FORAGING AMONG THE SMALL AND MID CAPITALISATIONS

Higher earnings growth expectations, the recovery in M&A activity and disparate economic growth within the EU point to a favourable year

Guided architecture is allowing organisations to partner with investment experts that can offer specialist knowledge on specific asset classes. New developments, for example in the areas of risk management or compliance, require significant investments in systems and professional staff to ensure that the high quality of current investment solutions offered to clients is preserved. The same sort of resources and infrastructure are also key preconditions of the development of new, innovative products. Over the past few years, the asset management business has been characterised by a relentless push for new excellence in all areas of investment management.

‘Mid and small caps are an attractive hunting ground for stock pickers and alpha seekers’

Catherine Guinefort, BNP Paribas Asset Management

Last year was supposed to be, according to the sceptics, the year when large-cap returns would have outperformed small and mid caps. But small and mid capitalisations have continued their rally for the fourth consecutive year, outperforming their large-cap counterparts by 11 per cent.

A stable macroeconomic outlook suggests that both large caps and small caps should do well in 2005. Therefore, more emphasis should be placed on stock selection. We consider stock selection as the key to successful investing. Mid and small caps are an attractive hunting ground for stock pickers and alpha seekers. An active portfolio manager in these segments can offer a higher return, compared with both large-cap managers and mid and small cap indices.

We identify three themes that could underpin mid-cap returns in 2005. First, mid caps have higher earnings growth expectations than their large-cap counterparts. Second, the recovery in M&A activity should favour medium-sized companies as attractive potential targets. Lastly, the weak dollar and the disparity between economic growth within European countries favour more domestic-oriented companies, mostly found in the small and mid-cap segments.

» Attractive fundamentals despite less compelling valuations

In a market environment where organic growth is becoming scarce, the small and mid cap universes will continue to be a “reservoir” of growth companies. Mid and small cap investors have sufficient scope to cherry pick the successful growth stories, and to find small and mid caps that will become the blue chips of tomorrow.

One aspect that is not fully taken into account is the nature of mid-cap business models, which are usually straightforward and easy to understand, hence enabling better anticipation of earnings trends. Medium-sized companies are usually either operating in their domestic markets or in international niche segments. Thus, it is possible to avoid companies where the business drivers are opaque, such as conglomerates or companies that have to deal with ongoing restructuring costs.

In spite of this, many investors are nervous concerning the outlook of this equity class mainly due to its recent good performance and stretched valuations. Historically, mid-caps valuations are close to a traditional 10-20 per cent valuation discount compared with

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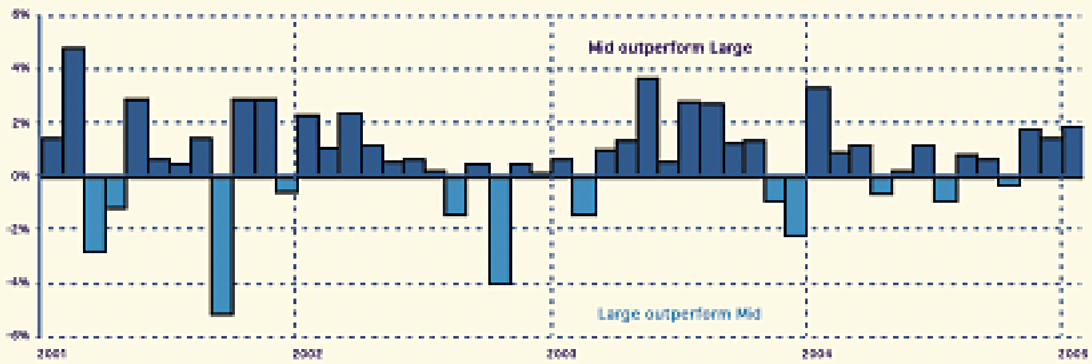
Small and mid caps have continued their rally for the fourth consecutive year



Source: IBES, DJ Stoxx Large, DJ Stoxx Mid, BNP Paribas asset Management

large caps. But, we consider that well selected mid-cap strategies should be underpinned by higher earnings growth into 2005.

Chart 2 below compares the 12-month forward fundamental ratios of the mid and large-cap universes. In terms of P/E there are no more discounts in favour of mid caps and it seems to be hard to believe that mid caps P/E can expand further. But the 12-month forward earnings growth is higher for mid caps and it should bolster performance in 2005.

In addition, we believe that over time the market will more accurately price the earnings and cash flow growth of a company irrespective of its size. The current premium may last longer than most market participants expect.

» Mid caps an attractive breeding ground for M&A activity

After a year of little to no investment, restructuring balance sheets, falling interest rate costs and finally, improvements in profitability, companies have built high cash-flow reserves.

Therefore, given a record free cash flow yield of 6.6 per cent for the pan-European market, M&A activity is likely to accelerate. Companies with higher excess cash flows can either give it back to their shareholders via share buybacks (or dividend increases) or use it to takeover another company. Recently we have witnessed an increase in M&A activity within the mid-cap segment. Some of the companies that have received bids include: Aggregate Industries, Amadeus, Somerfield, Kidde and Warner Chilcott.

In 2004, M&A amounted to 3 per cent of the total market's capitalisation, a gradual recovery from the trough levels seen two years ago.

We should expect more companies to be subject to M&A bids for the foreseeable future. In an environment of weak top-line growth, rising raw material prices, cheap cost of funding and a lack of pricing power, we expect a pick up in acquisitions particularly among the unconsolidated sectors (such as banks) and the small and mid cap segments. It is an ideal alternative for companies that have difficulty growing organically.

» Countries matter more

Recently the country effect has become more important in terms of performance contribution rising from a low of 9 per cent back in May 2003 to 16 per cent currently. In Europe, there has been a wide spread of returns over 2004, with Austria up 41 per cent and, at the other extreme, Switzerland increasing just 2 per cent. The difference in local growth and real rates are likely to make the divergence wider rather than narrower.

In addition, the mid and small-cap segments are huge beneficiaries of the euro's strength. The performance of this asset class has accelerated during Q4 2004 following the further decline of the US dollar. This is not sur-

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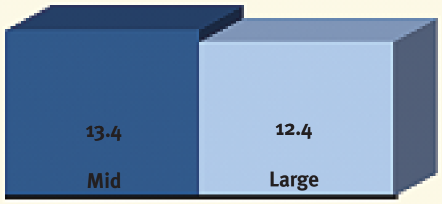
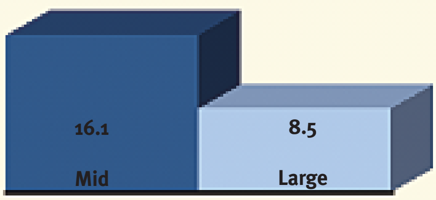
Price to earnings ratio



EPS growth estimates 2004-2005



Source: IBES, DJ Stoxx Large, DJ Stoxx Mid, BNP Paribas asset Management prising as the bulk of their earnings are domestic.

This makes it worthwhile to look at countries across Europe when assessing medium size companies. We believe that a country approach allows for a better analysis, as local expertise allows for a stronger understanding of domestic trends and of niche markets.

Advantage of the asset class

Mid and small caps are a crucial alpha generator and source of growth stocks. These asset classes provide access to niche growth themes, such as dental implants in medical equipment, stamping machines, mobile phones and construction.

Another justification for investing in mid and small caps is that the market is less efficient than that of the large caps. Fewer analysts cover mid caps and these stocks are also less widely held by portfolio managers.

Little difference exists between mid and small caps as they possess similar growth characteristics and P/E based valuations. Thus, we prefer mid caps where liquidity risk and standard deviation are lower compared with small caps.

We consider small and mid caps as a long-term investment both from a return enhancement and risk diversification perspective.

The approach

The market inefficiency that asset managers are trying to capture is primarily the discrepancy between the way a company is viewed by the market in the short term and the reality of the company's financial outlook for the medium and long term, which could be deduced through rational financial analysis. This discrepancy can lead to either an over or undervaluation of certain stocks, which fund managers aim to take advantage of when choosing stocks for client portfolios.

These distortions can be caused by several external factors. These include over reactions to the publication of short-term results, a short-term fad, an adverse shock on individual stocks or entire sectors and forced sales or programme trades caused by changes in the index or regulatory changes for certain participants within the market.

For certain stocks, the analysts/portfolio managers may have their own growth hypotheses which may vary considerably from market opinion and lead to radically different investment conclusions.

The reason that small and medium-sized caps are covered less by the financial market professionals is due to:

- Imperfect information available to all participants within the market.
- A lack of understanding of mid-cap businesses, which may either operate in a niche market or focus their strategy on their domestic market.
- Moreover, the move from mid-cap to large-cap status generates a significant revaluation (it increases trading volume particularly after inclusion within a major index).

BNP PAM believes that a systematic and disciplined approach with a proven and structured process, based on proprietary research, can exploit information efficiently and identify quality, medium growth companies.

We believe that it is the individual characteristics of a company that represent its intrinsic value and thus are the primary driver of the stock's performance in the market. In addition, an integrated risk management system is crucial in order to build and monitor portfolios and produce strong risk-adjusted return.

This leads us to conclude that an active, bottom-up management with research focusing on the most attractive companies and an embedded risk control is the most appropriate investment philosophy to capture the excess return of the mid cap universe.

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CORPORATE STATEMENT

The Europe mid-cap product is managed by a team of three portfolio managers who have been working together for a long time. Catherine Guinefort initiated this strategy in 1994 and has managed it since inception. Damien Kohler joined her in 1997 and Dominique Dequidt in 2001. BNP Paribas Asset Management has €196.3bn of assets under management and is one of the leading players in European fund management. The asset management business employs over 1400 staff in 20 countries. Its fund management teams are active in all of the world's major financial markets, including Paris, London, New York, Tokyo and Hong Kong. They are specialised by asset class, investment style and geographical area.

BNP PARIBAS
ASSET MANAGEMENT

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