

Three Small-Cap Myths

Frank Gannon, assistant portfolio manager at Royce & Associates, dispels three of the most common misconceptions about investing in smaller companies.

There's always been an abundance of generalisations circulating about the economy and the stock market. In most cases, these offer a degree of truth, but they're often exaggerated or misunderstood. This is particularly true with the small-cap asset class. As we begin the New Year, we thought it might be helpful to focus on three longstanding misconceptions about small-caps and explain our take on them.

First, it's a common belief that smaller companies are more fragile, especially from a balance sheet perspective, than their larger siblings. From our perspective, solid balance sheets in the small-cap world are much more common than many believe. Balance sheet strength is crucial for companies that need access to credit to finance their growth in today's difficult, credit-starved environment. But rather than concentrating primarily or exclusively on long-term debt, we search for companies with balance sheets that show low leverage.

We measure leverage more broadly by looking at the ratio of assets to stockholder equity. Using this method allows us to note changes in long- and short-term debt, as well as in accounts receivable. This type of examination paints what we believe to be a more complete picture of a company's financial wherewithal. Interestingly, as of the middle of December our research with FactSet shows that 71% of the Russell 2000 Index (excluding financials) would pass our basic balance sheet test, while only 54% of the S&P 500 (excluding financials) would meet the criteria.

Small-cap investing pays dividends

Second, as investors increasingly look for income from equities many assume that dividends are the sole province of larger-cap equities. From our perspective, dividends and small-caps are not mutually exclusive. According to FactSet, as of the middle of December, of the 4,417 US small-cap companies (those with up to \$2.5 billion in market capitalisation), 1,102 pay a dividend. And of those dividend-paying companies, 926 have a dividend yield of 1% or greater. Not surprisingly, the number of smaller companies that pay a dividend outside the US is even more dramatic. In many foreign markets, there's typically both a stronger embrace by shareholders of dividends and a higher incidence of founding-family owners who want dividends for income. Yields in many foreign markets are also quite generous, especially within smaller companies.

Finally, many investors believe that almost all of the revenue for smaller companies is generated domestically and, therefore, US small-caps lack exposure to faster-growing foreign economies. While roughly 35% of the S&P 500's revenues are generated overseas, approximately 20% of Russell 2000 companies' revenues as of the end of December are derived from non-US sources. We believe that smaller companies are more international than many investors believe. In fact, if one were to look at the weighted average percentage of revenue being generated outside the US for many of our smaller companies portfolios, you would find a number closer to, if not greater than, the S&P 500 figure.

PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

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Issuer: Legg Mason Asset Management Hong Kong Limited.