slow, steady, leak of oil from the engine which the hi-tech diagnostics in the fully enclosed engine system had failed to identify. No oil and the engine seized up, simple as that. The car that I thought I could still part exchange for a few thousand pounds was now worth nothing.

Something similar has happened to the market for UK smaller company equities over the last year. A combination of central bank tightening from previously extremely accommodative levels, increased regulation and the economic uncertainty around trade wars and the prolonged Brexit negotiations have gradually drained the oil (or 'liquidity' to use a more appropriate term) from the engine of the market. The result is that shares in UK smaller companies have become extremely difficult to deal in. Trading has become so thin that just a few shares might change hands every day. This means that even low volume orders to buy or sell can lead to sudden swings in prices ('volatility').

The problem has become somewhat of a vicious circle. As market participants have withdrawn, the volatility of these small companies' shares has increased and, the more the volatility, the less keen investors are to take on the risk. We hear that even some of the large UK institutional investment funds are withdrawing from the smaller company market as the risk controllers reign back the portfolio managers from taking positions in companies that may be difficult to exit. So, in addition to the increased volatility, there has been some steady selling pressure which has left many small companies at very low valuations compared to either historic levels or international peer groups. The market appears to have seized up like my old car.

It is hard to know what will break this cycle. We can hope that some clarity over Brexit might add some oil to the engine. In addition, central banks are already stepping back from increasing interest rates as the global economy slows, which may help liquidity at a macro level. But just as likely is that if we are right, and these small companies are extremely undervalued, then the diagnostic system will work properly, unlike my poor old car, and the market will attract new participants in the form of international corporate buyers (see the take over of Dairy Crest by Canada's Saputo) or bids from private equity funds who will take companies private again (i.e if the market can't value these assets effectively, then someone else will!)

Whatever the outcome, it's vital that we get this engine going again. Small companies are the life blood of any economy. The entrepreneurs, the innovators and the disrupters of today could be the market leaders and the FTSE 100 constituents in 10- or 20-years' time. At MVAM we believe it's time to hold our nerve and tough it out through this period of uncertainty. We have conviction in the small companies we hold and believe they have a bright future. When the engine does finally roar back into life, we will be in the fast lane.

Mole Valley Asset Management Ltd.

Website: www.mvam.com

Tel: 01306 776999

Email: enquiries@mvam.com

Authorised and Regulated by the Financial Conduct Authority—Reg No. 613008