Small-Cap Premium: A Factor That Matters

Stockholm (HedgeNordic) – Value stocks might have underperformed broader market indices in the past few years, but **Kempen Global Small-Cap** managed to beat its benchmark despite giving its portfolio a value-tilt. How? Through careful stock selection.

Managed out of Amsterdam by a four-member team comprised of Jan Willem Berghuis, Maarten Vankan, Chris Kaashoek, and Luuk Jagtengerg, the Kempen Global Small-Cap Fund delivered an annualized return of 11.7 percent since launching in June of 2014 versus 10.1 percent for its benchmark, the MSCI World Small Cap Index. And here is their story:

Small-Cap Premium: A Factor That Matters

Jan Willem Berghuis, Portfolio Manager (Head)

Pursing an investment philosophy succinctly described as “quality at an attractive price,” Kempen’s global small-cap team “are bottom-up fundamental stock pickers focused on finding true value opportunities in the small-cap space,” according to Jan Willem Berghuis. The small-cap focus enables the team to practice a very engaged strategy, which involves frequent communication with management teams. “The advantage of investing in small-cap stocks is that we can talk to the management teams,” Berghuis tells HedgeNordic, who emphasizes that communication with management “is key to understanding the overall investment case.”

Having the small-cap space defined as investment universe enables Kempen Global Small-Cap to harvest the small-cap premium. “Over the long run, small-cap stocks have delivered between 1.5 percent to 2 percent higher returns on average than large-cap stocks,” says Maarten Vankan.

> “We are bottom-up fundamental stock pickers focused on finding true value opportunities in the small-cap space.”

The universe of smaller-sized public companies is a better hunting ground for active managers for multiple reasons. “Small-caps are very suited for active management, argues Vankan, “because often there is limited or sometimes no sell-side coverage." This provides ample opportunities to generate alpha, accentuates the portfolio manager.


Maarten Vankan, Portfolio Manager

The global small-cap team at Kempen also considers the intrinsic characteristics of smaller companies as an advantage of investing in small-caps. In this space, "management team members are sometimes the founders of the companies, with them and their families often having significant skin in the game through minority ownership," Vankan points out. "There is often better alignment between the interests of managers and shareholders," he argues.

All the benefits stemming from the exposure to small-caps may come at a cost, particularly for short-term- oriented investors. "Small-cap stocks tend to be more volatile than large-cap stocks," says Vankan, who emphasizes that "if you have a short-term investment horizon, the higher volatility could be a downside." But if you have a longer horizon of three years or more, "volatility is not very relevant as you benefit from the compounding effect of higher returns."

Quality at an Attractive Price

With over 4,000 small-cap stocks in developed markets, there is an immense amount of options when building a concentrated, market-beating portfolio. Kempen's global small-cap team relies on a proprietary in-house stock filters screening to find attractively valued high-quality stocks in that universe of over 4,000 stocks. The first step of Kempen's screening process involves finding higher-quality companies with above-average returns on capital employed, followed by a value screen that excludes three-fourths of the most expensive stocks that remained after the proceeding screening process. "This process reduces our universe from 4,000 to around 500 stocks," says Berghuis.

From there, the global small-cap team roll up their sleeves and get busy building a portfolio of 60 to 90 attractively-priced quality stocks. "From these 500 companies, our research processes focus on finding the quality companies with strong business models and management teams," explains Berghuis. These companies tend to be smaller-sized companies focusing on a particular niche. "These niche leaders enjoy the benefits of scale and are hard to compete with," adds Berghuis. Return on capital employed is a good baseline measure of business quality, and Kempen Global Small-Cap's portfolio exhibits an above-average return on capital employed versus its benchmark.

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The team's bottom-up analysis process involves assessing both business and management quality. To evaluate business quality, the team relies on the five forces model developed by Michael Porter, a framework widely used to analyze a company's competitive environment. The assessment of management quality involves evaluating five "management-related items such as capital allocation, strategy, alignment, operations, and ESG," according to Berghuis. "Assessing the quality of a company and its management team are two important aspects of our approach," he outlines, further adding that the assessment of business and management quality "provides us with a margin of safety on the quality side."

After evaluating a company's quality, Kempen's global small-cap team invest in the stocks where they see a margin of safety between price and value. In the small-cap space, "we feel that share prices do not always reflect the intrinsic values of those businesses," reckons Berghuis. "It is our task to identify these mispricings and benefit from them." The Kempen team acknowledges that "investors seem to be paying less attention to valuations in the current market environment, but we want to remain disciplined with our valuation approach," says Berghuis. "Our valuation discipline could be a headwind in the short run, but we believe our approach will pay off in the long run."

What Kempen Thinks of Value Investing

"Simply buying a stock with a low price-to-earnings multiple" is not value investing, according to Berghuis. For Kempen's global small-cap team, value investing involves finding a quality company that is mispriced. "A company with a low valuation could be true value but could also be a value trap," he continues. For that reason, value investors should arguably do more research than the average investor to avoid value traps by making sure those companies are high quality with strong management teams in charge.

Whereas so-called value stocks as a whole underperformed in the past decade, Kempen's global small-cap team has "been able to compensate for the value-tilt through stock selection over the past five years," says Vankan. "That has been the key to our success" – the key to outperforming its benchmark since launching in 2014. "If we had bought the basket of 500 stocks left after our quality and value screens, we would have underperformed our benchmark as well," adds the portfolio manager. The wide range of investment opportunities available in the small-cap space has also played a role in Kempen Global Small-Cap's outperformance. With an active share of almost 98 percent, the fund is far different from the typical index-hugging fund.

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