Size Doesn't Matter (Very Much)

The biggest company by London-listed market value in our UK equity portfolios is Diageo, with a current capitalisation of £46bn. Although this is a major company by any standards, it ranks only 12th largest in the FT All-Share Index and is dwarfed by other giant constituents, such as Royal Dutch, £156bn or HSBC, £115bn. Diageo seems even smaller from a global perspective, barely making it into the top 75 members of the MSCI World Equity Index by market value.

We acknowledge, therefore, that whatever else our UK strategy is, it is not a means to get exposure to UK or global "mega-caps". By extension, we also acknowledge that in the circumstances of a prolonged period of outperformance by sectors dominated by such big boys we could lag. We're thinking here of Oil, Banks, Telecommunications, Mining, Utilities and, most topically, Pharmaceuticals. The fact is we currently have zero exposure to these sectors, which combined account for over half of the value of the UK stock market.

By corollary it must be true that given we are so underweighted in mega-caps, we must also be overweight to mid and small-caps, even though we do not think about portfolio construction in this way. UK market followers know that mid and small have been at the vanguard of the rally of the last couple of years and it could be that, willy-nilly, we have been beneficiaries of this investor preference. We agree this could be so and, indeed, have been writing and briefing our investors about this as a possible trigger for underperformance from our strategy.

However, there are two mitigating circumstances that we believe it is important to convey to our investors. First, as regards this exposure to mid and small caps we claim we are exposed to different kinds of companies and for different reasons than for many holders of this type. What we mean is that many portfolio investors make tactical switches in and out of market capitalisation bands when they want to capture anticipated changes in economic activity or changes in other investors' risk tolerance. In short, people tend to buy mid and small caps when they believe economic activity is likely to pick up or when they expect "concept" or sometimes speculative "growth" stocks will be bid up. At other times tactical capital tends to move back into mega-caps when investors worry about economic slowdown, or in the aftermath of the popping of a speculative bubble.

Although what we have described above is a perfectly valid way of approaching the investment challenge, it is the antithesis of what we do. In particular we do not own any mid or small caps for their purported leverage to an economic cycle. For instance, in addition to the list of mega-cap sectors to which we have no exposure, we have never had any investments in – Autos Parts, Building Materials, Chemicals, Construction, Electronics, Forestry & Paper, General Retail, House Builders and many other cyclical sectors. The closest to such that we do own are the regional brewers, notably Greene King and Young & Co – however in our eyes they are the exception that proves the rule, because their appeal to us is precisely that their business is not affected, or not affected much, by the rise and fall of consumer confidence in the UK. The resilience of their revenue through the recent recession confirms that it takes a great deal to discourage the average Brit from his or her "affordable treat" at a well-maintained community pub.

Next - if we don't own much mega-cap and we don't own any mid-cap plays on the economic cycle we know we've begged the obvious questions - What do we actually own and why? I'm going to answer this in a specific and deliberately slightly simplistic way, which I hope will explain our view on the relevance of market capitalisation as a factor in strategic stock selection. In our UK Equity Fund* we own:

World's #1 Emerging Market FMCG Company (Unilever)

World's #1 Spirits and Dark Beer Company (Diageo)

World's #1 International Beer Brand (Heineken)

World's #1 Educational Publisher (Pearson)

World's #2 Index Service Provider (LSE, post Russell)

World's #1 Scientific Publisher (Reed Elsevier)

World's #1 Online Newspaper (MailOnline)

World's #1 Trading and Investment Infrastructure Software Provider (Fidessa)

World's #5 Most Valuable Luxury Fashion Brand (Burberry, according to Interbrand survey)

World's #1 Chocolate Company (Mondelez)

World's #1 Business Information Provider (Thomson Reuters)

World Leading Independent Investment and Industry Analysis Periodicals- Bank Credit Analyst, Metal Bulletin (Euromoney)

In addition we own:

UK's #1 Asset Management Company (Schroders, by market capitalisation)

UK's #1 Accounting Software Provider (Sage, with valuable European/US position too)

UK's #1 Investment Services Platform (Hargreaves Lansdown)

UK's #1 Independent Private Wealth Manager (Rathbone, by market capitalisation)

UK leading pub-owners/beer brewers, including #1 Cask Ale, #1 Premium Cask Ale (Greene King, Fullers, Young & Co)

Scotland's #1 Soft Drink (IRN-BRU)

Scotland's #1 Football Club (Celtic, by market capitalisation only, I hasten to add)

USA's #3 Soft Drinks Company (Dr Pepper)

USA leading food manufacturer – 98% household penetration (Kraft)

What we're conveying here can be summarised as "size doesn't matter" – that much. In our opinion our portfolio comprises a collection of exceptional brands and franchises, many so at global level, or if not, strong regional or national champions. What is attractive about them has nothing to do with their market capitalisations. Many of them could be described as small companies, certainly by global standards – but that does not mean that they are not dominant in their own way. So, Pearson is not as big as Apple, in fact it is only 1/36th of the size. Yet, arguably, Apple needs Pearson more than vice versa in order to achieve their separate ambitions in EdTech. Burberry is Interbrand's 77th most valuable global brand and, by the way, one of only five UK-listed or owned brands in the 2013 global top 100 (and two of those five belong to one company – Diageo). Meanwhile, Louis Vuitton is Interbrand's 17th most valuable. But so what? Burberry is better at being Burberry than Vuitton could ever be. The British company can never aspire to that timeless French chic, but Burberry too is a unique icon with its Britpop cool. Domestically Young & Co may never be as big as Mitchells & Butlers, but M&B can never own the Marquess of Anglesey in Covent Garden or the White Cross at Richmond, because they are one-of-a-kind assets and Young & Co owns the freeholds.

Biggest is not necessarily best.

Mind you, with $2.1 trillion of mergers and acquisitions announced so far in 2014, up 77% by value on 2013, it is clear that corporations around the world recognise that an important way to respond to the threats and opportunities thrown up by both globalisation and disruptive digital technology is to consolidate, for scale benefits and synergy. We expect this process is only just getting going – after all, even after this year's big uplift, deal volumes and values are only half those of the last peak, in 2007. What's also important in 2014 is the average premium paid on this year's deals is 24%, suggesting that stock markets still offer good value for companies and investors looking to lock into strategic upside.

A final point of clarification and, for some, possible comfort. The qualifying market capitalisation for FTSE 100 status is c£3.5bn. On this basis some 83% by value of our UK fund is capitalised at this level or higher. This is not a small-cap strategy.

Nick Train
Lindsell Train

**All classifications according to Lindsell Train analysis.*

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