Numis

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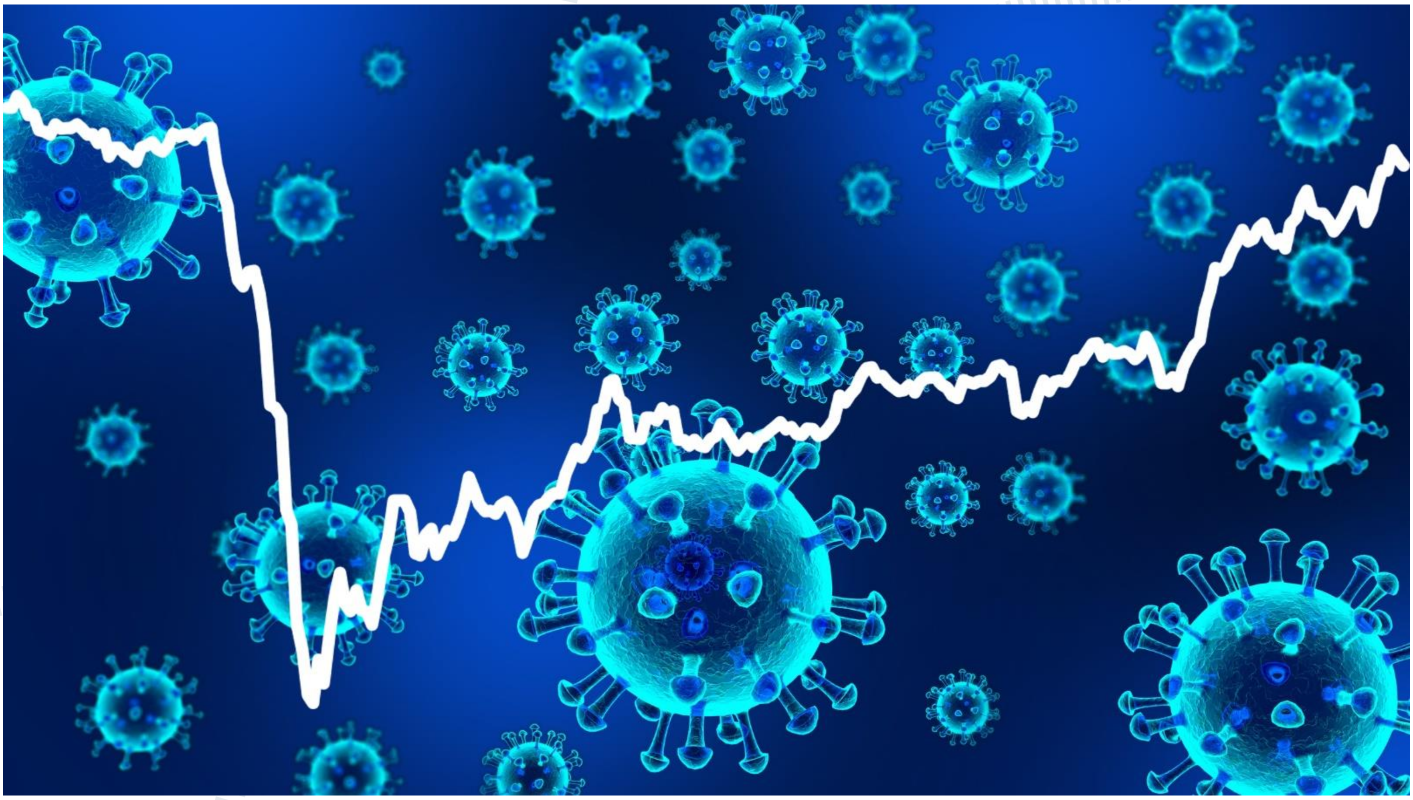
Numis Smaller Companies Index

2021 Annual Review



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Quick Guide to the Numis Smaller Companies Index

The NSCI is produced by Scott Evans and Paul Marsh of London Business School

The definitive benchmarks with a long-run history

The Numis indices were launched at the start of 1987. They have been published continuously for 34 years and also have a 32-year back-history to 1955. Since their launch, they have provided the definitive benchmark for monitoring the performance of smaller UK companies. With the introduction of the Numis Large Cap index in 2020, the Numis family of indices now covers all UK stocks listed on both the LSE main market and AIM. Numis index data and related research is distributed by Numis.

The Numis index family

The main version of the NSCI covers the bottom tenth by value of the main UK equity market. It has been calculated on a consistent basis for 66 years. The NSC plus AIM index adds in AIM stocks that meet the NSCI size limit. The NSCI ex-investment companies (XIC) screens out investment instruments. In addition, the NSC 1000 index targets the bottom 2% of the UK market, on an XIC basis. The Numis Mid Cap covers the bottom 20% by value of the main UK equity market, excluding the bottom 5%. The Numis Large Cap index covers the top 80% by market value of the main UK equity market. The Numis Alternative Markets Index includes all companies listed on qualifying UK alternative markets. Currently only AIM qualifies.

Performance in 2020

Over 2020, the total returns on the Numis indices were as follows (performance relative to the FTSE All-Share in brackets): NSCI, 1.1% (+10.9%); NSCI XIC, −4.3% (+5.5%); NSC 1000, 3.6% (+13.4%); Numis Mid Cap, −5.7% (+4.2%); Numis Large Cap, −10.8% (−0.5%); Numis Alternative markets index, 19.3% (+29.2%).

Long-run performance

Over the last 66 years, from 1955–2020, the NSCI gave an annualised return of 14.6%, which is 3.4% above the FTSE All-Share; the NSCI XIC returned an annualised 14.7%, and the NSC 1000 gave an annualised return of 16.1%, 4.9% above the FTSE All-Share.

Index composition for 2021

At the start of 2021, the number of constituent companies in the indices are: NSCI, 680 (334 XIC); NSC plus AIM, 1,483 ; NSC 1000, 529; Numis Mid Cap. 213; Numis Large Cap, 115; Numis Alternative Markets index, 818. At the end-2020 rebalancing, the largest NSCI constituent had a value of £1,500 million; the largest NSC 1000 company was worth £608 million; the Numis Mid Cap included all companies between £765 million and £3,731 million, while the Numis Large Cap included all companies larger than £3,731 million.

Industry weightings

The NSCI has a significant weighting in industrials, financials, consumer services and investment instruments, which together comprise over 80% of the NSCI and over 85% of the NSC 1000. In relative terms, the NSCI and NSC 1000 are heavy in industrials, technology, and investment instruments. They are light in oil and gas, basic materials consumer goods, health care, utilities and financials (excluding investment companies).

Volatility and diversification

Individual index constituents have volatile share prices. However, a diversified portfolio of NSCI constituents has historically had similar variability to the FTSE All-Share. Volatility rose across the market in 2020, but it increased more for small-caps. Smaller company returns are imperfectly correlated with larger company returns, and risk is reduced by diversifying across both segments of the market.

Ratings and investment style

At the start of 2021, the dividend yield on the NSCI was 2.09% (XIC, 1.49%) and the P/E multiple, ex-loss makers, was 14.24 (XIC, 10.83). The dividend yield on the NSC 1000 was 2.45% (XIC, 1.39%) and the P/E ratio was 14.89 (XIC, 10.38).

New topics in this year's Review

This year's Review looks at some of the surprises and challenges that the global pandemic brought to bear on the UK equity market. This includes dividend cuts, fund raising, the failure of factor investing, the performance of AIM and of investment companies and how UK small- and large caps performed in an international context.

Contents

Foreword

by the Head of Research, Numis

It is with great pleasure that for the ninth year Numis publishes the Annual Review of the Numis Smaller Companies Index. Over the last 34 years, the index has been produced by Professor Elroy Dimson and Professor Paul Marsh of London Business School, with Scott Evans taking over Elroy Dimson's role from 2016. Over the years, through their production of the Index and their associated research on smaller companies, the Numis index team have had a major impact on the practicalities of investing in smaller and mid-sized companies in the UK.

During their careers at London Business School, and through their widely cited book, Triumph of the Optimists, and other publications, Elroy and Paul have made a profound contribution to investment research. As part of the original design team for the FTSE 100 Index, as well as their creation of the NSCI, they have also had a central role in the design of stock market indices in this country and around the world. Scott Evans brings to the team a deep knowledge of UK small-caps gained from over 20 years of working at a senior level in investment banking, together with his extensive experience as an academic and researcher.

The Numis Smaller Companies Index is a central part of the extensive range of research services that Numis provides to investors as well as to corporate clients. With a back history that now covers 66 years since 1955, the NSCI provides a remarkable opportunity to set contemporary issues in a truly long-term context. It enables investors to take a strategic view on today's markets that is based on evidence that is comprehensive and authoritative, and underpinned by research of the highest quality.

2020 saw the launch of the Numis Large Cap index which targets the top of 80% of the UK equity market by value. It completes the family of size-based indices and together with Numis Alternative Markets index provides complete coverage of UK companies listed on the London Stock Exchange.

The Numis family of company indices provides the definitive measure of the performance of low, mid and large capitalisation companies. The indices are a unique research resource for the serious investor in smaller companies and the UK equity market given their consistent definition and the length of the index history. We congratulate the authors on completion of this detailed and comprehensive study. It contains many insights that will help you as an investor. Please do not hesitate to contact Numis if you would like to follow up on the ideas presented in this volume.

Will Wallis

Head of Research, Numis Securities

Highlights of 2020

by Scott Evans and Paul Marsh

Positive return, despite everything

A global pandemic accompanied by nationwide lockdowns and a ballooning of the national debt brought one of the most turbulent and volatile years in living memory. It was not the ideal back-drop for equity investors, nor an obvious environment for small-cap outperformance. It is therefore something of a surprise to report that despite the sell-off in Q1 of 2020, small-caps, measured by the NSCI ended the year up by 1.1%.

Small caps beat the new Numis Large Cap by 11.4%

2020 saw the introduction of the Numis Large Cap index. This covers the top 80% by value of the main UK market, currently comprising the largest 115 UK companies. We describe it more fully later. The NSCI's modest return looks much better against last year's −10.3% return from the Numis Large Cap, showing the NSCI beat large-caps by 11.4%.

NSCI XIC was 5.5% ahead of the FTSE All-Share

The chart below shows the performance in 2020 of the Numis indices relative to the UK market as measured by the FTSE All-Share. This is a relative chart, so the performance of the All-Share plots as a horizontal line. The NSCI beat the FTSE All-Share by 10.9%, while the Numis Large Cap underperformed by −0.5%. The Numis Mid Cap return was −0.1% relative to the All-Share. The most widely used benchmark for small-cap performance, the NSCI (ex-investment companies) beat the FTSE All-Share by 5.5%.

AIM was the star of the year

AIM stocks enjoyed outstanding performance in 2020. As we discuss later in this review, the outperformance of the Numis Alternatives Markets index was not limited to the very largest AIM stocks, but was more widespread. The result was an absolute return of 19.3%, outperforming the NSCI by 18.2% and the FTSE All-Share by an impressive 29.2%.

UK investment companies had a good year

The chart below reveals a large disparity between the versions of the NSCI that include and exclude investment companies. A difference of this magnitude is highly unusual, and we investigate the reasons for this later in this report.

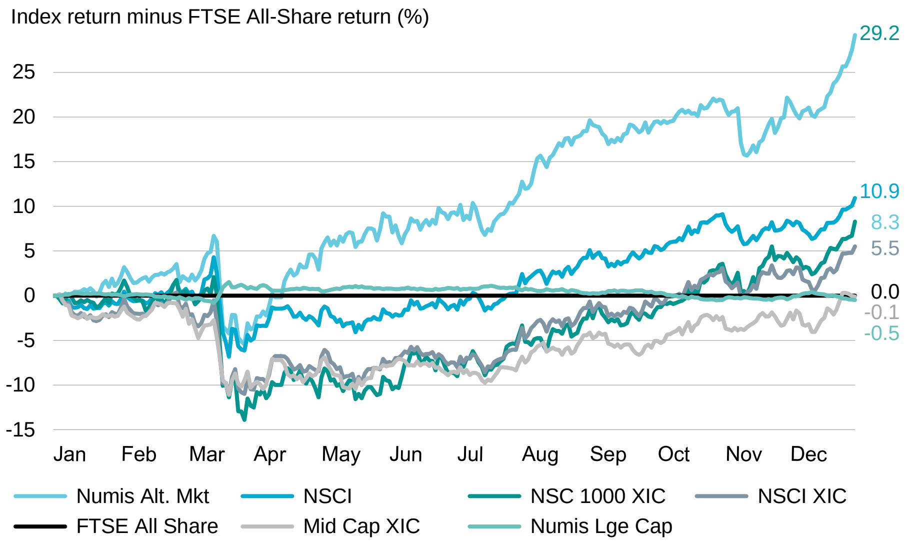
Dividend cuts and capital raises

Dividend cuts and capital issuance were also events that make 2020 stand apart from recent years. For small- and large-caps alike, the number of companies cutting dividends and raising equity was the highest since the period following the global financial crisis.

Looking forward

As we enter 2021, we very much hope that it will be another unforgettable year, but for very different reasons than 2020.

Figure 1. Performance of Numis indices in 2020 relative to the FTSE All-Share



Source: Scott Evans and Paul Marsh, Numis, FTSE Russelll

Small- and large-cap performance in an international context

UK in an international context

To place the performance of the UK in an international context, we examine the world's largest equity markets – all those with more than a 1% weighting in the FTSE World index at start-2020. This gave 15 countries which made up 92% of total world capitalisation. We measure returns using the MSCI small- and large-cap indices, except for the UK where we use the NSCI XIC for small-caps and the Numis Large Cap XIC for large-caps.

Asian small-caps performed the best

Looking first at the performance of small-caps, the left-hand chart below plots the 2020 returns (blue bars) and size premiums (line plot) for the 15 countries and the world index. In absolute terms, UK small-caps performed badly compared to other international markets with only French small-caps doing worse. In a complete reversal from last year, the Asian countries of Korea, China, India and Taiwan topped the rankings in 2020 having been the underperformers in 2019. Over 2020 all four recorded absolute returns of over 20%, with Korean small-caps returning an impressive 45%.

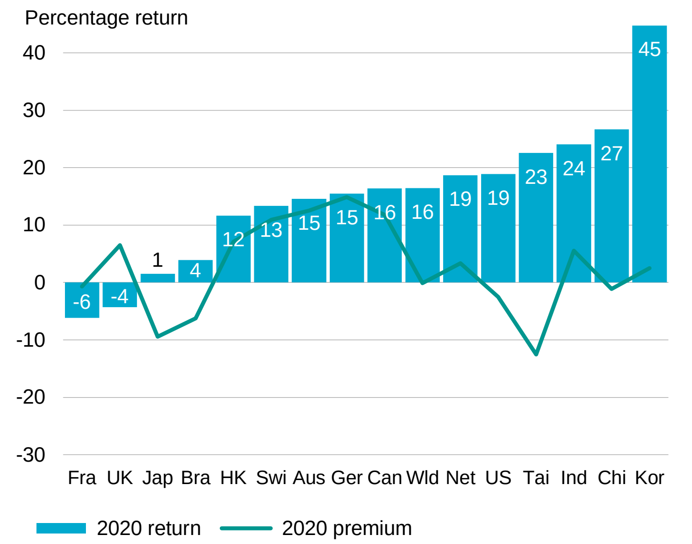
Positive premium from UK small-caps

Measured relative to large caps, the performance of small-caps is more mixed. A number of the countries which ranked in the middle of the chart in terms of absolute performance experienced the highest small-cap premiums relative to large-caps. These included Hong Kong, Switzerland, Austria, Germany and Canada. Here the size premium ranged from 7.1% in Hong Kong to 14.9% in Germany. There was a small negative size premium in the USA of −2.5%, and given the dominance of the USA in the world index, this led to a negative size premium of −0.1% on the world index. UK small-caps, despite a negative absolute return of −4.3% in 2020, nonetheless outperformed the Numis Large Cap XIC, recording a positive size premium of 6.5%.

UK large-caps the underperformers

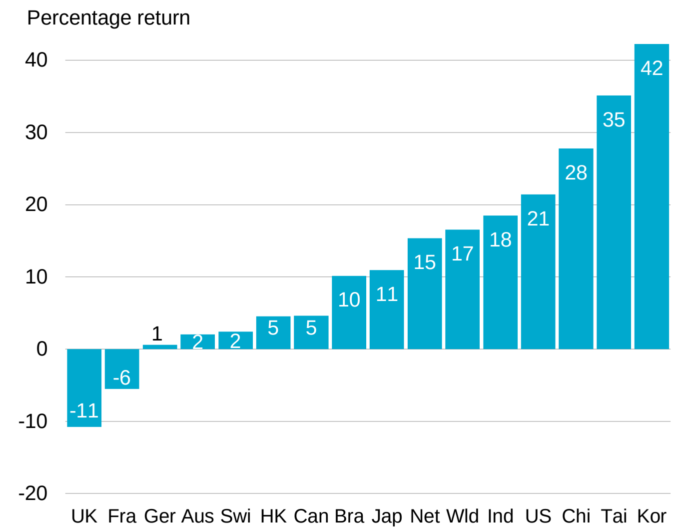
Given the negative return of the NSCI XIC, its positive size-premium highlights the poor performance of UK large caps in 2020. To put this in context, the right-hand chart ranks the absolute return of large-cap indices in the 15 markets and the world. Since large-caps dominate markets, this ranking will closely reflect total market performance. Clearly, there was a wide range of returns. The UK was the worst performer with only our nearest neighbours (France) also ending the year with a negative return. There was also a sharp divergence in performance between the traditionally closely correlated UK and US markets. Heavy weightings in technology for the USA and oil and banks for the UK helped contribute to this performance differential. Hopefully, with 2020 behind us, 2021 will see a better year for absolute and relative performance from UK companies.

Figure 2. Global small-cap performance in 2020



Source: MSCI, Scott Evans and Paul Marsh, Numis

Figure 3. Global large-cap performance in 2020



Source: MSCI, Scott Evans and Paul Marsh, Numis

Deep dividend cuts, but are they temporary?

Dividends matter

Any analysis of long-run investment returns will stress the importance of dividends in evaluating long-term performance. We show the importance of reinvested dividends very clearly in Figure 51 on page 60 later in this report. One immediate impact of the pandemic for UK companies in 2020 was the cutting, or at least suspending or postponing of dividend payments. The result was that dividends for the NSCI experienced the largest one-year fall (in real terms) since the index began in 1955 (see Figure 53 on page 63).

Analysis of cuts

To analyse dividend changes, we compared the dividends paid in calendar year 2019 with those paid in 2020 for all non-investment companies in the NSCI and Numis Large Cap indices. We analysed several bands of dividend changes, ranging from a cut of 100%, through smaller cuts, no-change, and dividend increases, focusing on both the percentage of companies and percentage of index value in each band.

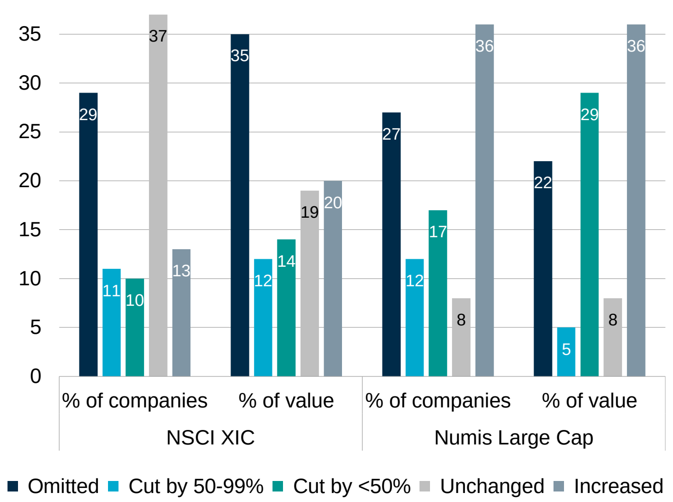
More cuts for small-caps

The left-hand chart below shows that while a similar proportion of companies in each index cut their dividends by 100%, these companies accounted for 35% by value of the NSCI XIC versus just 22% of the Numis Large Cap XIC. Aggregating across all dividend cuts, 50% of NSCI companies cut their dividends compared with 56% of large-caps. In value terms, these represented 61% of the NSCI and 56% of the Numis Large Cap. Yet overall, the impact of dividend cuts was far more severe among small- than large-caps. Where their experience differs markedly is within the unchanged and increased categories. Here large-caps saw 36% of index companies (by value or number) increase their payments, albeit in most cases by modest amounts. This compares to 20% by value and 13% by number for small-caps. In the no-change category small-caps are the largest category. However, the majority of no-changes for smaller companies arose from companies that have habitually been non-dividend payers, and where no dividend was paid in either period.

Record fall in dividend income

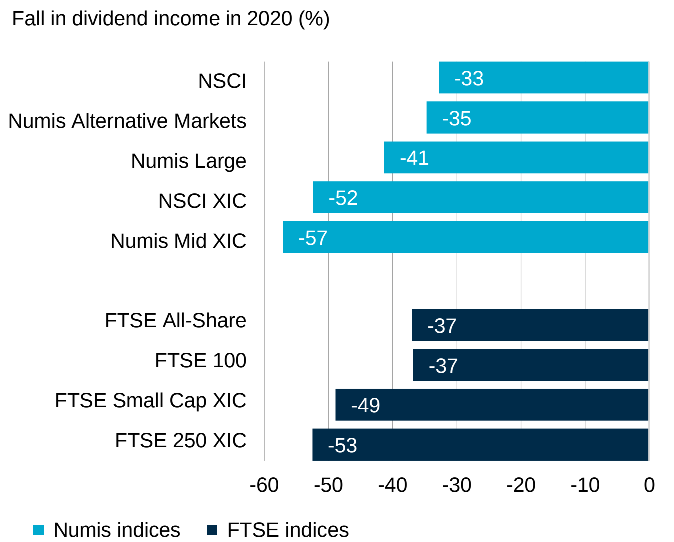
The important measure is thus not so much the number of companies cutting their dividend, but the total fall in dividend income. The right-hand chart compares the total fall in income for members of both the Numis and FTSE index families. The clear message is that 2020 dividend cuts were huge, and the largest on record – greater than during the global financial crisis. Particularly badly impacted were mid-caps, closely followed by small-caps. An interesting point is that small-caps outperformed large-caps in 2020, despite experiencing a greater fall in dividends. Hopefully, the market was looking ahead, and we await what 2021 brings in terms of dividend reinstatements for both small and large-caps alike.

Figure 4. Companies dividend changes in 2020



Source: Scott Evans and Paul Marsh, Numis.

Figure 5. Fall in dividend income in 2020



Source: FTSE Russell, Scott Evans and Paul Marsh, Numis.

Reaction to dividends cuts in abnormal times

Large cuts to dividends were commonplace

We have seen that many companies cut their dividend last year and a large number chose to delay or cancel the payment completely. In normal times such news would have a significant impact on equity prices and we would expect to see a negative reaction to the announcement. Alternatively, as the events of the global pandemic have unfolded and companies have issued statements indicating they were reviewing or changing their dividend policy, investors may have taken a more sanguine view and seen cash preservation as a more prudent approach, and, under the circumstances, a "good thing".

Examining the impact of dividend announcements

To examine the impact of dividend announcements in 2020, we use data from the London Share Price Database. We examined the price impact of all announcements made during 2020 for all fully-listed and AIM stocks, but excluding investment companies and habitual non-dividend payers. We split the announcements into five groups, based on content. These ranged from a 5% plus increase in the dividend, down to a cut of 50% or more. We then calculated the average cumulative abnormal return over the ten days either side of the announcement, where the announcement is defined as time zero. For clarity, the cumulative abnormal return immediately prior to the announcement is scaled to be zero. These are "abnormal" returns, as they are adjusted for movements in the UK market.

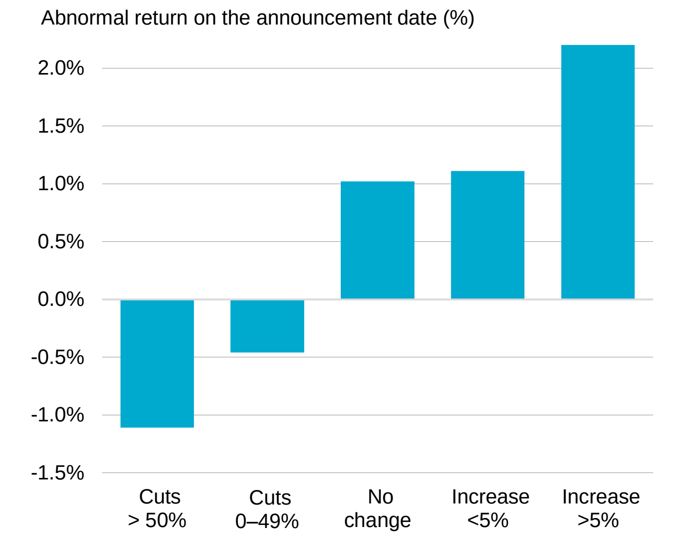
Share price reaction broadly as expected

The chart on the left below shows the announcement day abnormal return for the five categories. It shows that the companies issuing the most positive news (i.e., dividend increases of over 5%) recorded the highest abnormal return. Those announcing the most negative news (i.e., cuts of more than 50%) experienced the lowest abnormal return. The chart on the right then plots the pattern of abnormal returns ten days either side of the announcement. It tells the same story.

Companies not being overly punished for cuts

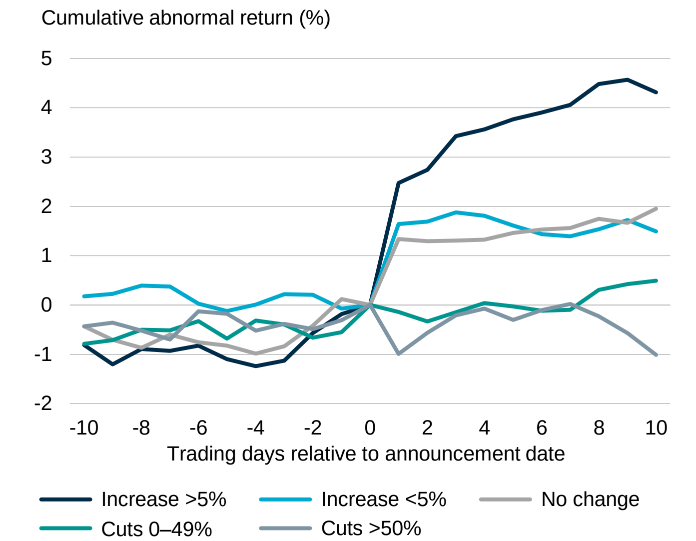
The relative ranking as shown in both charts is what we would expect, as those companies with the most positive dividend announcements experienced the highest returns, and those with the most negative announcements experienced the most negative returns. There are two more surprising outcomes, however, probably related to the current environment. First, no change in dividend is seen as a positive event and the reaction is very similar to a small increase (i.e., the sigh-of-relief factor). Second, cuts, and even major cuts of greater than 50% have only a mildly negative impact. This analysis suggests that, for the time being at least, companies are not being overly punished for cutting their dividends, and that investors recognise that this is often the prudent thing to do.

Figure 6. Impact of dividend announcements



Source: Scott Evans and Paul Marsh, Numis.

Figure 7. Abnormal returns and dividend changes



Source: Scott Evans and Paul Marsh, Numis.

Raising capital in a crisis

Reaction to a crisis

A natural response from corporates in times of crisis is to preserve cash and raise funds. We have seen that companies were quick to cut or postpone dividend payments last year, and if the flurry of RNS announcements during the initial lockdown were anything to go by, they were also busy raising cash.

Fund raising in 2020

To examine the extent to which the corporate sector and the companies of the NSCI moved to raised funds in 2020 we have used the further issues data provided by the London Stock Exchange. We have analysed the change in issuance over the year, and compared the amounts raised since the global financial crisis (GFC). We have excluded investment companies and companies listed on AIM. The data is summarised in the left-hand chart below, which details the number of companies that raised funds, the average size of funds raised and the total amounts raised in 2020 and 2019.

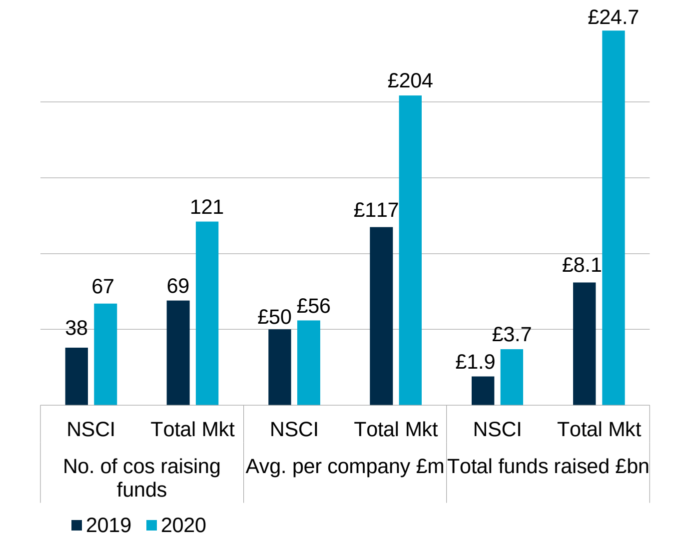
Increase in funds raised

Turning first to the number of companies involved, the first set of bars shows that within the NSCI XIC, 69 companies were active raising funds in 2020. This compared to just 38 the previous year. They raised £3.7 billion in total, which was 95% more than the previous year. The increase in the average funds raised was a lot smaller than the total increase given the 75% rise in the number of companies involved. As such, for small-caps, 2020 was a year when a lot more companies raised a similar amount of money to the average sum raised the previous year. For the entire market, the major difference is the significant increase in the total and average amounts of money raised in 2020 compared with the previous year. A total of £24.7 billion was raised by 121 companies which was a threefold increase in total funds raised and a 95% increase in the average value.

A very different crisis with less funds raised than in the GFC

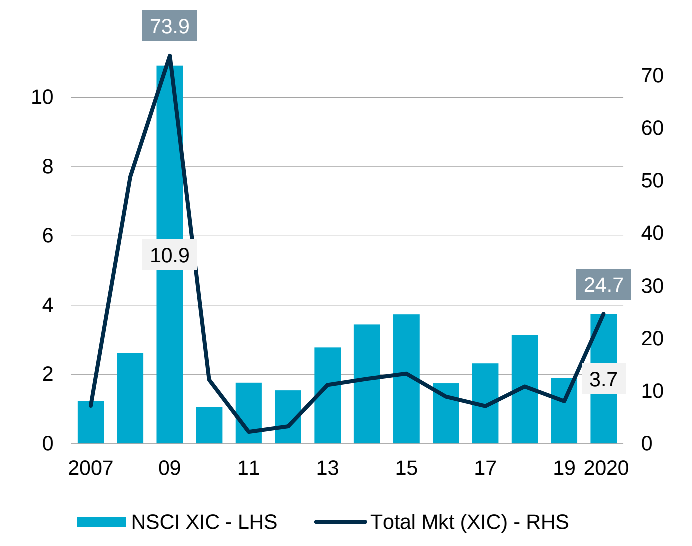
To put this in perspective, the chart on the right-hand side compares total funds raised for the NSCI XIC and the total market (XIC) from 2007 to 2020. The chart clearly shows that capital raisings in 2020 have been nowhere near the amounts raised in the aftermath of the global financial crisis (GFC). Small-caps raised £10.9 billion from a total of £74 billion (£51 billion having already been raised in 2008). The GFC, however, was a very different crisis to the COVID pandemic. In 2008 a major liquidity problem in the financial sector permeated through to the real economy and resulted in a global recession. Our current crisis is primarily one of health and the impact on the real economy has been more selective. Certain industries have done well whereas other have been hit hard. As such we should not necessarily expect to see a return to 2008/2009 in terms of capital raisings.

Figure 8. Further equity issues 2019 versus 2020



Source: London Stock Exchange; analysis by Scott Evans and Paul Marsh, Numis

Figure 9. Further equity issues 2007 to 2020



Source: London Stock Exchange; analysis by Scott Evans and Paul Marsh, Numis

Factor failure within the NSCI

Seeking to boost returns by exploiting factors

Factor investing, often known as "smart beta", continues to grow in popularity. The latest FTSE Russell survey of major global investors reports that 78% of respondents have implemented or are evaluating factor-based strategies. These factors are the result of academic research, which has found them to be associated with common patterns of return and, more importantly, with premiums. For many years, we have analysed factor returns within the UK smaller companies universe. This information is made available to Numis index clients on a monthly basis. In particular, we focus on five factors within the NSCI XIC universe, namely, value, size (within small-caps), income, momentum and low volatility.

Appreciable long-run factor premiums within the NSCI

Figure 10 shows the evolution of these factor premiums over the 66-year life of the NSCI. Size gave the smallest premium with smaller-smalls beating larger-smalls by 0.7% per year. The next three factors have enjoyed similar premiums: higher yielders have beaten lower yielders by 3.2% per year; value stocks have beaten growth stocks by 3.4% per year and low volatility stocks have beaten higher volatility stocks by 3.8% per year. The final factor, momentum, gave by far the largest premium, with winners beating losers by an annualised 16.9%, but this is a risky trading strategy with high turnover and costs.

All five factors gave negative premiums in 2020

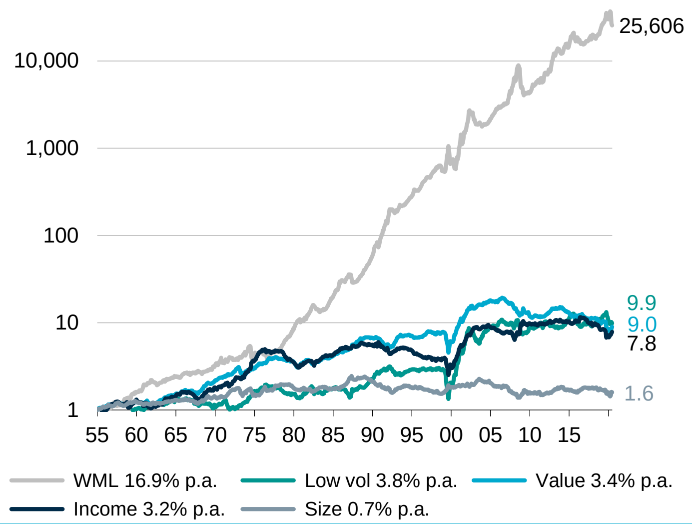
Figure 11 shows factor performance in 2020. We have regularly cautioned that factor premiums are often negative in the short-run, and can remain so for extended periods. But this is the first year on record that all five factor premiums have been negative.

Value and income hit by the crisis; momentum by the recovery

Momentum investors tend to suffer from "whiplash" when markets swiftly reverse. The eccentric pattern in Figure 11 highlights the problem momentum suffered from the sharp recoveries in early summer and November. Low volatility stocks initially fared well in the severe March downturn, but subsequently trended down to become the worst performer of the year. Smaller-smalls were also badly hit by the crisis, and were trailing by 12% at one stage. However, they recovered strongly in the final quarter, ending the year with a negative premium of just 3%. Income and value were also hit hard by the crisis, showing similar patterns through the year, but with income ending ahead. Late in the year, there was a glimmer of hope for hard-hit value investors, with value outperforming growth by 15% in the final quarter, but small-cap value investors still ended the year some 13% behind small-cap growth investors.

Figure 10. Long-run factor premiums

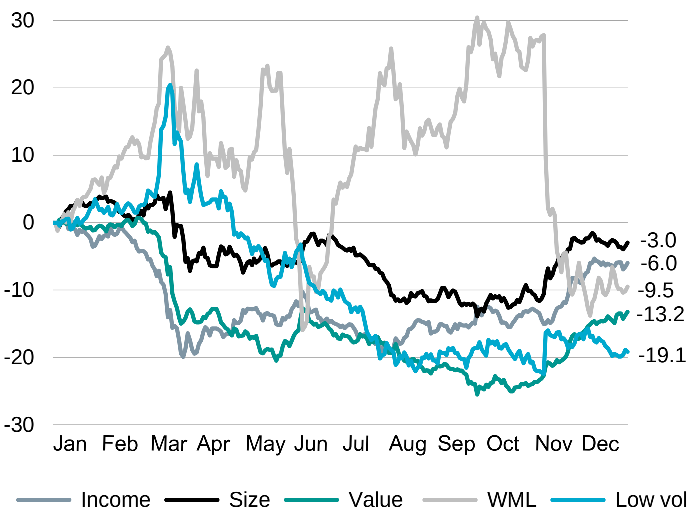
Cumulative returns from style premia within NSCI XIC, 1955−2020



Source: Scott Evans and Paul Marsh, Numis

Figure 11. NSCI XIC factor performance in 2020

Cumulative return from factor (%)



Source: Scott Evans and Paul Marsh, Numis

Value investing: a glimmer of hope?

Value investors seek cheap stocks relative to their fundamentals.

Value investing has a long history, going back to Ben Graham, Buffet's mentor. Value investors seek stocks that are cheap relative to fundamentals. Academic researchers operationalise this by looking at the long run performance of stocks that sell for low multiples of earnings, book value or dividends. Fama and French (1993) the pioneers in this area, documented a strong historical US value premium, and then found this held in most other countries. While value investors employ far more sophisticated analysis than just buying low price-to-book stocks, it is remarkable how well such a simple metric mirrors their fortunes.

The value premium has now long been negative

Historically, value stocks beat growth stocks over the long run and across countries. It also worked well within smaller companies. Unfortunately for value investors, the premium went into reverse almost everywhere just before the global financial crisis. Within the NSCI XIC, the value premium has fallen 54% from its high in December 2006. Investors in the USA – where the value effect was first identified, have suffered a 36-year drawdown – ironically dating back to before Fama and French's research. 2020 was a poor year for value investors almost everywhere, including, as we have seen, within UK small-caps.

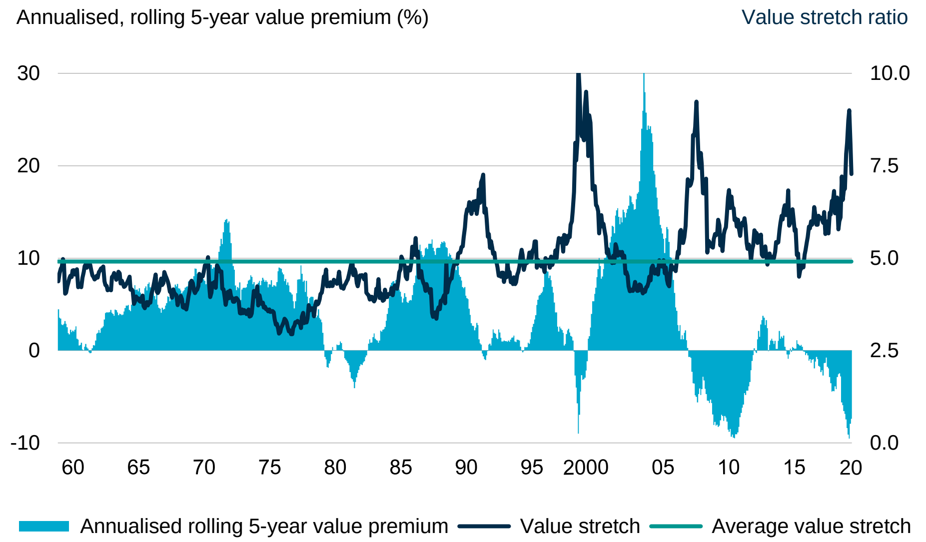
Timing the turn using value stretch

Figure 14 shows the rolling 5-year value premium within the NCSI XIC. The recent poor performance of value is very evident. Can we find clues as to when the situation might reverse? As we saw above, Q4 of last year might offer a glimmer of hope. One measure that has been suggested is value stretch which is defined as the difference between the price-to-book of the NSCI growth portfolio and the value portfolio. This is a measure of how much investors are prepared to pay per unit of book value for growth stocks rather than value stocks. When value stretch is high, this could indicate that the value factor is cheap, and this might help us "time" our investment in value stocks.

Value remains in the doldrums

The line plot in Figure 14 shows that value stretch was extremely high until three months ago, and while now lower, it remains high. To test whether value stretch can be used to time investments, we regressed the future value premium on the prior level of stretch. We found no useable relationship. While the value factor will surely reassert itself at some stage, our research indicates that value stretch does not tell us when.

Figure 12. Value premium and value stretch within the NSCI XIC, 1960–2020



Source: Scott Evans and Paul Marsh, Numis.

A remarkable year for AIM

Stand-out year for AIM

One of the stand-out features of 2020 was the performance of AIM stocks. Over the year, the Numis Alternatives Index returned 19.3%, outperforming the FTSE All-Share by 29.2% and the NSCI by 18.2%. The index is unusual as it is often viewed as a small-cap index, but the lack of any size criteria means the largest companies are measured in the billions of pounds whereas the smallest are measured in the hundreds of thousands.

High exposure to its largest companies

The index differs from other small-cap indices in that it has much higher exposure to its largest constituents. The top ten stocks account for 23% of index value. This compares to 6% for the NSCI. Given this exposure, AIM's strong performance must reflect good performance from these larger stocks. But did they punch above or below their weight?

AIM minnows punched well above their weight

To analyse this, we split the index into quintiles of equal numbers of companies. The left-hand chart shows that stocks in the largest quintile had market caps of £133 million or more, while all other quintiles contained minnows. The smallest 20% of stocks had market caps below £5.5 million. The first panel shows that the largest quintile contained 80% of index value, while the smallest, just 0.5%. The second panel shows that the largest quintile was responsible for 70% of the weighted return on the index, while the smallest quintile contributed 2.1%. The largest AIM stocks thus contributed less than their index weight, while the smallest quintile punched well above its weight. The final panel shows why. While the average stock return within every quintile was excellent, the smallest two quintiles enjoyed huge returns. Within AIM, it was a case of the smaller the better.

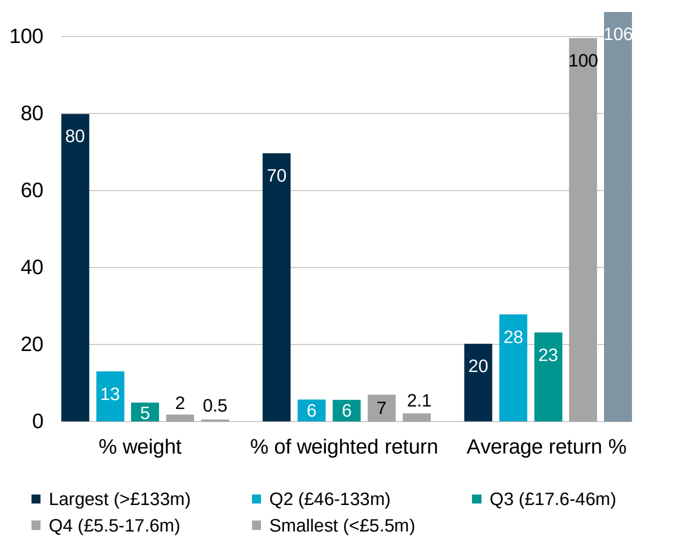
Aim stocks beat the NSCI in most industries

The right-hand chart compares industry performance within the Numis Alternative Markets index (XIC) and the NSCI XIC. The bars show the relative performance over 2020. The weight within AIM and the load-ratio (i.e. the industry weight in AIM relative to the equivalent in the NSCI XIC) are listed to the left. The two industries in which AIM has the highest load factors and some of the highest weightings, healthcare and technology, proved two of the weakest. In all other industries except financials, AIM outperformed, often by a very large margin. AIM's success was broadly based in 2020.

AIM benefitted from strong style tailwinds

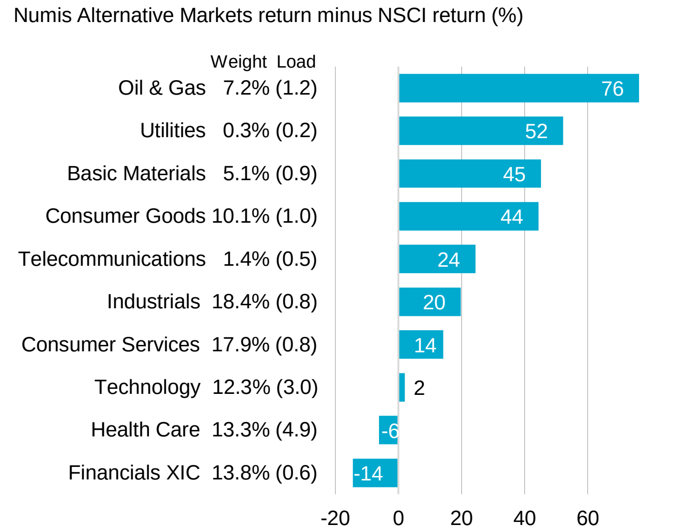
Finally, AIM enjoyed a strong tailwind from factors. We have seen that in 2020, growth outperformed value, low yield outperformed high, and high volatility stocks beat low vol stocks. AIM is heavy in growth stocks, lower yielders, and stocks with higher volatility.

Figure 13. AIM size quintiles in 2020



Source: Scott Evans and Paul Marsh, Numis

Figure 14. Relative weights and performance of AIM vs NSCI



Source: Scott Evans and Paul Marsh, Numis

Investment companies – a closer look

ICs growing in importance, especially in small-caps

Listed investment companies (ICs) are becoming a larger part of the UK market, and a dominant part of the small-cap universe. Their weighting in the NSCI, NSC 1000, Numis Mid, and even Numis Large Cap has grown steadily. Professional investors prefer XIC benchmarks that exclude ICs for three reasons. First XIC benchmarks give a purer measure of performance as ICs tend not to invest in the benchmark they form part of – most NSCI ICs do not invest in UK small-caps. Second, if they do, this constitutes double counting. Third, fund managers avoid ICs to prevent imposing double fees on clients.

Strong performance in 2020 led to big differences in XIC indices

Historically, there have been relatively small year-to-year differences in return between the versions of the Numis indices that included ICs (IIC) and the XIC indices. However, like many things last year, the performance of the IC sector was unusual. ICs performed strongly, leading to appreciable differences between IIC and XIC indices. For example, the NSCI (IIC) gave a 1.1% return, while the NSCI XIC returned −4.3%. Even within the Numis Large Cap which had a tiny start-year weighting in ICs of just 0.6%, the XIC version outperformed the IIC index by 0.5 percentage points.

UK ICs are not a proxy for the UK market

Those who are not steeped in the investment company world often view ICs as a proxy for the UK market. Their assumption is that a majority of them invest in UK equities. However, last year, the sector performed strongly despite the weakness of UK equities. Within the NSCI, the IC sector had the largest weighted positive return of all of the broad industry groups. It was also the second largest within the FTSE All-Share. This sector is clearly not a proxy for the UK equity market and has become a proxy for something else.

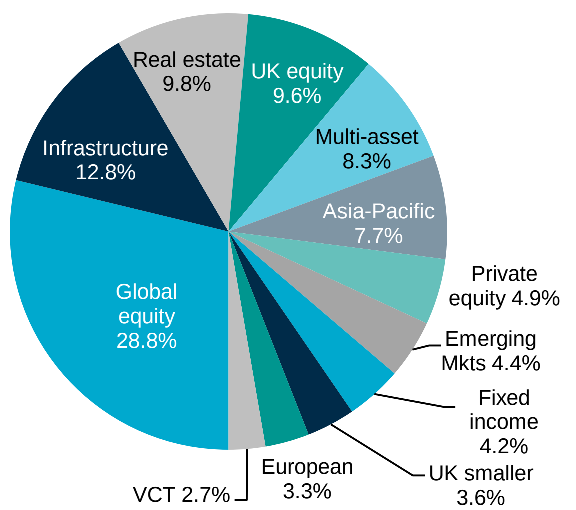
Many invest overseas or in other asset classes

To investigate this, we categorised all main market listed ICs into their region and asset class exposures. Just over 400 ICs were grouped by whether their main investments were in equity (public), private equity, fixed income, infrastructure (including renewables), property, VCT or multi-asset. We also categorised equity exposure by region into UK, Europe (ex UK), emerging markets, Asia-Pacific, global, and dedicated UK small-cap.

UK ICs have low exposure to the UK

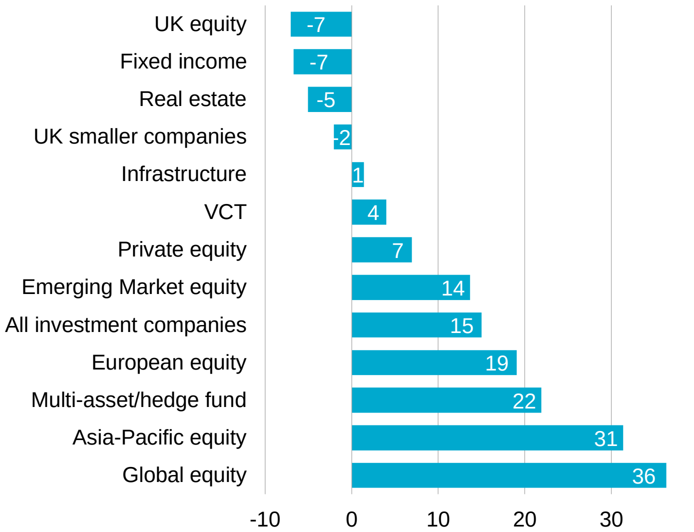
The chart on the left shows the proportion by value of ICs falling in each category. The exposure to pure UK equity is relatively small compared to global equity, Asia-Pacific, Europe and emerging markets. The chart on the right ranks how ICs performed depending on their category. What seems clear is that the large exposure to markets outside the UK has been a significant component in the strong outperformance of the IC sector in 2020.

Figure 15. Investment companies by category in 2020



Source: AIC, Trustnet, Morningstar, London Stock Exchange, Scott Evans and Paul Marsh, Numis

Figure 16. Investment company performance ranking



Source: Scott Evans and Paul Marsh, Numis

The Numis Large Cap index

100% coverage of the UK market

2020 saw the introduction of the Numis Large Cap index which targets the top 80% of the fully listed UK equity market by value. It completes the family of size-based indices, which includes the NSC 1000, NSCI, and Numis Mid Cap. AIM is covered by the Numis Alternative Markets index. The Numis family of indices thus now provides complete coverage of all UK companies listed on the London Stock Exchange. As with the other Numis indices, the index has an extensive back history (to 1955), has capital gains and total returns versions and is available including and excluding investment companies.

Total value of £1,958 billion

The Numis Large Cap index enters 2021 with an aggregate value of £1,958 billion. It has 115 companies and 117 constituent shares. The largest company at the end-2020 rebalancing date was Unilever which had a market capitalisation of £117 billion.

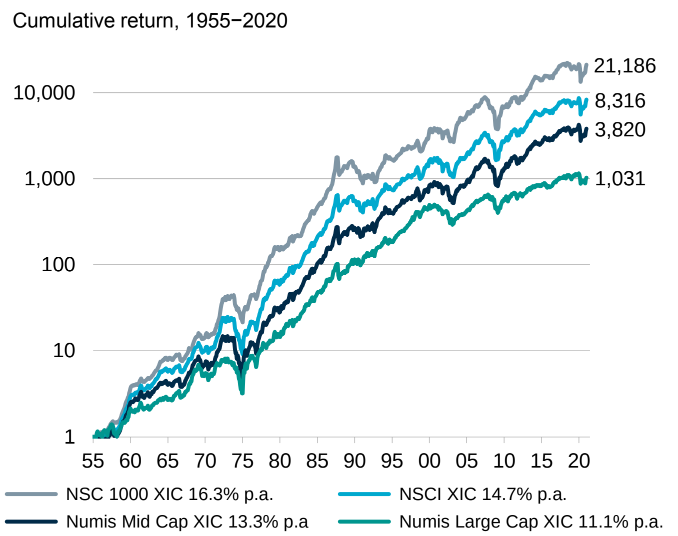
Long-run returns

The left-hand chart below plots total cumulative returns (XIC) since 1955 for the Large Cap and other size-based Numis indices. While there have been periods when large-caps outperformed, over the long-term, the performance ranking matches the order of size, painting a picture of “the smaller the better”. The figures to the right of each series show the terminal value from an initial investment of £1 in the index, with dividends reinvested, but ignoring taxes and transactions costs. They show that investing in the NSC 1000 XIC rather than the Numis Large Cap would have generated more than 20 times the wealth.

Advantage of fixed percentage

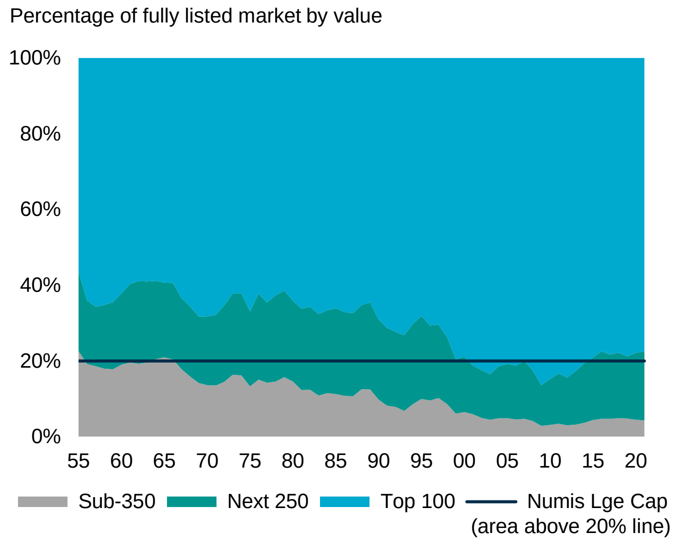
The chart on the right shows the advantages of using a fixed proportion of the market as opposed to a fix number of companies for size-based indices. The Numis Large Cap index is fixed at the top 80% of the market; the Numis Mid Cap covers the bottom 20% excluding the bottom 5%; and the NSCI is the bottom 10%. These are rebalanced each year to restore their target coverage. Indices based on fixed numbers of stocks will, over time, cover very different amounts of the market, particularly given the secular increase in UK market concentration. This can be seen by the blue shaded area which represents the top 100 companies. In the past this has represented as little as 56% of the market, as much as 86%, and now stands at 77.5%. Similarly, the section below the top 350 companies (the FTSE Small Cap, Fledgling plus some FTSE-ineligibles) once accounted for 23% of the market, dipped as low as 2.9%, and now stands at 4.3%, explaining why the FTSE Small Cap has become less useful over time as a small-cap benchmark.

Figure 17. Long-run returns of size ranked indices, 1955-20



Source: Scott Evans and Paul Marsh, Numis

Figure 18. Large-cap size limits compared with other indices



Source: Scott Evans and Paul Marsh, Numis

1. Index overview

by Scott Evans and Paul Marsh

A roller-coaster ride

It was truly a roller coaster ride for the UK market and hence for all of the Numis indices in 2020. After a slow start in January, the realisation of the seriousness of COVID-19 led to the sharpest market decline since the global financial crisis. At its March low point, both the FTSE All-Share and Numis Large Cap were down by a third, while the Numis Smaller Companies index ex-investment companies (NSCI XIC) had fallen by 44%. There was a strong rebound in the second and fourth quarters, especially for small-caps. By the year-end, the NSCI had regained all of its lost ground with a total return of 1.1%. While the return was lower on an ex-investment company (XIC) basis, the NSCI XIC nonetheless outperformed the FTSE All-Share by 5.5% over the year.

AIM companies were the star performers

The stand out performance in 2020 was from the Numis Alternative Markets index. This index which currently comprises all AIM listed companies, returned 19.3%, outperforming all other Numis indices by a significant margin. AIM's strong performance also helped to lift the NSC plus AIM index, which on an XIC basis, recorded a total return of 4.9%.

Poorer year for mid- and large-caps, better for minnows

It was a less good year for the Numis Mid Cap, which despite a strong rebound in the second and fourth quarters, ended the year down by −9.9% (XIC). The same was true for the Numis Large Cap index which, despite a more resilient Q1 performance, ended the year lower by −10.3%. In contrast, the "smaller smalls" in the NSC 1000 XIC, while hit the hardest in Q1, outperformed large caps for the subsequent three quarters, ending the year only marginally down with a total return of −1.1%.

Index cut-offs are £1.5 bn (NSCI) and £3.7 bn (Large Cap)

After a volatile year, and following index rebalancing, the NSCI enters 2021 with a total value of £244 billion. The cut-off for inclusion has fallen to £1,500 million, and the number of companies is now 680 (334 XIC). The Numis Mid Cap starts 2021 with a value of £367 billion, and embraces all companies with capitalisations between £765 and £3,731 million (213 constituents). The Numis Large Cap has a value of £1.9 trillion, and includes all fully listed companies with capitalisations above £3.731 billion (115 constituents).

Start-2021 valuation ratios

After re-balancing, the NSCI XIC starts 2021 with a dividend yield of 1.49% and a PE ratio (excluding loss makers) of 10.4. This contrasts with the Numis Large Cap, which has a yield of 2.84% and a PE of 17.2.

Table 1. The Numis indices during 2020

	Start-2020	End-2020	2020 High	2020 Low	All-time High
Total return index					
NSCI	21812.83	22053.38	22236.89 (29 Dec 20)	13152.96 (19 Mar 20)	22236.89 (29 Dec 20)
NSCI XIC	24153.03	23117.10	24368.31 (2 Jan 20)	13530.47 (19 Mar 20)	24368.31 (2 Jan 20)
NSC 1000 XIC	21085.48	20762.33	21240.23 (17 Jan 20)	11755.24 (19 Mar 20)	22319.39 (21 May 18)
Numis Mid Cap XIC	25571.59	23032.13	25836.31 (2 Jan 20)	14324.52 (19 Mar 20)	25836.31 (2 Jan 20)
Numis Large Cap	16383.37	14694.70	16675.03 (17 Jan 20)	10909.59 (23 Mar 20)	16675.03 (17 Jan 20)
Numis Alt. Markets	2203.54	2629.70	2629.70 (31 Dec 20)	1381.51 (18 Mar 20)	5403.42 (10 Mar 00)
FTSE All-Share	7837.96	7068.59	7957.14 (17 Jan 20)	5146.67 (23 Mar 20)	7957.14 (17 Jan 20)
Capital gains index					
NSCI	7681.00	7580.62	7736.11 (2 Jan 20)	4605.62 (19 Mar 20)	7736.11 (2 Jan 20)
NSCI XIC	8448.81	7945.05	8520.78 (2 Jan 20)	4716.03 (19 Mar 20)	8558.13 (22 May 18)
NSC 1000 XIC	9539.75	9239.37	9602.44 (17 Jan 20)	5301.19 (19 Mar 20)	10620.30 (21 May 18)
Numis Mid Cap XIC	8533.25	7562.54	8620.28 (2 Jan 20)	4759.28 (19 Mar 20)	8611.31 (27 Dec 19)
Numis Large Cap	4458.96	3868.85	4536.29 (17 Jan 20)	2943.32 (23 Mar 20)	4684.86 (22 May 18)
Numis Alt. Markets	1186.32	1400.46	1400.46 (31 Dec 20)	741.91 (18 Mar 20)	3898.22 (10 Mar 00)
FTSE All-Share	4196.47	3673.63	4257.93 (17 Jan 20)	2727.86 (23 Mar 20)	4324.41 (22 May 18)

Source: FTSE Russell, Scott Evans and Paul Marsh, Numis

The Numis family of UK indices

The family of Numis indices now spans the entire UK equity market. The original index, introduced in 1987, was the Numis Smaller Companies Index (NSCI) which covers the bottom tenth by value of the fully listed UK equity market. The NSCI XIC is the version of the NSCI that omits investment companies. The NSC plus AIM index brings AIM securities into the index if they are below the NSCI's market-capitalisation limit. In 1994, the NSC 1000 index was introduced targeting "minnows" defined as the bottom 2% by value of the UK equity market XIC). This was followed in 2015 by the Numis Mid Cap, which covers the bottom 20% of the fully listed UK market, but excludes the bottom 5%. In 2017, the Numis Alternative Markets index was launched which includes all companies listed on qualifying UK alternative markets – currently only AIM qualifies. Finally, in 2020, Numis added a Large Cap index which covers the top 80% of the fully listed market. All the Numis indices are available both including and excluding investment companies, and as both capital gains and total returns (including reinvested dividends) indices. All indices have long, 66-year back histories since 1955.

Smaller company benchmarks

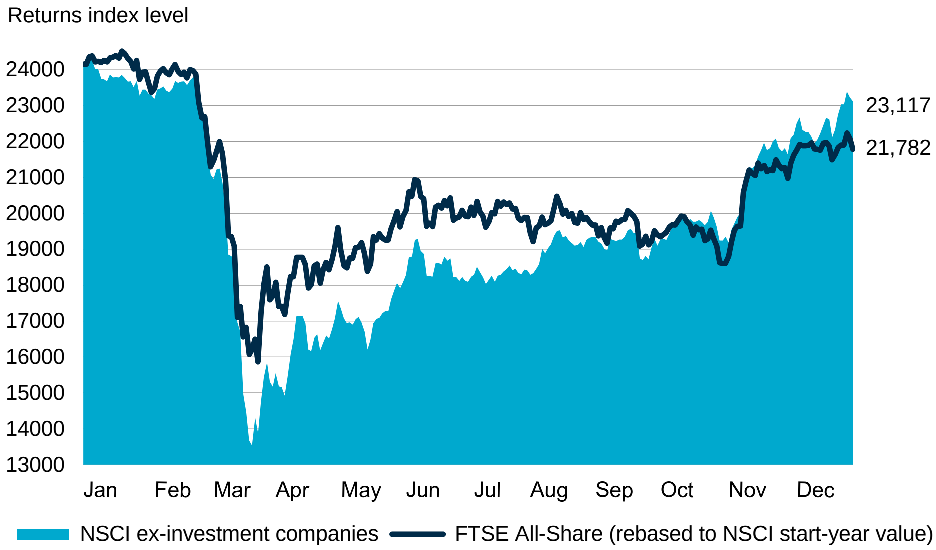
The Numis Smaller Companies Index (NSCI) remains the pre-eminent benchmark for UK small-cap investors, most often in its XIC version. The NSC plus AIM XIC and NSC 1000 XIC are also used as benchmarks. As noted above, in order to cover one-tenth of the value of the UK equity market at the start of 2021, the upper market capitalisation cut-off of the NSCI was set at £1,500 million. The corresponding start-2021 cut-off for the NSC 1000 was £608 million; the rebalanced NSC 1000 now has 529 companies.

NSCI worth 3.0x the FTSE SmallCap

The NSCI covers a pre-specified 10% of the value of the UK equity market. In contrast, the FTSE SmallCap comprises FTSE All-Share constituents that rank below the largest 350 index constituents. This gives rise to a different profile for the two indices. Since its inception in 1992, the FTSE SmallCap has shrunk from covering around 10% of the UK equity market – the same as the NSCI – to just 3.4% today. If it were rebalanced at the same date as the NSCI, the largest FTSE SmallCap constituent would have been worth £645 million (this being the 351st ranked FTSE-eligible company), which is above the cut-off for the NSC 1000 (£608 million) but far smaller than the NSCI cut-off (£1,500 million).

In the following section we look in more detail at the performance of all the Numis indices over 2020. This is followed by a detailed analysis of the characteristics of the indices as we enter 2021. Section 4 then updates the long-term performance record.

Figure 19. The NSCI XIC during 2020



Source: FTSE Russell, Scott Evans and Paul Marsh, Numis