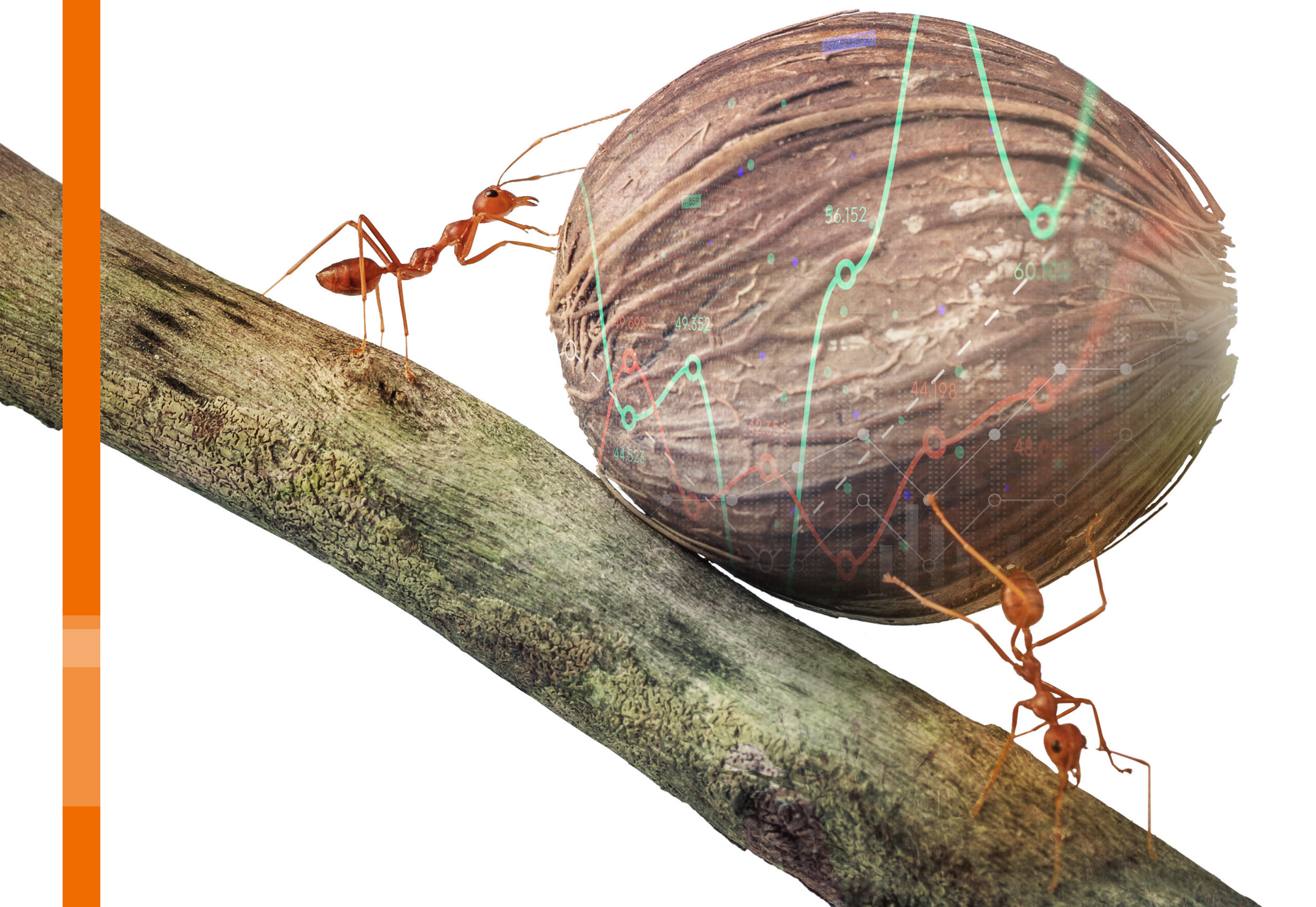
WHITE PAPER

EXPLORING BIG OPPORTUNITIES IN SMALL-CAP STOCKS



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EXPLORING BIG OPPORTUNITIES IN SMALL-CAP STOCKS

The **Henderson Smaller Companies Investment Trust** has an enviable track record – it has outperformed its benchmark in 16 of the last 18 years, and 2021 marks the 18th consecutive year that the Trust has increased its total dividends. However, it hasn't been an easy ride, with several events sparking record drawdowns in the UK equity market over past decade. Meanwhile, the debate over small-cap versus large-cap stocks has raged on underneath the surface. This paper will explore the pros and cons of investing in small-to-mid-cap stocks and how the Henderson Smaller Companies Investment Trust's approach has enabled it to generate exceptional long-term returns within the small cap space.

During the past decade, we've seen the digital world blossom, opening up exciting growth opportunities – the development of artificial intelligence, the internet of things, and digital automation have touched virtually all sectors in a meaningful way, from healthcare and education through to transportation. Consumers and businesses have become increasingly comfortable with transacting through web-based platforms. Along with this digital revolution, certain technology companies have enjoyed explosive growth.

Nevertheless, there's certainly been plenty of volatility for investors to endure. A decade of market turbulence began with the 2011 eurozone sovereign debt crisis, which saw Greece relegated to emerging market status. The bailouts that followed to soothe heightened European political and economic instability created angst among many leading EU members. Indirectly at least, this may have led to the UK's momentous decision to leave the EU - another stormy landmark for financial markets. Across the pond, US politics loomed large, with the highly controversial Donald Trump presidency leading to some of the most unusual moments in modern US political history. While all this has unfolded, we've seen China become increasingly powerful as a force to rival the US, and with their bilateral relationship becoming much more adversarial, particularly on the trade front. Finally, the coronavirus pandemic has capped off a turbulent decade, with the initial economic shock caused by lockdowns/ restrictions prompting an unprecedented level of global monetary and fiscal stimulus, which has easily eclipsed that offered in response to the Great financial crisis of 2008. On a more positive note, vaccines have enabled countries to reopen, and companies continue to benefit from the slow release of pent-up consumer demand. However, COVID-19 variants, inflation, supply chain issues and central bank tapering have muddied the outlook for markets, feeding through into bouts of volatility for capital markets.

Against this backdrop, the underlying debate among investors between the pros and cons of large-cap and small-cap stocks has raged on. Historically, large-cap stocks have been favoured for their stability – though offering lower growth – whilst smaller companies have been perceived as having higher risk but with more attractive growth prospects. Typically, investors attracted to large-cap stocks look for consistent dividend payers, with at least some growth prospects and the financial resilience to get through the more difficult points in the business cycle and times of crisis. But many small-cap stocks can also get through recessions and the most challenging of times: such firms have the potential to achieve higher revenue/earnings growth versus large caps over time. So there are certainly substantial rewards to be had if one can get stock selection right within the small-cap space.

THE SMID-CAP STORY

Smid-cap stocks – companies with small or mid-sized capitalisations – tend to be more nimble than their large-cap counterparts and can offer greater growth potential. Naturally more adaptable to change, smid-caps are often better placed to quickly take advantage of emerging trends and events. With their more entrepreneurial culture and flexibility, smid-caps are generally well placed to prosper when economies are expanding, regularly eclipsing their large-cap counterparts. As a group, however, there's usually less room for execution errors as smid caps have smaller financial bases compared with the big blue chips. It's generally accepted that as a group, smid-caps tend to be comparatively more vulnerable during recessions and times of crisis but individually, this doesn't need to be the case at all.

Having a smaller financial base means that smid-cap stocks, in general, can benefit much more from a lower interest rate environment. At present, the combination of economic growth and low-interest rates has been beneficial to many smid-cap stocks as they have been able to use cheaper funding to pursue more attractive growth opportunities. However, supply chain constraints, labour shortages and higher input costs are some of the key challenges that small and large companies alike have had to navigate. Larger companies can usually absorb higher costs more easily due to economies of scale. But quality growth businesses in general, including smaller companies, tend to be well-positioned to pass on rising costs to their customers. This has been particularly true for small companies that offer a strong/unique service or product during the pandemic amidst higher input costs.

Diversification, a term often associated with large-cap stocks, is also possible when investing in UK smaller companies: the industrials, consumer discretionary and technology sectors of the Numis Smaller Companies Index have much larger weightings versus the FTSE 100. Given smaller companies' skew towards higher growth, the sector biases are also to some extent reflective of those industries with higher growth potential. As such, sectors such as health care, energy, and basic materials make up a much smaller proportion of smid-cap stocks versus large-caps as these areas tend to be dominated by the bigger companies. Meanwhile, tobacco, a sector that has generally been in significant long-term decline as fewer people smoke, is not represented at all in the UK smaller companies' universe.

Along with these common traits, due to the lack of broker coverage, market inefficiency is greater in the small-cap space. Information about small-cap stocks is harder to find compared to large-cap stocks. Analysts typically give little attention to these companies; thus, there is a high probability of improper pricing of small-cap stocks. This situation creates vast opportunities for investors to leverage the inefficiencies in market pricing and earn a great return on their investments.

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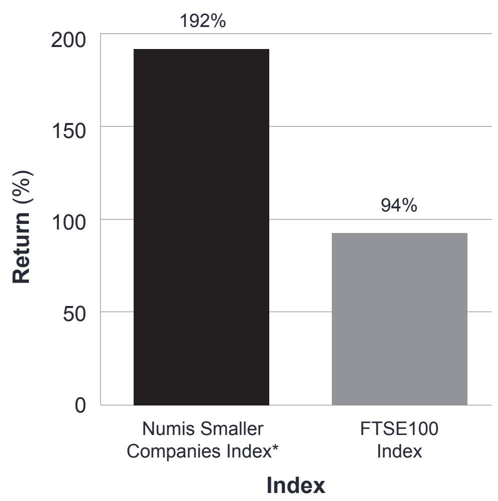
LEADING THE CHARGE

UK small-cap stocks have dramatically outperformed large-cap stocks over the past decade. For example, a return of 175% for the Numis Smaller Companies Index over the ten years through to November is twice the return of the FTSE 100 index. The past decade has naturally benefited small-cap stocks in general as interest rates have remained extremely low. At the same time, the macroeconomic picture has been mixed, with the unprecedented plunge in economic activity experienced in 2020 at the onset of the coronavirus crisis a case in point.

UK SMALL-CAP VS LARGE-CAP



Source: Bloomberg, data on a total return basis for the ten years to 31 December 2021
*Numis Smaller Companies Index (excluding investment trusts capital gains)

Many smaller companies have achieved faster organic growth and higher operational leverage over time versus their large-cap counterparts. The more entrepreneurial spirit of management teams within smaller companies has enabled them to achieve higher margins through lower variable costs by focusing on market niches, offering new technologies and services. As a result, smaller firms as disruptive innovators can sometimes become the large companies of tomorrow, as they compound faster organic growth over time. For instance, in 2020, the once mid-cap alternative finance provider and asset manager Intermediate Capital elevated to the FTSE 100 – a company that was the Trust's top holding in 2019 and 2020. Intermediate Capital has distinguished itself as a leading provider of mezzanine finance to leverage buyout markets. It also owns a highly successful mezzanine, property lending and credit fund management operation. The asset manager's portfolio of investments has performed well, but the primary growth engine of the business has proved to be the fund management operation. This division has enjoyed real success in asset gathering due to the strength of its performance track record, the quality of the team and underlying demand for its product in an income-hungry world.

Some smaller firms have also successfully grown over time by employing their own mergers and acquisitions (M&A) strategy to selectively buy attractive targets with high growth characteristics. Others become targets of M&A activity themselves as their larger contemporaries, or the venture capital players have sought to boost their own long-term growth prospects through acquisition. There's been particularly heightened takeover activity in the UK smid-cap space during the past year, partly helped by the removal of Brexit uncertainty, as global corporates and investors have sought out higher growth prospects.

Brexit and Covid-19 conspired to create risk-off sentiment against UK assets in general. However, the gradual fading of these headwinds has left behind some attractively priced opportunities in the UK equity market versus developed peers, providing a catalyst for private equity and M&A activity in the UK. As a result, several takeover bids have been received: for AA, the roadside assistance and insurance group, from Towerbrook and Warburg Pincus; for Codemasters, the video games company, from Electronic Arts; for GoCo, a price comparison website, from Future; for John Laing, an infrastructure investor, from KKR; for SDL, a language services group, from RWS; for Sanne, an alternative assets fund administrator, from Apex; for Urban & Civic, an urban regeneration business, from Wellcome Trust; and for Vectura, a medical device development company, from Carlyle.

Of course, where there are higher returns to be had, there's more risk on the table. While smid-cap stocks are generally riskier than large-caps, the **Henderson Smaller Companies Investment Trust**, managed by **Neil Hermon**, aims to mitigate this trait through deep fundamental research and providing diversification through a broad range of companies and sectors.

A DISCIPLINED AND CONSISTENT INVESTMENT APPROACH

Neil and his team take a long-term approach when selecting investments, targeting quality growth companies, but only investing at a reasonable price. The guiding philosophy for the team is that smaller companies can deliver superior returns over the long term versus the broader market. The team believe that smid-cap stocks have an implicit advantage over large-caps, benefiting from several factors: faster organic growth, higher operational leverage, entrepreneurial management, sources of new technologies and services as well as M&A activity. Along with these factors, the limited broker coverage enables the team to delve deep into the fundamentals of the somewhat overlooked smid-cap cohort to uncover opportunities that will generate solid returns.

At the centre of idea generation for Janus Henderson's UK Small and Mid-cap Equity team is the GARP (growth at a reasonable price) approach to investing. Bottom-up stock selection is based on the team's long-standing 4Ms process[1], combined with a valuation overlay. The process is backed by fundamental, qualitative analysis and engagement with management teams, with the aim of gaining a deep and clear understanding of individual companies and the markets within which they operate. Together with this, the team's strong valuation discipline draws on a broad range of investment techniques.

FOUR Ms

	Buy criteria	Sell criteria
Model	Enduring francise, competitive advantage. For companies with weaker models, there may still be opportunities to invest for a period of superior growth.	Undersirable changes in company strategy.
Management	Structure, strategy, key individuals' motivation, vision, ownership, governance, consistency and record.	Changes in management, directors selling.
Money	Financial structure, balance sheet, cashflow, ability to be self-financing.	Deteriorating financials - eg, insignificant cash flow.
Momentum	Positive earnings surprises, business momentum can be maintained longer than the market discounts.	Negative earnings surprises or earnings downgrades.

[1] Source: Henderson Smaller Companies Investment Trust: A decade of outperformance, as at August 2021

Evaluating companies through the '**4Ms**' process: the team analyses the quality of a given firm's business 'Model' and its 'Management', how it makes and uses 'Money', and the 'Momentum' of earnings reported to investors. When it comes to the business **Model**, the team looks for evidence of an enduring franchise and factors that provide a competitive advantage. From a **Management** perspective, the team analyses and assesses the management team's strength, quality, structure, motivation, and vision. When looking at **Money**, the team dissects the firm's financial structure and balance sheet - it's vital that companies have the ability to weather challenging economic conditions. In addition, the team look at cash flow strength and the ability of a company to self-finance. Finally, the team considers **Momentum**, analysing data such as positive earnings surprises and how business momentum can be maintained longer than the market discounts.

CONVICTION TO RUN THE WINNERS

Stock	Tenure	Return (share price total return)
RWS	+15 years	+798%
Howden	+10 years	+930%

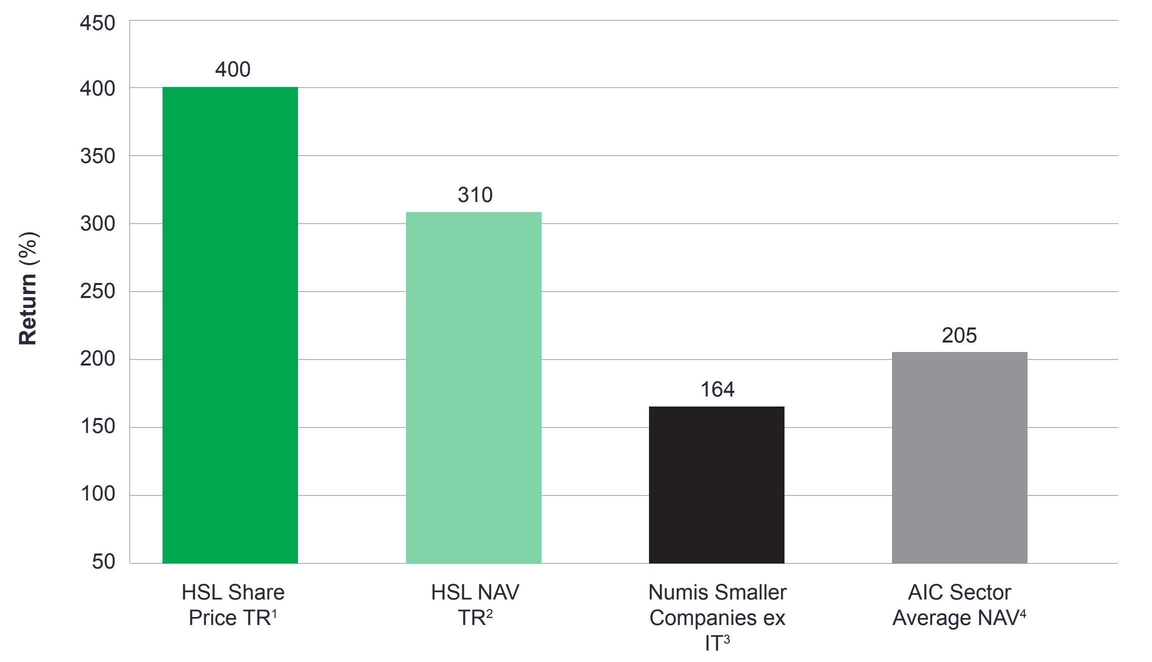
Source: Bloomberg, share price total return, 30/12/2011 to 30/11/2021

The Trust's bottom-up stock selection process and long-term approach results in a relatively long average holding period for stocks in the portfolio, at over five years. Indeed, 19 stocks in the Trust's portfolio have been held for over 10 years, including the likes kitchen supplier Howden and intellectual property and translation provider RWS. These are also some of the best-performing stocks in the portfolio (see table above[2]) – a testament to the Teams approach to running their winners. RWS, for instance, has particular strengths in intellectual property, life sciences and technology. Moreover, the company has demonstrated long-term sustainable growth through acombination of organic and acquisitive expansion, as evidenced recently by its acquisition of translation-services rival SDL.

[2] Source: Bloomberg, share price total return, 30/12/2011 to 30/11/2021

While smaller companies have significantly outperformed large-cap over the past decade, the Trust's outperformance versus its small-cap benchmark speaks for itself, highlighting that effective active management is essential when it comes to investing and generating solid returns within the small-cap space. It makes sense to target robust businesses that can weather the storms and can prosper in good times to generate attractive and consistent returns. It is a strategy that has paid off handsomely. The Trust has returned 467% (share price total return) in the decade through to November 2021, versus 200% from the Numis Smaller Companies Index. This compares to an 85% return for the FTSE 100, 98% for the FTSE 250 and 211% for the Euro Stoxx Small.[3] The Trust has outperformed the Numis Smaller Companies Index benchmark in 16 out of the past 18 financial years. In addition, the Trust has grown its dividends year-on-year for nearly two decades.

STELLAR OUTPERFORMANCE
TOTAL RETURN PERFORMANCE TO 31 MAY 2021



Note: Data on a total return basis for the ten years to 31 May 2021. Past performance is no guife to future returns

Source: Bloomberg, data on a total return basis for the ten years to 31 December 2021
Past performance is no guide to future returns

[3] Source: Bloomberg, data on a total return basis for the ten years to 31 December 2021

STAYING THE COURSE

While the past decade has undoubtedly been fraught with volatility and some testing events, it's certainly been a rewarding one for small-cap investors and a particularly successful one for the Henderson Smaller Companies Investment Trust. In short, the Trust's disciplined approach to bottom-up stock picking has allowed it to continue an impressive run of solid performance, tuning out the background macro noise as the team targets stocks with excellent fundamentals that can grow strongly over the long term.

Smaller companies tend to have some advantages over large-cap stocks, but this doesn't mean that all smid-stocks will be a good investment: smaller companies can be riskier and more volatile. But this is precisely why Neil and his team stick to their tried and test investment process. Though volatility remains in the market, the outlook for smid-cap stocks remains bright, with earnings supported by the slow release of pent-up consumer demand. Coronavirus variants and higher inflation pose risks, but monetary policy should remain accommodative for some time to come. Although central banks have begun to wind down their quantitative easing policies, interest rates are unlikely to rise significantly – leaving smaller companies well placed to continue benefiting from a historically low interest rate environment. Neil and his team will remain steadfast in their approach – utilising a rigorous investment process to find companies within the smid-cap space that can grow over time, with the ability to ride out the challenging times, as well as being able to prosper when the economy is expanding rapidly.

Annual Performance (cum income) (%)

Discrete year performance % change (updated quarterly)	Share Price	Nav
30/09/2020 to 30/09/2021	66.1	56.3
30/09/2019 to 30/09/2020	-10.6	-4.0
28/09/2018 to 20/09/2019	-2.9	-5.2
29/09/2017 to 28/09/2018	18.4	10.6
30/09/2016 to 29/09/2017	23.6	26.2

All performance, cumulative growth and annual growth data is sourced from Morningstar

GLOSSARY

Fiscal policy
Government policy relating to setting tax rates and spending levels. It is separate from monetary policy, which is typically set by a central bank. Fiscal austerity refers to raising taxes and/or cutting spending in an attempt to reduce government debt. Fiscal expansion (or 'stimulus') refers to an increase in government spending and/or a reduction in taxes.

Fundamental analysis
The analysis of information that contributes to the valuation of a security, such as a company's earnings or the evaluation of its management team, as well as wider economic factors. This contrasts with technical analysis, which is centred on idiosyncrasies within financial markets, such as detecting seasonal patterns.

Inflation
The rate at which the prices of goods and services are rising in an economy. The CPI and RPI are two common measures.

Monetary policy
The policies of a central bank, aimed at influencing the level of inflation and growth in an economy. It includes controlling interest rates and the supply of money. Monetary stimulus refers to a central bank increasing the supply of money and lowering borrowing costs. Monetary tightening refers to central bank activity aimed at curbing inflation and slowing down growth in the economy by raising interest rates and reducing the supply of money.

Private equity
Investment into a company that is not listed on a stock exchange. Like infrastructure investing, it tends to involve investors committing large amounts of money for long periods of time.

Volatility
The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

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