



Smaller Companies Funds:

European Industry Trends

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Executive Summary

- This report examines fund flows and assets over more than twelve years to understand how investor sentiment and portfolio allocations to small cap funds have evolved over time.
- Inflows to small cap funds in 2013 (€15.5bn) remain on course to be the largest annual total for the asset class, with the previous high being €8.2bn in 2010.
- Sales activity indicates that where investors have been willing to take on equity risk outside emerging markets, then smaller companies funds have enjoyed unprecedented attention.
- The rising proportion of inflows to small cap funds partly reflects more modest inflows for European large cap funds than were seen before the financial crisis. If the return to equity funds becomes more widespread, so the small cap proportion is likely to fall back even if their volume of inflows (in absolute terms) remains strong.
- A typical investor's developed equity allocation to smaller companies has varied between 5.2% and 7.7% since 2001 and currently stands at the top end of this range.
- Total net assets invested in smaller companies funds stand at €131.1bn. This represents a 31% growth since the end of 2010 (€100.3bn) and more than double the level seen at the end of 2001 (€58bn).
- Passive funds represent 7.1% of the small cap universe. The impact of passively managed small cap funds has been far smaller than in other parts of the industry, suggesting that investors have generally been convinced that small caps are an area where active managers can really add value.

David Stevenson

Head of Product & Business Development

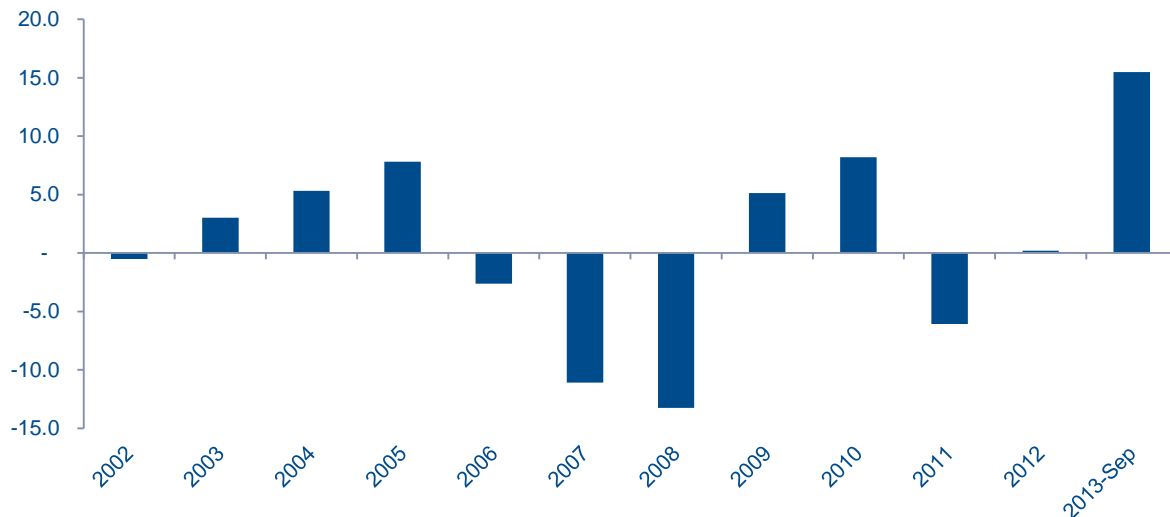
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Introduction

This short report puts the recent improvement in appetite for smaller companies funds into historical context. Fund flows and assets over more than 12 years are examined in order to understand how investor sentiment, market cycles and portfolio allocations to small cap funds have evolved, and to create a more informed view as to how this is likely to develop.

All of the analysis is based on mutual funds and ETFs registered for sale in Europe. Comparisons are made through the report between small (including small and mid caps) and large cap funds (including those that do not have a specific small or mid cap focus) funds. The latest data is to the end of September 2013. Fund flows and net sales are used interchangeably through the report.

Annual flows into small cap funds (€ billion)



Source: Lipper FundFile, data 30 September 2013

Small cap proportion of equity sales

Putting this into the wider context of equity appetite, the proportion of equity fund inflows that have moved into small cap funds reached 26% in the third quarter. This is the largest proportion of quarterly equity inflows on record.

The proportion of small cap net flows has been higher on several occasions (in Q4-2007, Q2-2006 and Q4-2002), but each of these instances was at a time when equity funds – both large and smaller companies – were suffering outflows.

It is also worth making this analysis more directly comparable between large and small cap funds. For example, there are insufficient emerging market small cap funds to have a dedicated sector, so these funds would be included in the whole equity universe, but could be excluded for the current analysis to create a more like-with-like comparison.

The resulting smaller universe includes those funds investing in Europe, US, UK, Switzerland, Sweden, Asia Pacific, Global, Nordic, France, Germany and Japan, across different market

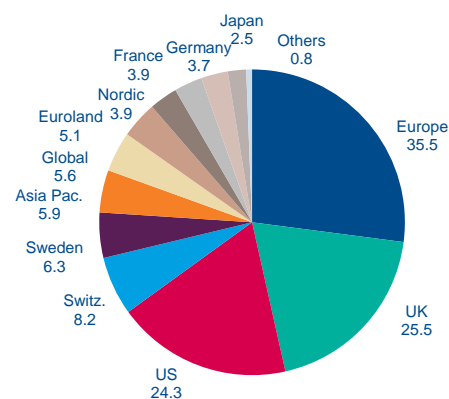
Record inflows

Net sales of smaller companies funds reached €6.4bn in the third quarter of this year. This is only the fifth time on record that inflows have topped the €4bn mark (using historical fund flows data starting in 2002).

This does not look to be a temporary move. Inflows to smaller companies funds total €15.5bn over the first three quarters of 2013, the last time the equivalent period exceeded €10bn was in 2006 (specifically Q3-2005 to Q2-2006). The 2013 total over the year-to-date remains on course to be the largest calendar year total for small cap inflows, with the previous high being €8.2bn in 2010 (and €7.8bn in 2005).

capitalisations. Europe, UK and US small cap equity funds account for 65% of the small cap universe.

Small cap fund sectors' assets under management (€ billion)

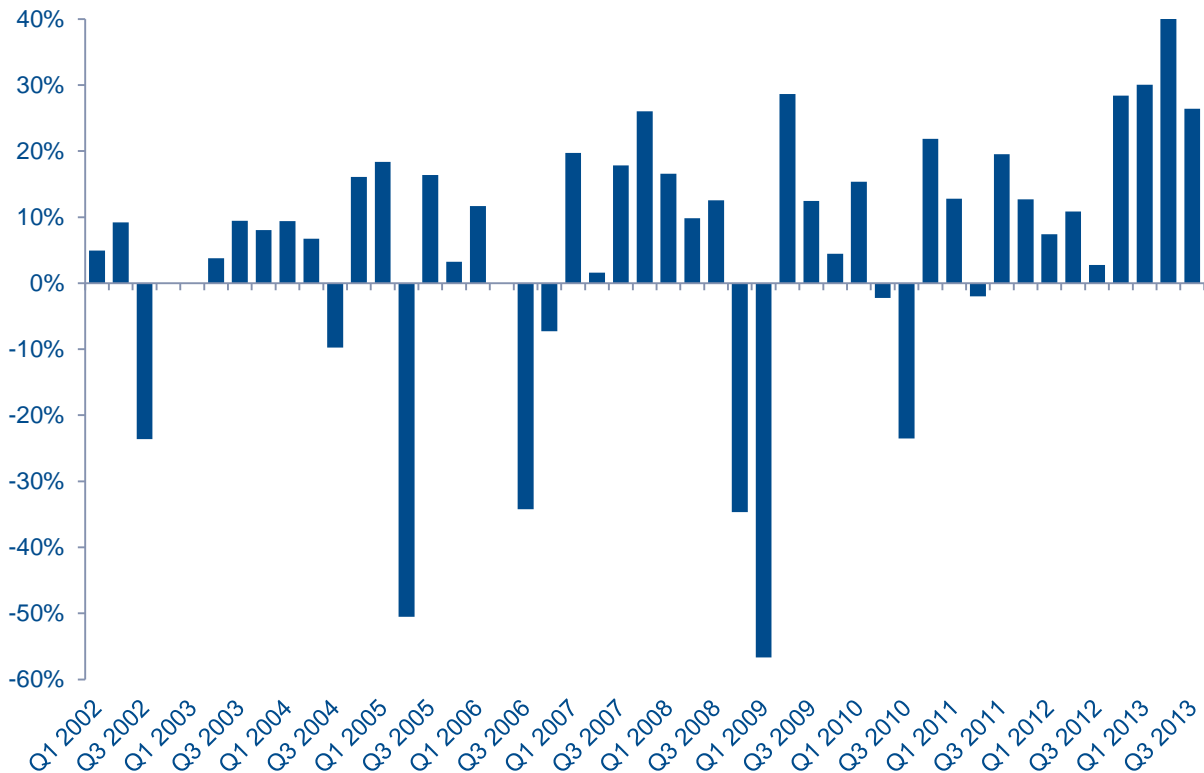


Source: Lipper FundFile, data 30 September 2013



This narrower universe, not surprisingly, boosts the proportion of equity flows to smaller companies funds. Indeed the proportion of flows over the past four quarters, when analysed on this basis, are at unprecedented levels. The proportion ranges from 26% to 40% in each of the past four quarters, underlining the view that this may not be a temporary move.

Proportion of equity fund flows into comparable small cap funds



Source: Lipper FundFile, data 30 September 2013

This data should not be looked at in isolation. The rising proportion of flows to small cap funds partly reflects more modest inflows for European large cap funds than were seen before the financial crisis, most notably in 2005-2006. As (or perhaps *if*) the return to equities becomes more widespread, so this proportion is likely to fall back.

Irrespective of this, sales activity over the past twelve months clearly indicates that where investors have been willing to take on equity risk outside emerging markets, then smaller companies funds have been part of the equation in a way that has not been seen for at least twelve years (and probably longer). At the same time investors have been more cautious in increasing their core holdings – most notably in European large caps – in the midst of an uncertain market environment. What also emerges is a strong indication of investors' willingness to

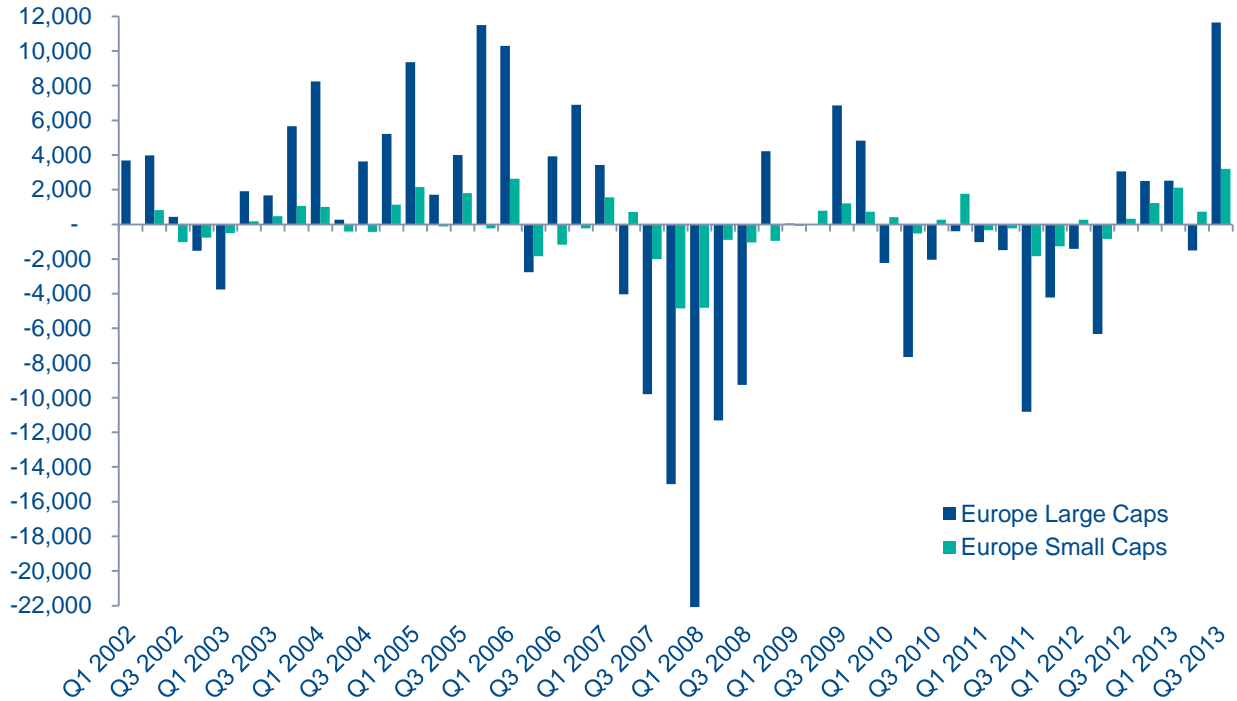
invest in small cap managers pre-empting a wider move into broad developed market asset classes.

European small cap flows

Drilling down further, this analysis can also be used to compare the flows into European large cap funds versus small cap funds (including both pan-European and Europe ex-UK funds). This approach underlines the point that has just been made: inflows to European equities remain below the levels seen for much of the period preceding the financial crisis.

At the same time, as with the wider small cap data, absolute sales volumes for European small cap funds are at or near all-time highs. European small cap flows for the latest quarter reached an all-time high of €3.2bn – above €2bn for only the fourth time on record.

Relative flows into European Large Cap and European Small Cap funds (€ million)



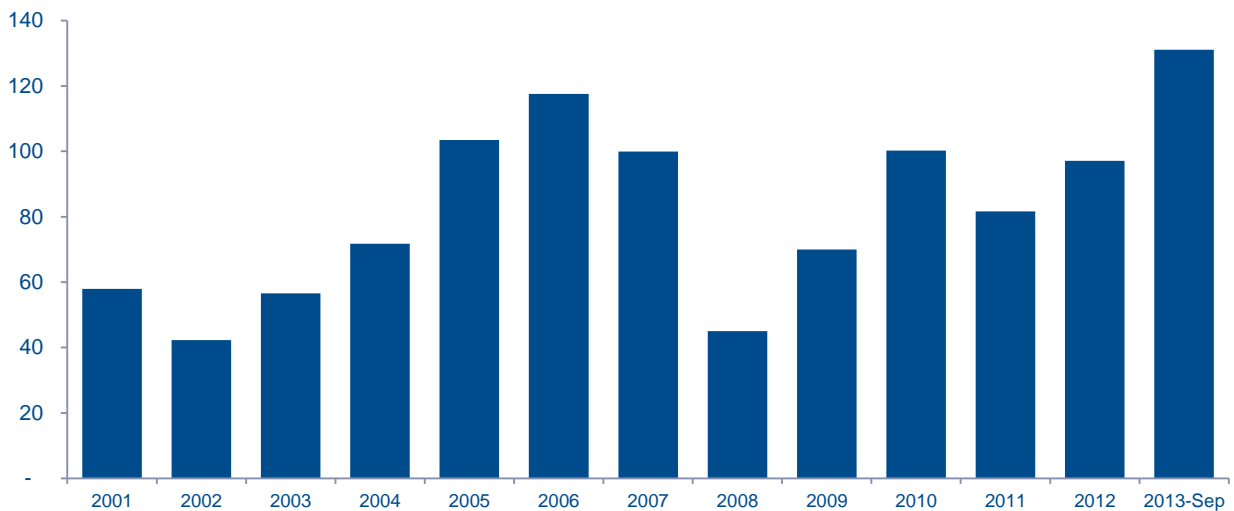
Source: Lipper FundFile, data 30 September 2013

Small cap fund assets

Total net assets invested in smaller companies funds stand at €131.1bn. This represents 31% growth since the end of 2010 (€100.3bn), but a staggering 191% growth since the

low-point (€45bn) at the end of 2008 (using annual figures). The data used for this report starts at the end of 2001, when small cap assets stood at €58bn, since when assets have more than doubled, with a compound annual growth rate of 7.7% to reach the current near-record high.

Small cap funds' historical assets under management (€ billion)



Source: Lipper FundFile, data 30 September 2013



Setting this into context, all equity funds, regardless of market capitalisation, now stand at €2,303.8bn. For this significantly larger universe, it is not surprising to find that growth rates have been lower. Assets stood at €1,185.5bn at the end of 2001, so these funds have recorded a compound annual growth rate of 5.7%. Assets at the end of 2008 bottomed out at €1,146.7bn.

From this, one can see that small cap assets now represent 5.7% of the equity total. This is not yet an all-time high, as the proportion was 5.8% at the end of 2005. The more rapid growth rate for smaller

companies funds since the financial crisis has also meant a rise in this proportion, which stood at just 3.9% at the end of 2008.

These proportions also serve to underline that small cap funds are still far from representing a bubble.

Small cap proportion of equity assets

If one again refers to the selected universe of equity sectors to create more like-with-like comparisons, the small cap proportion of this total (7.7% in September 2013) has just nudged above the 2005 high (7.4%).

Small cap proportion of equity funds' assets under management



Source: Lipper FundFile, data 30 September 2013

An historical perspective reveals that a typical investor's equity allocation to smaller companies funds has varied between just below 4% to just below 6% over the full period under review. However, due to where the vast majority of small cap funds invest, it is probably more useful to say that a typical investor's developed equity allocation to smaller companies has varied between 5.2% and 7.7%.

These 'typical' allocations certainly provide food for thought for fund investors – particularly those investing in actively managed products (as analysis below further illuminates).

If the comparison is further filtered to look solely at European equities (both large and small cap), then smaller companies now represent 11.6% of the total. The equivalent figure at the end of 2005 was 9.3%. As with sales flows, the boost in this proportion since the financial crisis (the year-end low was 6.8% in 2008) also reflects the much slower growth in assets for European large cap funds.

Small cap equity fund assets as a whole are approaching the record high of €132.5bn (reached in May 2007), although

European small caps in isolation are further from their previous high water mark, currently standing at €40.6bn, compared with €52.5bn achieved in May 2007. As appetite for European equities continues to return, this figure can be expected to rise, even if the small cap slice of the European equities pie may shrink in percentage terms.

Active v Passive

Within the universe of smaller companies funds, the proportion of passively managed funds (both ETFs and index tracking mutual funds) has slowly been rising. At the end of 2001 just 0.3% of small cap assets sat in passive funds. Today passively managed assets stand at €9.3bn, representing 7.1% of the small cap universe.

Importantly the real growth in passive small cap strategies came in 2009 and 2010 – slightly later than in other parts of the passive arena. One can see that small cap passively managed assets have increased sixfold since the end of 2008. Having said this, the rise in assets for these funds since 2010 is a more manageable 40%.

With the impact of passively managed small cap funds far smaller than in other parts of the industry, these findings would suggest that investors have generally been convinced that small caps are an area where active managers can really add value.

This has been elucidated in academic work such as Eugene Fama and Kenneth French's 'The Cross-Section of Expected Stock Returns' (Journal of Finance, June 1992). This is all the more appropriate when Fama has been jointly awarded the Nobel Prize in Economic Sciences this year.

Performance v Sales

In order to link investor demand to market cycles it is interesting to pull together fund flows and index returns. To create like-with-like comparisons this section of the report looks solely at European equities. Quarterly data on fund flows for European large cap funds and European small-cap funds was compared with MSCI Europe and MSCI Europe Small Cap indices (with net dividends reinvested).

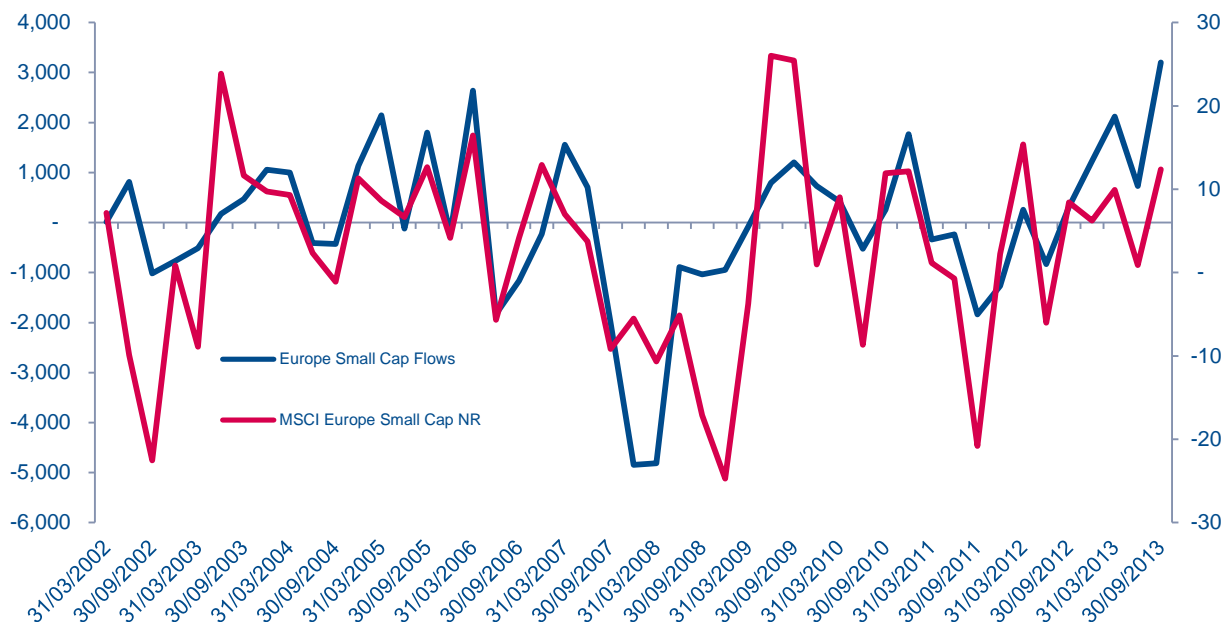
There is no correlation between fund flows and cumulative index returns over the full period assessed (2002 to Q3-2013, in line with the full history of fund flows available). But when looking at discrete (rather than cumulative) quarterly index movements then a moderately strong correlation begins to emerge (0.60 for small caps and 0.46 for large caps).

Dividing the full history into three periods where markets moved broadly upwards (2003 to 2007 and 2009 to 2013) or downwards (2007 to 2009) sheds more light on this. The correlation is stronger in rising markets and weak in falling markets. The strongest period of correlation is over the past five years (0.65 for small caps and also for large caps).

This suggests that strategic inflows are not related to longer-term index movements, whereas tactical inflows – or perhaps the timing of a strategic investment – clearly look to be influenced by recent stock market activity. However if one takes these findings as one part of the wider analysis built up through this report, then one can reasonably infer that recent inflows are not simply the result of a tactical move, but part of a longer term trend.

Please remember, past performance is not a guide to future performance.

European Small Cap fund flows (€m) compared to MSCI Europe Small Cap index (%)



Source: Lipper FundFile, data 30 September 2013

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