MAERKI BAUMANN & CO. AG

PRIVATBANK

Small or large companies?

Market Comment, November 2023

Since 2022, the stocks of small- and mid-cap companies have tended to lag behind the performance of those of their large-cap blue chip counterparts in many countries. This situation is nothing new and has already been observed in various countries in the past. A phase of weak economic performance accompanied by a marked rise in interest rates was experienced in Europe in 2018, with this also being the case more recently in 2022/23. The start of both 2018 and 2022 was characterised by a valuation difference between mid and small caps and their large-cap rivals. Should some of the factors described below change, small- and mid-cap companies have the potential to make up ground on large-cap stocks.

It came as a surprise to many investors last year that mid- and small-cap companies failed to outperform the market's large-cap stocks. Viewed over the long term, it is indeed true that smaller-cap companies usually perform better in relative terms. There can be various reasons for this. For example, smaller companies are often snapped up by financially stronger blue chips that are looking to increase their market share, tap into new business areas or expand their product range.

There are factors that can weigh on the performance of smaller-cap companies, especially in Europe. This was seen back in 2018 when interest rates spiked sharply owing to the monetary policy of the world's most important central bank, the US Federal Reserve (the Fed). The picture has been similar again since last year when the Fed hiked up interest rates far more significantly than had been expected by the market consensus. By historical standards, the hike in US key interest rates has been clearly record-breaking with respect to both the magnitude of the increases and the speed of their implementation, and this continues to be the case. This has thus led to corrections in the valuation of higher valued investments, with this being especially true for small- and mid-cap corporations. A global comparison also shows that at the beginning of 2018 and 2022 the valuation of small- and mid-cap companies was by no means low in terms of price/asset value ratio. However, some technology and communications companies in the US were markedly more expensive than other large caps with respect to their valuation. A similar picture could be observed using other valuation criteria.

> "Over the long term, small caps offer an interesting return, even if their beta is often higher than that of large caps."
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> Gérard Piasko, Chief Investment Officer

There are also other reasons why small and mid caps have put in a below-average performance since 2022 in a multi-year comparison. As smaller companies often cover fewer product areas in terms of numbers, they are less diversified and are thus hit many times harder by an economic slowdown such as the one experienced in Europe in 2022/23. In the event of a slowdown in economic growth, larger groups can at least partially offset the weakness exhibited by an individual product area with another.

Large, internationally active companies also benefit from greater regional diversification with respect to their income streams, meaning they can distribute their costs more efficiently at an international level. This can put such companies at a relative advantage in the event of significant currency fluctuations. While not always true, it is also more often the case that large-cap groups are active in more defensive sectors (e.g. the pharmaceutical industry in the SMI), with small-cap companies tending to operate in more cyclical segments such as the machine industry.

A further factor that has to be taken into account is general market sensitivity, which is also referred to as beta. Companies with a lower level of capitalisation typically exhibit a higher beta and are therefore often more volatile than large-cap blue chips during phases of considerable market volatility as seen in 2018 and 2022. Incidentally, this characteristic is related to the fundamental factors mentioned above.

However, a long-term historical comparison spanning many economic cycles reveals that the performance of smaller-cap companies is not necessarily inferior. In the period since 1995, for example, the majority of small-cap corporations around the world have largely outperformed large-cap companies.

As always, preference is ultimately also a question of risk appetite. While companies with a higher beta appear riskier, investments in these firms tend to generate a higher total return in the long run as a kind of reward for the greater level of risk taken on. This has been apparent in the performance of small-cap companies relative to their large-cap counterparts since 1995. Equities in general, too, have outperformed bonds over the long term despite the greater degree of risk they entail. Nevertheless, this doesn't mean that it will necessarily be the same in the short run. It is therefore important to know how much appetite investors have for taking on risk and what time horizon they have when investing.

Gérard Piasko

Gérard Piasko is Chief Investment Officer and head of the investment committee of private bank Maerki Baumann. Before he was for many years Chief Investment Officer of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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Maerki Baumann & Co. AG
Dreikönigstrasse 6, CH-8002 Zurich
T +41 44 286 25 25, info@maerki-baumann.ch
www.maerki-baumann.ch