

Numis Smaller Companies Index

Industry Update

Q1 2014 review

UK smaller companies performed well again in Q1 2014, up by 3.5% and outperforming the UK market by 4%. This extends the sector's run of strong outperformance since 2012. Style and sector influences have been relatively limited so far in 2014. In other words, for smaller company fund managers this year has so far been a true "stock pickers market", so frequently predicted by strategists yet in practice so rare.

- **Good performance in Q1 2014:** The Numis Smaller Companies Index, excluding Investment Companies, produced a total return of +3.5%. This beat the FTSE All-Share index, which declined very modestly in Q1, by 4.1%. Since the index bottomed just over five years ago, the Numis Smaller Companies Index return has been +280%.
- **Style factors not to the fore:** There were, of course, some style and sector factors at work during Q1 2014, most notably a strong performance by microcaps, which we discuss in this note. However the scale of these has been relatively limited. As such, the smaller companies sector has predominantly been a stock pickers market through the first quarter.
- **Microcaps outperform:** The smallest small companies have done well, with the FTSE Fledgling index up by 8% in Q1. Style factors including Value/Growth and Momentum were however broadly neutral in Q1.
- **Resources performance in line:** The key underperforming sectors for the last two years in smaller companies have been Mining and to a lesser extent Oil & Gas. Individual share price performance in these sectors in Q1 has been highly variable, but in aggregate the main market smaller company resources sectors performed in line. Elsewhere the consumer-driven sectors of Retail and Travel & Leisure produced another good performance, while Technology and Healthcare also did well. Industrials did comparatively poorly.
- **Numis Smaller Companies Index background:** The Numis Smaller Companies Index is the most widely used UK smaller companies benchmark. The index is compiled by Professor Paul Marsh and Professor Elroy Dimson of London Business School, and has been distributed by Numis since 2012. The index was first published in 1987, with a back-history dating from 1955. The primary index covers around 800 companies which make up the bottom 10% of the UK main listed market by value. Over 1955-2013 the Numis SC Index ex Investment Companies total return beat the FTSE All-Share by an average of 3.5% pa.

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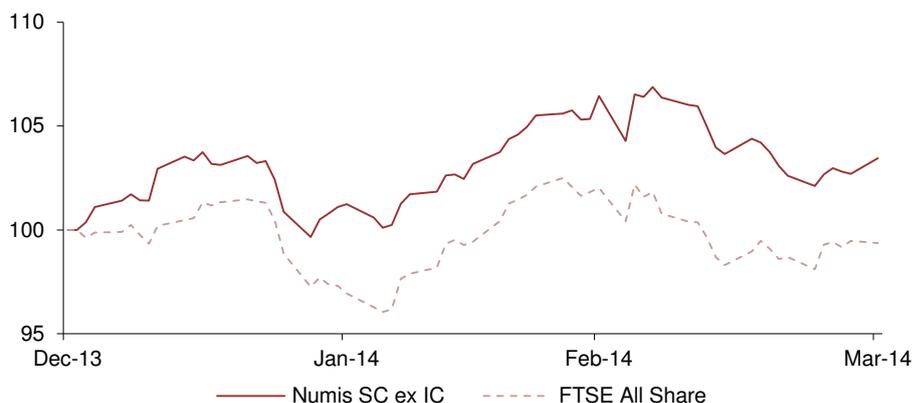
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Smaller company performance

UK smaller companies have started the year well. Total returns of 3.5% from the main Numis smaller company benchmark compare with a small drop in the FTSE All-Share index, giving outperformance of 4.1%. The chart below shows the benchmark Numis Smaller Companies excluding Investment Companies total returns index year to date, by comparison to the FTSE All-Share index.

Figure 1. Smallcaps outperformed in Q114



Source: Numis Securities Research Department, Datastream

The strong start to 2014 follows an extended period of smaller company outperformance. This is in particular discussed in the Numis Smaller Companies Index 2014 Annual Review, Elroy Dimson & Paul Marsh, January 2014 (copies available on request). The primary Numis benchmark outperformed by 16% in 2013, with a total return of 37%. This followed outperformance of 18% in 2012 (30% total return).

The table below shows the performance of various indices for Q1 2013 and for the whole of 2012, giving a broader perspective on smaller company performance.

Table 1. UK smaller company index performance, Q1 2014 and 2013

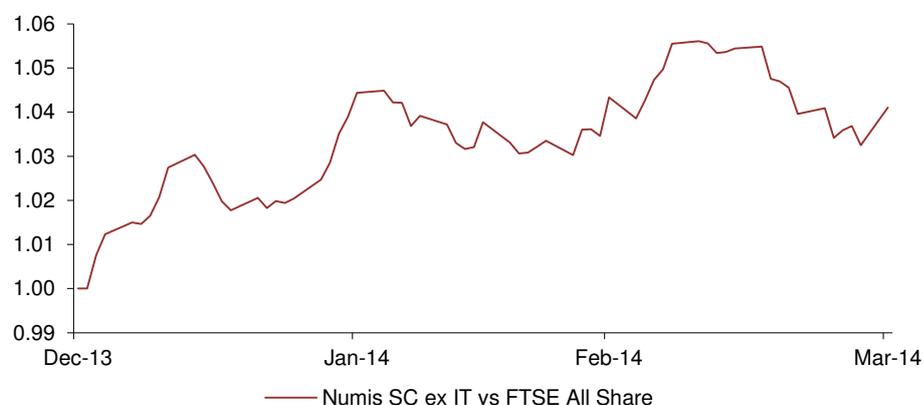
| | Q114 % change (capital gains) | Q114 % change (total returns) | 2013 % change (capital gains) | 2013 % change (total returns) |
|---|-------------------------------------|-------------------------------------|-------------------------------------|-------------------------------------|
| Numis SC Index (ex Inv Cos) | 3.0 | 3.5 | 33.1 | 36.9 |
| Numis SC Index (ex Inv Cos) rel All-Share | 4.5 | 4.1 | 16.4 | 16.1 |
| Numis SC + AIM (ex Inv Cos) | 3.0 | 3.4 | 27.7 | 30.9 |
| Numis SC + AIM (ex Inv Cos) rel All-Share | 4.5 | 4.0 | 11.0 | 10.1 |
| Numis SC Index (inc Inv Cos) | 2.2 | 2.7 | 28.0 | 31.7 |
| Numis SC + AIM (inc Inv Cos) | 2.4 | 2.8 | 24.7 | 28.0 |
| Numis 1000 Index (ex Inv Cos) | 3.6 | 3.9 | 42.2 | 46.0 |
| Numis 1000 Index (inc Inv Cos) | 1.9 | 2.5 | 30.5 | 34.2 |
| FTSE All-Share | (1.5) | (0.6) | 16.7 | 20.8 |
| FTSE 100 | (2.2) | (1.3) | 14.4 | 18.7 |
| FTSE 250 (inc Inv Cos) | 2.1 | 2.5 | 28.8 | 32.3 |
| FTSE 250 (ex Inv Cos) | 2.4 | 2.7 | 31.3 | 34.9 |
| FTSE 350 | (1.6) | (0.7) | 16.4 | 20.5 |
| FTSE SmallCap (inc Inv Cos) | 0.9 | 1.4 | 29.6 | 32.8 |
| FTSE SmallCap (ex Inv Cos) | 1.7 | 2.1 | 40.2 | 43.9 |
| FTSE Fledgling (inc Inv Cos) | 5.0 | 5.4 | 35.8 | 39.0 |
| FTSE Fledgling (ex Inv Cos) | 7.9 | 8.3 | 45.2 | 48.4 |
| FTSE AIM All-Share | 0.0 | 0.2 | 20.3 | 21.3 |

Source: Numis Securities Research Department, Datastream

The most notable index performance so far in 2014 has come from the minnows, with the FTSE Fledgling ex Investment Companies index giving a total return of +8.3% YTD. This repeats the pattern seen in 2013. Overall smaller companies, as measured by the Numis index, have modestly outperformed midcaps (FTSE 250) so far in 2014. This also repeats the pattern seen in 2013. Once again the FTSE 100 has been the least rewarding part of the market.

The Numis + AIM index is increasingly used as a smaller companies benchmark by fund managers. Year to date the choice of NSCI or NSC + AIM benchmark has made very little difference, with only 0.1% difference in total return. The FTSE AIM All-Share index is flat for the year to date, significantly below the Numis indices. However this flat overall AIM performance has not translated to underperformance of the Numis + AIM index performance. This is because AIM has been dragged down by poor performances from the shares of the three largest AIM companies (ASOS, Gulf Keystone and Indus Gas), none of which qualified for the NSC + AIM index at the start of 2014.

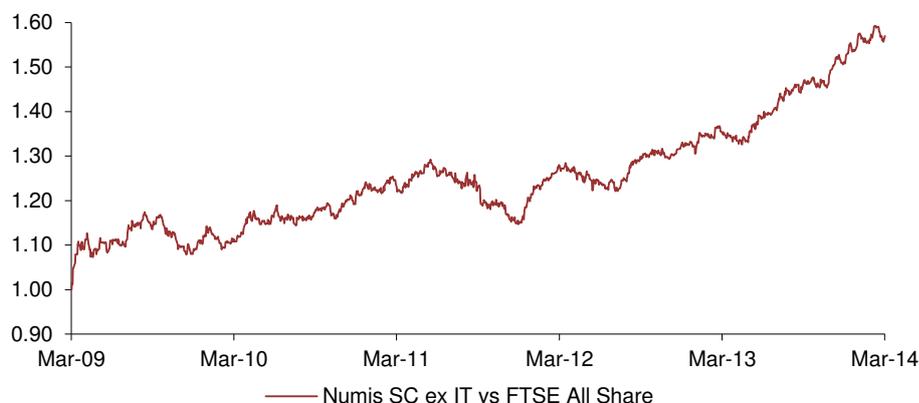
Figure 2. Smallcap relative performance in Q114



Source: Numis Securities Research Department, Datastream

Looked at over a longer time period, UK smaller companies have been an exceptionally strong asset class. In total returns terms the Numis SC index ex ITs has more than tripled over five years, returning 335% of the initial value (+27% CAGR). In relative terms the index is 57% ahead of the FTSE All-Share over this period (213% of the initial value, or 16% CAGR), illustrated in the chart below.

Figure 3. Smallcap relative performance over five years



Source: Numis Securities Research Department, Datastream

Industry group and stock performance

The table below shows the performance of broad industry groupings within the Numis SC Index, excluding Investment Companies.

Table 2. Industry grouping total return within the Numis Smallcap Index

| | Weighting (start of 2014) | Return 2014 YTD | Weighting (start of 2013) | Return 2013 |
|--------------------|------------------------------|--------------------|------------------------------|----------------|
| Financials | 20 | 2 | 17 | 44 |
| Consumer Services | 18 | 6 | 24 | 44 |
| Industrials (1) | 16 | 1 | 12 | 43 |
| Support Services | 12 | 2 | 15 | 46 |
| Technology | 8 | 7 | 6 | 18 |
| Oil & Gas | 5 | 3 | 5 | 12 |
| Mining | 4 | 5 | 4 | (38) |
| Health Care | 3 | 7 | 3 | 37 |
| Other | 14 | 4 | 13 | 38 |
| Index (ex Inv cos) | | 4 | | 37 |

(1) The ICB Industrials sector ex Support Services (includes Construction, Capital Goods and Industrial Transportation)
Source: Numis Securities Research Department

Year to date sector performance has diverged less than in recent years. The Resources sectors underperformed substantially in 2013, but this was not repeated in Q1 2014. The leading sectors in Q1 2014 have been Consumer Services (led by Retail and Travel & Leisure), Technology and Health Care. Looked at in more detail by sector, we pick out the following highlights and lowlights:

- **Consumer Services:** The Consumer Services sector has continued as the largest individual sector contributor to performance. Notable strong performances YTD have included WH Smith, Restaurant Group, SuperGroup, and Entertainment One, with underperformers including ITE, Mothercare and, in the +AIM index, Blinkx.
- **Financials:** Financials sector performance has been muted, with robust performance by Real Estate services offset elsewhere. The insurers Partnership Assurance and Just Retirement were the two biggest negative contributors to the NSCI index in Q1 2014, with Tullett Prebon and Lancashire also performing poorly. In the +AIM index, Songbird and Plus500 have been particularly strong.
- **Industrials:** Capital Goods has underperformed, with notable laggards including Oxford Instruments, Vesuvius, Fenner and Xaar. Bodycote has been the most significant gainer in this area. Construction has performed in line, with Tyman and Galliford Try doing well, but Kier and Keller less so. Note that the Building companies are classified in "Other".
- **Technology:** Pace and CSR are among the key positive performers year to date for the main listed Numis index. In the broader Numis + AIM index Quindell has been the largest positive contributor to performance of any company in any sector.
- **Health Care:** A strong performance overall, led by Al Noor, but held back by Genus. In the +AIM index Abcam was a notable underperformer.
- **Resources:** Performance for the overall Resources sectors has been broadly in line with the index, but underlying that there have been highly divergent movements. African Barrick Gold, Heritage Oil and Kazakhmys have notably outperformed, while Ferrexpo, Kenmare and Caracal have fallen back. When AIM constituents are included in the overall assessment, the Resources sectors have been broadly flat in Q1.
- **Other:** Among the range of sectors that we include here in "Other", strong performers include FirstGroup, Greencore, and Colt.

Style returns in smaller companies

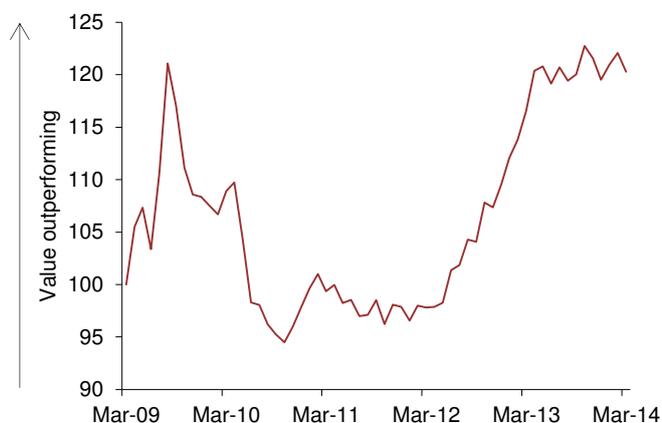
We look at four different style definitions. Long term performance data quoted here all refer to the period up to the end of 2013:

- **Value:** Value is measured by ranking stocks by their ratio of equity book value to market value. The 40% highest book-to-market group are measured as Value, and the 40% lowest as Growth. Since 1955 Value has outperformed Growth by +4.7% per annum.
- **Size:** In addition to the comparison of the overall bottom 10% of the market with the whole market, shown above, we also provide data on size performance within the Numis SC Index. We divide into smaller small (the 70% of the Numis SC Index by number with the lowest capitalisation) and larger small (the top 30%). Since 1955 smaller small companies have modestly outperformed larger small companies (+0.9% pa), although since 2000 smaller small and larger small have performed exactly in line with each other.
- **Momentum:** We produce two momentum measures. The primary measure that we focus on is “12-1-1”. This involves ranking stocks by their returns over the past 12 months and defining winners as the top 20% of performers, and losers as the bottom 20%. The strategy is to then wait 1 month before investing for 1 month in the winners and losers, then to repeat the process, rebalancing each month. We also provide data on a “6-1-6” strategy (measure over 6 months, wait 1 month, hold for 6 months, rebalance every 6 months). Over the very long term, winners have very strongly outperformed losers, on average by 18% pa since 1955, using the “12-1-1” approach.
- **Yield:** We define high yield and low yield as the 30% of highest and lowest yielding stocks immediately prior to the start of the year. We also monitor the performance of non-dividend payers. Since 1956 high yield UK smaller companies have returned 18.7% annualised total return, low yield UK smaller companies have returned 14.0%, and non-dividend payers have returned 9.5%.

Value versus Growth

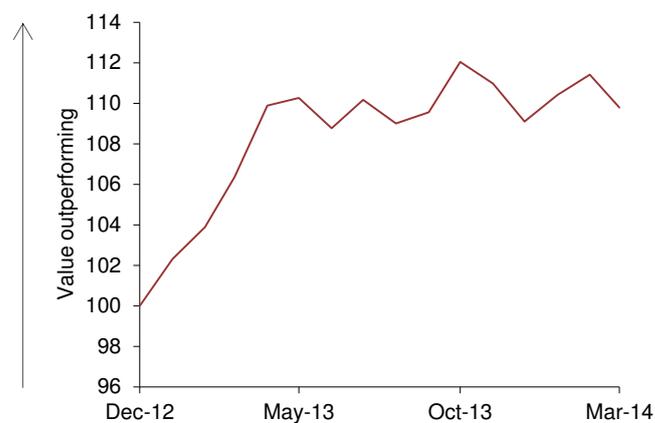
The Value style outperformed significantly from the middle of 2012 through to Q2 2013. However relative performance has been very steady over the last 12 months.

Figure 4. Value vs growth (5 years)



Source: Numis Securities Research Department

Figure 5. Value vs growth (15 months)

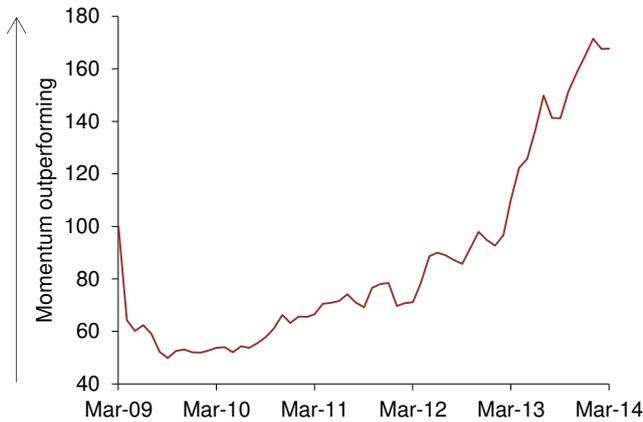


Source: Numis Securities Research Department

Momentum

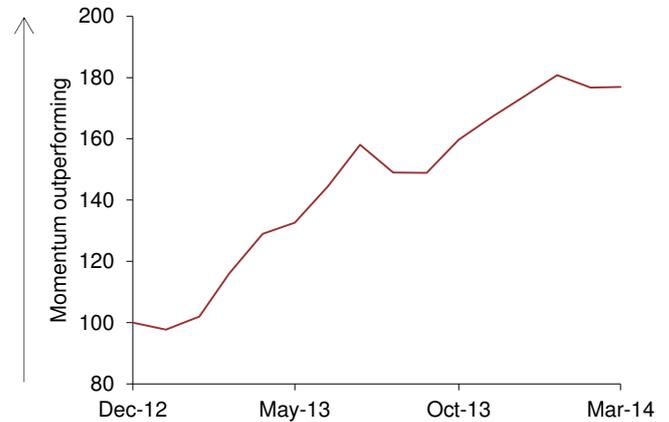
Momentum has been an exceptionally strong style factor over the last few years. Since the start of 2013 smaller companies with strong price momentum have outperformed those with weak price momentum by around 75%. Relative performance has not however been particularly notable in the last three months.

Figure 6. Winners vs losers (5 years)



Source: Numis Securities Research Department

Figure 7. Winners vs losers (15 months)

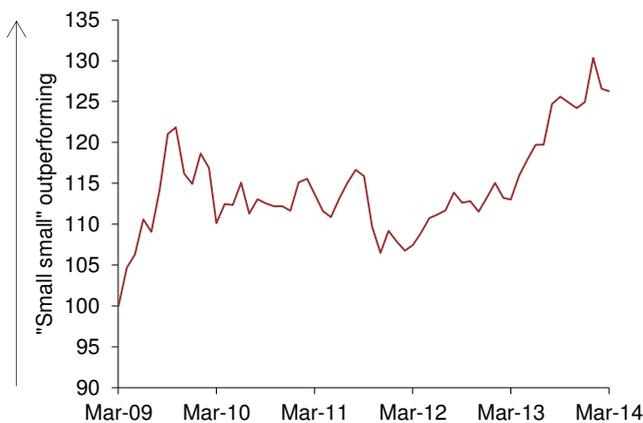


Source: Numis Securities Research Department

“Large small” versus “small small”

For a number of years through until the start of 2013 there was little to choose between larger small companies and smaller small companies. However in the last year in particular smaller small companies have performed very well.

Figure 8. “Large small” vs “small small” (5 years)



Source: Numis Securities Research Department

Figure 9. “Large small” vs “small small” (15 months)

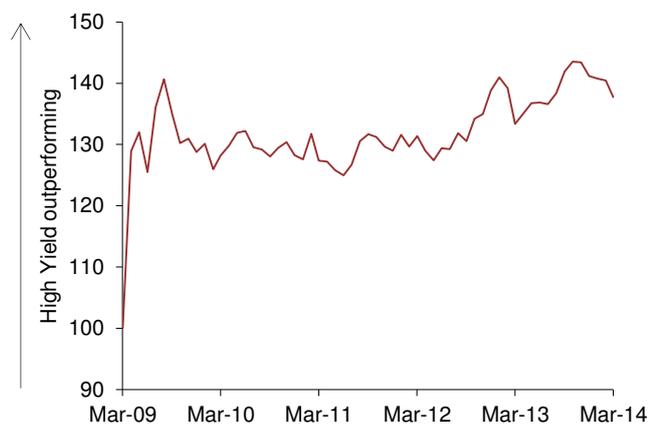


Source: Numis Securities Research Department

High Yield versus Low Yield

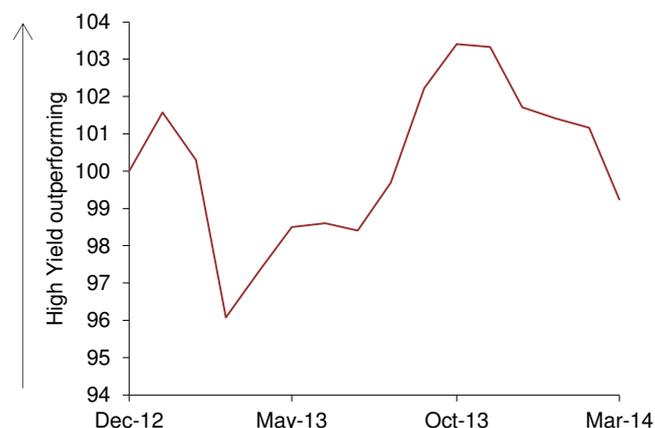
While there have of course been monthly fluctuations, there is no clear recent trend in the performance of high yield and low yield companies. The performance of zero yield companies is not reflected on the chart, but also has been broadly similar since the start of 2013, albeit the long term performance of zero yield companies has been poor.

Figure 10. High Yield vs Low Yield (5 years)



Source: Numis Securities Research Department

Figure 11. High Yield vs Low Yield (12 months)



Source: Numis Securities Research Department

Numis Index cutoff update

At the start of 2014 the cutoff for the Numis Index was £1,503m, with all companies at or below this level being included in the index.

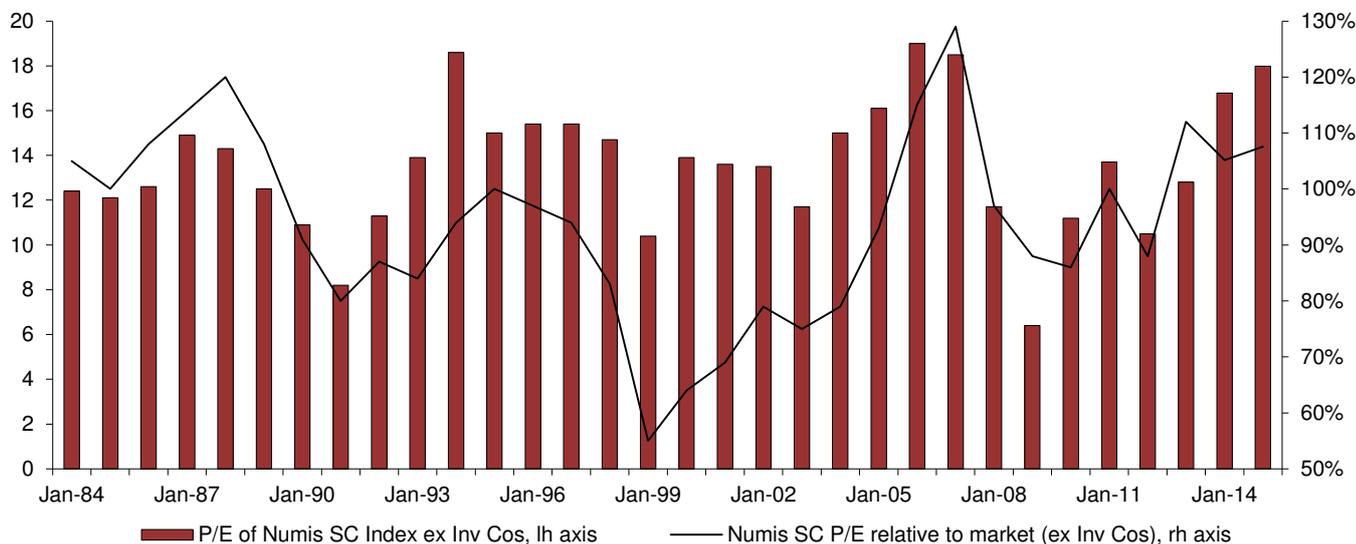
The first quarter of 2014 has seen significant new issue activity, biased towards smaller companies issuance. In fact this has been the first Q1 when births of NSCI-eligible stocks have exceeded deaths since before the global financial crisis. On the main market there were 12 NSCI-eligible IPOs in Q1 2014 (4 of which were investment companies) and only one “death” (itself an investment company).

NSCI re-balancing takes place only once a year, to minimise the need for trading for investors tracking the index. However, as a result of these new smaller companies, if the NSCI index rebalancing had taken place at the end of March, then the cut-off would have been £1,377m, or almost 10% lower than the actual cut-off at the start of the year.

Smaller Company P/E ratios

The chart below shows the trailing PE of the aggregate Numis Smaller Companies index, by comparison to the trailing PE of the market overall.

Figure 12. Smaller company trailing PE ratios



Source: Numis Securities Research Department

The trailing P/E valuation is at comparatively high levels compared to history, both in absolute and market relative terms, although these metrics remain, as the chart shows, below historic peak levels.

We calculate that the Numis Smaller Companies index ex Investment Companies is currently on a trailing PE of 18.0x, compared to the overall UK market on a trailing PE of 16.7x. In absolute terms a trailing PE of 18x is approximately a 33% premium to the 30-year average trailing PE for smaller companies of around 13.5x. The 7% premium for smaller companies compares to a 30-year average discount of around 7%.

We caution that these valuation calculations are backward rather than forward-looking. Multiples can also be influenced by loss-makers moving in or out of the calculations, and by fluctuating levels of items such as intangible amortisation.

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| | |
|--------|-------------------|
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| Add | > +10% to +19.99% |
| Hold | 0% to +/-9.99% |
| Reduce | -10% to -19.99% |
| Sell | > -20% |

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| Add | 27.8% | 30.4% | 32.8% | 29.9% |
| Hold | 31.7% | 10.7% | 31.5% | 11.5% |
| Reduce | 4.5% | 0.0% | 2.8% | 0.0% |
| Sell | 2.3% | 0.0% | 2.1% | 0.0% |
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The above table shows the split of recommendations based on the last recommendation for each research stock during the last four calendar quarters.

The above table shows the split of recommendations based on all recommendations during the last calendar quarter for all securities and within each category the proportion of issuers to which Numis supplied material banking services.

For the split of recommendations by sector for the period from 1 Jan 2012 to 31 Dec 2012, please contact the Research Department of Numis Securities Ltd.