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**After the strong outperformance seen by small-cap stocks in recent years, what are the prospects for the sector from here? This article examines where the market is now and the opportunities that continue to be found in the asset class.**

In terms of the broader market for European equities, these stocks still look attractive on valuation, and in the most recent reporting period we have continued to see strong company results.

Looking specifically at European small caps, their recent performance has left them trading on a current year PE which is slightly higher than their large-cap counterparts. While we generally consider it more profitable to buy small caps when they trade at a discount to large caps, the underlying fundamentals remain appealing for the asset class. For example, excluding financials, small cap 2011 earnings-per-share growth is still expected to significantly beat that of large caps.

So given a mixed macro-economic environment and the lack of a clear valuation differential, how should investors seek to benefit from small caps?

We continue to believe it is crucial to pursue a bottom-up strategy in building a European small cap portfolio. This plays to the strengths of our traditional stock-specific method of managing our funds. In short, we look for companies that have pricing power – this is the ability to protect margins and so continue to invest in the business and grow over time. We prefer companies that can do this whatever the domestic economic environment, but we also look for companies that benefit from expanding into ever more globalised markets.

To illustrate the company-specific factors that can play such a large role in performance, we give three examples of companies with strong business cases and prospects below.

Fielmann is the leading chain of opticians in Germany. The company has around 50% market share in terms of volumes and as it continues to grow its footprint of stores, so the group's pricing power increases. This helps keep down the prices of glasses and contact lenses for the consumer and so drives footfall to the stores. This virtuous circle has allowed the company to grow for many years and it should continue to do so.

French pharmaceuticals group Virbac enjoys a lucrative niche position as it develops and produces drugs and medications for pets and farm animals. Virbac is one of very few sizeable independent companies that produce medical products for animals. Its competitors tend to be animal-medicine divisions within the major pharmaceutical groups, which may have a greater focus on human drugs. Long-term developments favour further growth for Virbac and the industry; meat is becoming an increasingly significant part of the diets of people in many developing countries, which is spurring growth in the numbers of animals raised for consumption. This in turn is driving rising demand for animal medications. Furthermore, consumer spending on pets is a relatively defensive source of revenues.

Andritz of Austria provides machinery used in the manufacturing process for a number of industries. Two are of particular importance for the company's growth prospects: pulp and paper (where the market is shifting from Scandinavia to emerging markets - especially Latin America) and hydro-electric power generation, which is becoming an increasingly strong area for growth in China. Operating in increasingly consolidated niches means that the company is able to exercise pricing power and maintain margins. Being based in the eurozone, the company has also benefited from the recent currency weakness, as it exports abroad, especially to emerging markets. This FX benefit also holds true for Virbac.

## **Conclusions**

With reasonable valuations and attractive growth prospects, we retain our positive view on European equities, including small cap. Furthermore, after the robust performance we have seen in the sector, we believe our long-term investment approach to analysing stocks and constructing our portfolios is particularly appropriate in the existing market environment.

As always, there are risks for the asset class. Macro-events, such as turmoil in the Middle East, worries over the sovereign debt problems in some peripheral eurozone markets and concerns over the effects of the Japanese earthquake/tsunami may affect sentiment from time to time. These may have an effect on inflation and interest rates, lending a note of caution to our generally positive outlook.

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