VIEWPOINT

June 2015

For Professional Clients only and, in Switzerland, qualified investors

BNY MELLON SMALL CAP EUROLAND FUND UPDATE

Investing in small caps equity: the key to capturing the European economic recovery, says Mark Bogar, manager of the BNY Mellon Small Cap Euroland Fund.

“The current European recovery should be positive for return of European small cap stocks. Typically, smaller cap companies have more operating and financial leverage.

“As the economy improves, that leverage provides a larger boost to earnings and thus stock returns. QE should provide multiple benefits including increased liquidity, lower interest rates and increased asset prices. Small cap companies can take advantage of this by having better access to loans from banks, cheaper financing and better ability to restructure with the higher asset prices”. Such is the opinion of Mark Bogar, fund manager of the BNY Mellon Small Cap Euroland Fund.

How do you think the European recovery will affect local small caps? Where do you see the best investment opportunities?

As the economy recovers, consumer discretionary and financials stocks should do well. Consumer spending should improve driving retail sales and auto sales higher. Banks should also do well as non-performing loans decline and loan growth improves. We also have seen opportunities in the health care sector. From a country perspective, Italian equities are attractive as the fundamental recovery is still in the early stages.

We remain optimistic about the longer-range performance outlook for international equities, as leading economic indicators in Italy, Spain and Germany appear to be favourable. Overall, lower energy prices have reduced living costs, bolstering hopes of the eurozone’s economic recovery, which has slowly started to gain steam.

The top industries in our current asset allocation are financials (25.6% of the portfolio), industrials (17.8%) and consumer services (13.8%)*.

> “From a valuation perspective, European small caps are cheaper than in the US.”

Do you think the valuation of European small caps is now too high? How does it compare to large and medium caps?

European small cap valuations began the year cheap versus history and now have risen to in line with historical averages. European small cap P/E’s are at 17.5x’s versus the Eurostoxx index at 16.0[1]. That premium is in line with history. Small caps typically trade at a premium given their better growth prospects. Also the large cap index has many large energy companies and banks which tend to lower the valuation.

Consensus earnings have been revised higher for European earnings year to date.[2] If the recovery holds, the positive earnings surprises should continue. Typically, valuations can rise in a positive earnings revision environment.

European corporate earnings trends benefit from currency weakness versus the US dollar, as forwards earnings maintain a strong positive correlation with a weakening of their currencies on a trade weighted basis

[1&2] Bloomberg

* Source: Lipper as at 30 April 2015. Performance is shown for Euro A unless otherwise stated. Total Return, including ongoing charge, but excluding initial charge, net of performance fees (if applicable), income reinvested gross of tax, expressed in share class currency. The impact of the initial charge can be material on the performance of your investment. Performance figures including the initial charge are available upon request.

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How do you define small caps in Europe, and how do they compare to other asset classes?

As we define small cap, the range of market cap for us is generally from US$100m in market cap to US$5bn in market cap with the median around US$3bn. From a valuation perspective, European small caps are cheaper than in the US – 17.50 P/E for Europe and 19.0 P/E for the United States. [3]

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The correlation of small caps to other areas of the market has been changing over the past two years, which means they are less likely to rise and fall in tandem with the broader market. This creates a better environment for skilled stock-pickers. Additionally, a number of factors are providing tailwinds for European small caps in particular.

The stronger US dollar will be a headwind for US companies with international earnings, while the opposite is true for European and Japanese companies with earnings outside their home territories.

Indeed small-cap companies in Continental Europe generate 30% of their revenue outside the eurozone, which should bolster their earnings over the next 12 months.[4]

What are the main risks for European equity investors and what actions can be taken?

Two main risks are Greece and the potential ineffectiveness of QE. The Greek debt situation still needs to be resolved. The ultimate impact should be relatively muted on the broader European economy as Greece is a small percentage of GDP. Also, most of the debt is now held in public hands and not the private sector. Second, QE may not result in Europe growth. However, macro data is already showing improvement, and the ECB seems committed to providing as much liquidity as is needed.

[3] Bloomberg
[3] Credit Suisse Research, Stoxx Europe Small 200 Index, as of December 2014

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