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Numis Smaller Companies Index

2020 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 benchmark

The Numis indices were launched at the start of 1987. They have been published continuously for 33 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. NSCI 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 65 years, 1955–2019. 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 Alternative Markets Index includes all companies listed on qualifying UK alternative markets. Currently, only AIM qualifies.

Performance in 2019

Over 2019, the NSCI gave a total return of 22.3%, versus 19.2% for the FTSE All-Share, an outperformance of 3.1%. The equivalent figures for other key Numis indices were NSCI XIC, 25.2% (6% underperformance), NSC 1000, 15.9% (3.3% underperformance) and Numis Alternative markets index, 14.7% (4.5% underperformance). Over the last 65 years, from 1955–2019, the NSCI gave an annualised return of 14.8%, which is 3.3% above the FTSE All-Share; the NSCI XIC returned an annualised 15.0%, and the NSC 1000 gave an annualised return of 16.3%, 4.7% above the FTSE All-Share.

Index composition for 2020

At the start of 2020, the NSCI has 696 constituent companies, of which 346 are non-investment companies. The NSC plus AIM index has 1,547 constituent companies, the NSC 1000 index has 536, and the Numis Alternative Markets index has 859. At the turn-of-the-year rebalancing, the largest NSCI constituent (Worldwide Healthcare Trust) had a value of £1,678 million, while the largest NSC 1000 company (Saga) was worth £582 million. The average market-cap of NSCI companies is £375 million; for the NSC 1000 it is £186 million.

Sector weightings

The NSCI has a significant weighting in industrials, financials, consumer services and investment instruments, which together comprise 80% of the NSCI index and 85% of the NSC 1000. In relative terms, the NSCI and NSC 1000 indices are heavy in industrials, technology, and investment instruments. They are light in oil and gas, consumer goods, health care, telecommunications, and utilities. At the sector level, the NSCI and NSC 1000 have no constituents at all in forestry and paper, tobacco, and gas, water and multiutilities.

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. The volatility of the NSCI has fallen in recent years. It is now at 9.3% which is slightly above its record low achieved two years ago and below the FTSE All-Share. 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 2020, the dividend yield on the NSCI was 3.07% (ex-investment companies, 3.16%) and the P/E multiple, ex-loss makers, was 18.13 (ex-investment companies, 14.90). The dividend yield on the NSC 1000 was 3.27% (ex-investment companies, 3.18%) and the P/E ratio was 16.45 (ex-investment companies, 12.10).

New topics in this year's Review

This year's Review looks back over the 65 years of the NSCI, how the composition of the index has changed, and which sectors have done best and worst. It provides a long run analysis of acquisitions and their impact; examines global small-cap returns; examines factor returns; and provides guidance on the likely magnitude of the future size premium.

Foreword

by the Head of Research, Numis

It is with great pleasure that for the seventh year Numis publishes the Annual Review of the Numis Smaller Companies Index. Over the last 33 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 65 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.

Two years ago we were delighted to launch the Numis Alternative Markets Index. This includes all companies listed on qualifying UK alternative markets. Currently, only AIM qualifies, so the index comprises all AIM listed stocks. However, the index back-history starts in 1980 and includes stocks traded on the now discontinued USM and Third Market.

The Numis index series provides the definitive benchmarks for monitoring the performance of smaller- and mid-sized companies in the United Kingdom. We congratulate the authors on completion of this detailed and comprehensive study of UK smaller and mid-sized companies over the last 65 years. 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

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Highlights of 2019

by Scott Evans and Paul Marsh

A new year, old issues prevail

The dominant themes of 2019 were, in many respects a continuation of the same issues that drove financial markets in the previous year. At the global level, the US-China trade war continued to influence equity markets and at home the Brexit saga intensified. Lacklustre GDP growth, a prime minister's resignation, the third general election in less than five years and a roller-coaster ride for sterling was not the ideal background for UK smaller companies to outperform.

Small caps outperformed

Notwithstanding all this, 2019 was a good year for small- and mid-caps. The NSCI hit an all-time high on 27 December, and finished the year with a total return of 22.3%, or 25.2% after excluding investment trusts (XIC). While most of the outperformance was confined to the very start and end of the year, the NSCI XIC nonetheless outperformed the FTSE All-Share by 6%. The star performance came from the Numis Mid Cap XIC index, which recorded an impressive 29.7% total return, outperforming the All-Share by 10.6%.

Not so good for micro-caps

It was not quite as positive for the smallest stocks in the market. The NSC 1000 – which represents the bottom 2% of the market on an XIC basis – and the Numis Alternative Markets index – which comprises all AIM stocks, and thus mostly contains even smaller-smalls – underperformed the FTSE All-Share by 3.3% and 4.5%, respectively. This relatively weak performance coincided with the suspension of Woodford Investment Management's high-profile fund, with its large exposure to illiquid stocks. As a result, liquidity became the watchword for 2019 as investors became more sensitive to their exposures to the less liquid stocks at the minnows end of the market.

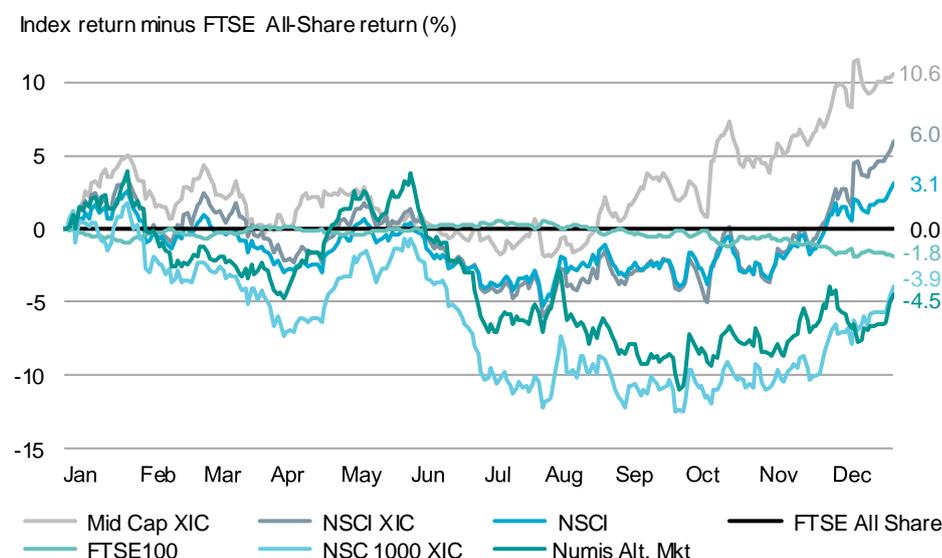
Limited number of IPOs

2019 was a subdued year for the IPO market with just 30 new companies eligible for inclusion in the NSC plus AIM index. This was well below the long-run annual average of 136 flotations. Of the departing companies, 43 were acquired and 16 were deemed valueless and were de-listed. The valueless companies had a combined size of £1.3 billion at the start of the year, but their overall impact on the index was limited.

65th anniversary of the NSCI

The strong performance of small-caps in 2019 has helped maintain their long-term positive record. As the NSCI celebrates its 65th anniversary, the 65-year annualised return stands at 14.8%, which is 3.3% greater than the annualised return for the FTSE All-Share.

Figure 1. Relative performance of Numis and FTSE indices during 2019



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

The NSCI index is 65 years old – its blue sapphire anniversary

The NSCI: 65 years old and not retiring

Launched in 1987 with a 32-year back history, the NSCI now has a 65-year history and is the longest running UK small-cap index. It was the first-ever UK small-cap index (the FTSE Small Cap followed in 1992); the first UK index to provide total returns as well as capital gains indices; the first to provide an ex-investment companies version; and importantly, the first to be launched with a very long back history. The NSCI is now the benchmark of choice for the majority of institutional small-cap investors.

The Numis family of indices

At the 1987 launch, two versions of the index were available. The main NSCI included companies representing the bottom 10% by value of the UK market. The Extended NSCI also included companies listed on the now defunct Unlisted Securities Market (USM). In 1994, the NSC 1000, covering the bottom 2% of the market, was launched to track market minnows. After the USM closure and the opening of the Alternative Market Index (AIM), the NSC plus AIM index began life in 1996. In 2015, Numis launched the Numis Mid Cap, followed in 2017 by the Numis Alternative Markets index. The former covers the bottom 20% of the market but excludes the smallest 5%, and the latter includes all companies listed on qualifying UK alternative markets – currently, only AIM qualifies.

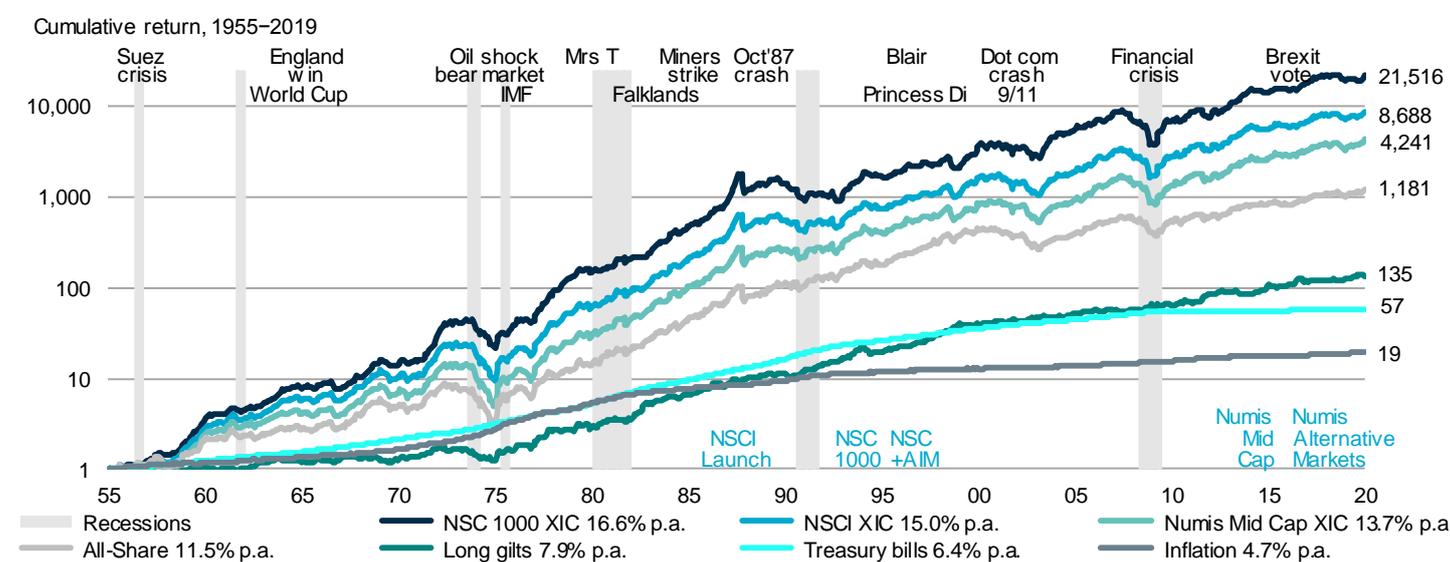
The size-effect and size premium

Besides wishing to serve the investment community, the NSCI launch was motivated by academic research. This showed that small-caps performed differently from large-caps (the size effect), and had, over the long run, outperformed (the size premium). The size premium gained prominence thanks to the work of Rolf Banz (1981) for the US market, and research by Marsh (1979) and Dimson and Marsh (1986) for the UK. There is now a substantial body of academic work from around the world focused on the size premium.

Long run, equities triumphed, and the smaller the better

Over the NSCI's 65-year life, the UK economy has seen boom and bust, and financial markets, both good and bad. Figure 2 below highlights key events, and shows long-run performance from the Numis indices and other UK assets. The figures on the right show the terminal wealth from investing £1 in 1955, while the legend shows the annualised returns. Clearly, UK equities, as measured by the FTSE All-Share, handsomely beat both gilts and treasury bills (cash). This is despite three painful bear markets. Indeed, events that were traumatic at the time now just appear as setbacks within a long-term secular rise. The chart also shows that small-caps greatly outperformed the large-cap oriented FTSE All-Share. Indeed, it was a case of the "smaller-the-better". The NSC 1000 minnows beat the NSCI small-caps, which in turn, beat the Numis Mid Cap.

Figure 2. The NSCI and comparative long-run returns



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

The evolution of the NSCI: constituents and concentration

Decline in constituents

One of the most striking features of the NSCI over its 65-year history has been the decline in the number of constituents. Figure 3 shows the number of NSCI constituents in 1955 was 2,517 (2,388 XIC). By the launch date in 1987 this had fallen to 1,206 (1,067 XIC). By start-2020, the number of NSCI XIC companies was 346, an 85% decline since 1955.

Average size has increased

While the number of constituents has fallen, average company size has risen. Figure 3 shows that in 1955, the average size of an NSCI XIC company was just £0.41 million. By 1987 this had risen to £24 million, and by 2020 to £444 million. The increase is partly due to inflation and the rise in equity markets. However, the average size of an NSCI company in 2020 is a thousand times larger than 65 years ago. This reflects the concentration of the UK equity market into fewer, but larger companies. As an example of this, the largest NSCI company in 1955 was Associated British Engineering with a market cap of £1.6 million. The largest UK company was BP at £431m, making it 269 times larger. By start-2020 the ratio of the largest NSCI company (World Healthcare Trust, £1.68 billion) to the largest UK company (Royal Dutch Shell, £176.3 billion) had fallen to 106 times larger.

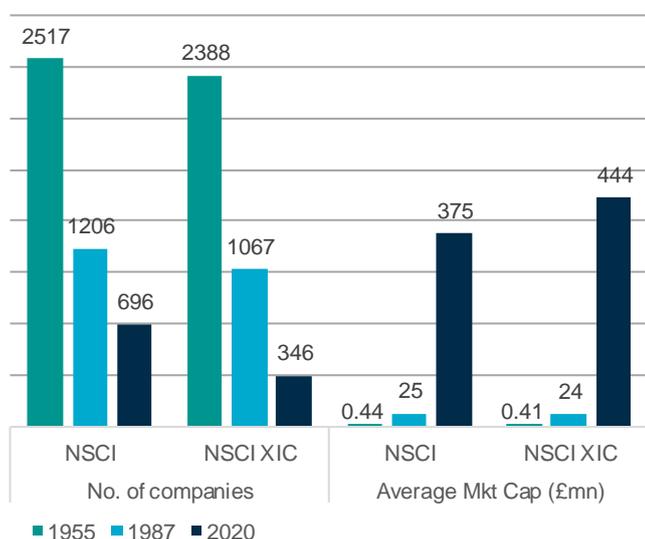
Not enough IPOs to offset deaths

Companies join the NSCI via IPO, a transfer from another market or because they became small enough. Companies that leave are acquired, become too big, transfer to another market or become worthless. Figure 4 shows the net result of joiners minus leavers. The green line shows the cumulative loss from deaths minus IPOs – 806 since 1997. The black line shows the cumulative loss from (net) transfers to AIM (166), while the grey line shows the cumulative net additions from rebalancing (63). Overall, the number of constituents has fallen by 909 from a starting value of 1,255 in 1997. The explanation for this decline is simple, not enough births (IPOs) to outweigh the deaths. This problem is not NSCI or small-cap specific – the total number of fully listed and AIM stocks has been declining sharply. Nor is it just a UK issue. The number of US listed stocks has fallen by over 30% in the last 25 years.

NSCI stocks are now larger and more liquid

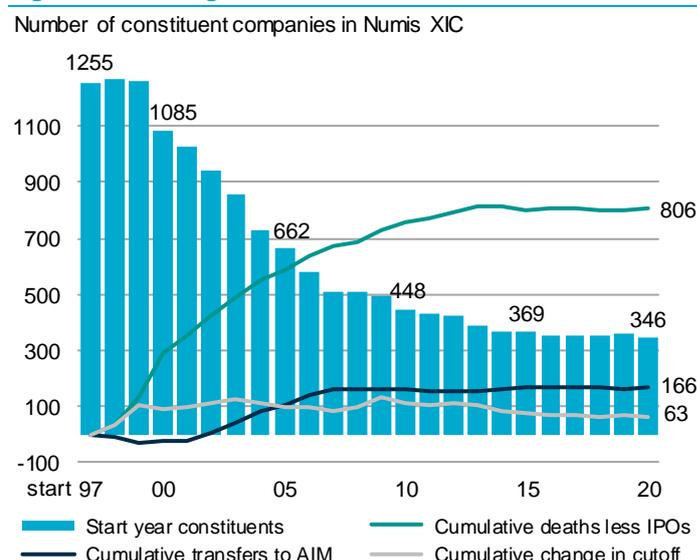
While there has been shrinkage in the number of constituents, there are some positive aspects for investors. There has been no decline in the NSCI's relative value, its absolute value has risen markedly, and NSCI stocks are now larger and more liquid. The number of very tiny companies has fallen, liquidity has improved, and even AIM now contains more investible securities. Nevertheless, a reinvigorated IPO market would be beneficial and healthy for all investors.

Figure 3. Number of companies and their size



Source: Scott Evans and Paul Marsh, Numis

Figure 4. Shrinkage in the constituents of the NSCI XIC



Source: II, Scott Evans and Paul Marsh, Numis

Changing industrial landscape

Sector composition and returns since 1955

The UK's industrial landscape has changed dramatically since 1955. First, there has been a major move from manufacturing to service industries. Second, there have been important advances in technology. For example, in 1955, TV was novel, recorded music limited to vinyl, mobile and smart phones non-existent, computers in their infancy and the web not even dreamt of. Third, privatization brought many new industries to the market, including telecoms, steel, utilities and rail. Most of the newly privatised companies were large-caps.

Industry classification schemes

Industry classification schemes need to keep pace with this changing landscape. Since UK classifications started in 1979, there have been four distinct regimes, with a switch to a fifth, the new ICB structure, coming later in 2020. We will implement this for the 2021 indices.

Big changes in industrial exposure over time

Figure 5 shows the top five NSCI sectors at the start of 1955, 1987 and 2020. It shows that investment trusts have always featured strongly in the NSCI, growing from an 11.3% weight 65 years ago to 41% today. The other sectors with large weights are very different today compared to 1955. The top sectors in 1955 were textiles, mechanical engineering, building materials and the long-gone sector of overseas traders, comprising a mix of end-of Empire stocks (e.g., tea and rubber plantations and tin mines). By 1987, these had mostly gone. Mechanical engineering was still in the top five, but the others had been replaced by leisure, property and electronics. Reflecting the steady move towards the service sector, by start-2020, the top industries are travel & leisure, financial services, support services and media.

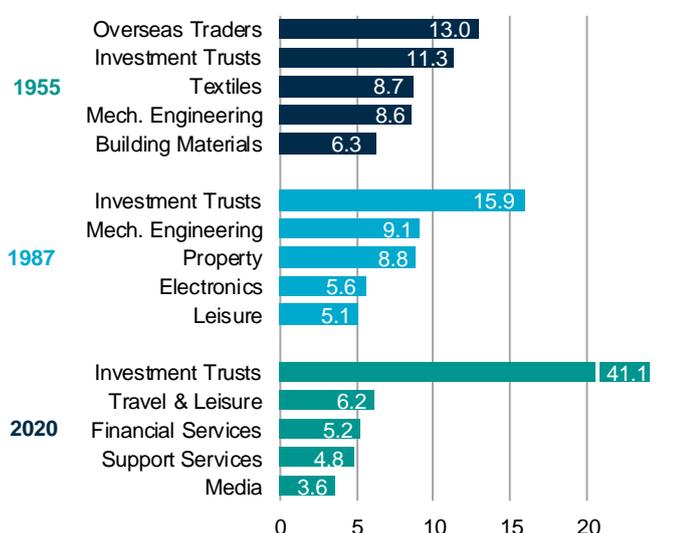
Leisure best performer since 1955

To examine sector performance, we created sector indices for the NSCI and the UK market from 1955–2019 for 20 sectors with continuous histories. Figure 6 shows that for the NSCI, the best performing sectors were leisure, construction and business services, while the worst were oil, consumer durables and mining. For the UK market, healthcare, mining and leisure performed best, while retail, manufacturing and consumer durables did worst.

Sector selection

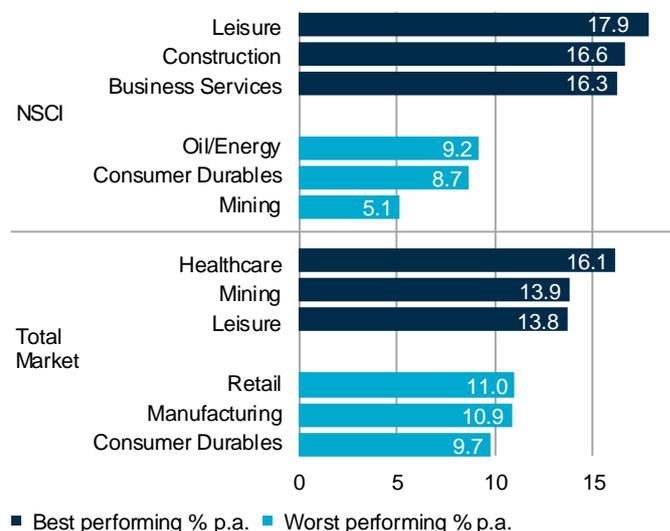
To put the returns in Figure 6 in perspective, £1 invested in 1955 in the small-cap leisure sector would today be worth £46,000 compared to just £26 if invested in small-cap mining. Investors with foresight and sector selection skills could have performed very well. Looking ahead, technology and industries will continue to evolve. In looking at new technologies, however, caution is required. Research by Dimson, Marsh and Staunton (2015) shows that, if anything, investors may have historically placed too high a value on new technologies, overvaluing the new and undervaluing the old. Leaning against this tendency may help.

Figure 5. NSCI sector weightings (%) in 1955, 1987 and 2020



Source: Scott Evans and Paul Marsh, Numis.

Figure 6. Best and worst performing sectors:1955–2019



Source: Scott Evans and Paul Marsh, Numis.

The size premium can be negative over long periods

What size premium can we expect in future?

At the 1987 launch, the annualized size premium over the NSCI's 32-year back history was 6%. In the glow of the post-launch publicity, small-caps did well for two more years, but then suffered a dreadful ten years from 1989–98, when the size premium fell to –8.1% per year (see Figure 7). This was an extreme example of a now well-established research finding, namely, that stock market regularities, once discovered, typically then perform less well than over the research period. These ten years were so poor that lengthy periods spanning them show a negative premium, the longest being the 30 years from 1979-2008.

The size premium is variable and has fallen from 6% to 3.3%

Just as investors were writing off small-caps, the NSCI recovered, and since end-1998, the annualized size premium has been 4.2%. However, there is much year-to-year variability (see section 4). Figure 7 shows that even the 10-year rolling premium varies a great deal. It also shows that, thanks to the ten lean years, the long run premium has fallen from 6% at launch to 3.3% today. Rather than asking why the historical premium is now lower, we should instead ask why the back-history premium was so high.

Impact of re-rating on size premium

In 1955, the NSCI had a far higher dividend yield (8.7%) than the UK market (see Figure 8). By 1987, this had reversed. In 1955, the NSCI included many end-of-Empire stocks and low growth manufacturers, which helped explained the high yield. However, the yield premium to the market mostly reflected valuations. From 1955-86, small-caps enjoyed a major re-rating. The price-to-dividend ratio rose from 11.5 to 32.3, adding 4% to the NSCI's annualised return. By 1987, further re-rating was, and has since proved to be, implausible. Removing this unrepeatabe element, the premium becomes 6% – 4% = 2%.

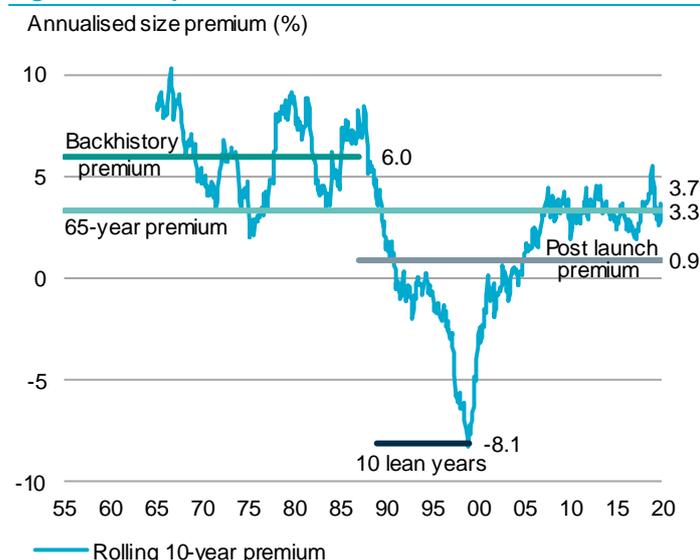
Why there should be a premium

Many arguments put forward for small-cap outperformance are spurious. Small cap earnings and dividends may grow faster, but this should be in the price. Individually, they are riskier, but within a diversified portfolio, they are no riskier than large-caps. However, they are less liquid, with higher spreads, trading costs and oversight costs. This should drive down prices to the point where small-caps offer a prospective premium. The smaller the smalls, the more this applies, leading to an expectation of “the smaller the better”.

The future premium will be smaller

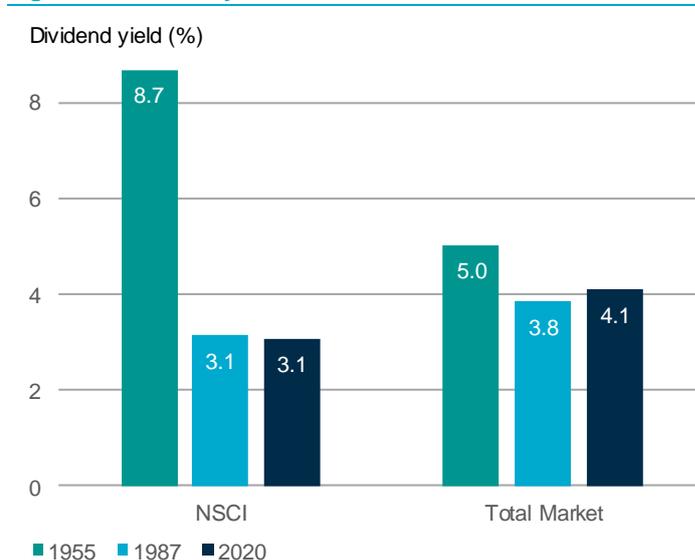
The 65-year size premium is 3.3%, but this includes the pre-launch period. The pre-launch premium was 6%, but 4% arose from an unrepeatabe re-rating. Post-launch, the premium has been 0.9%, but that includes the ten lean years. Prospectively, we expect a long-run premium in the range 1–2%, but we will continue to see much year-to-year variation.

Figure 7. Size premium, NSCI vs FTSE All-Share, 1955–2019



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

Figure 8. Dividend yields in 1955, 1987 and 2020



Source: Scott Evans and Paul Marsh, Numis.

Acquisition activity over the long-term

Arrivals and departures

The composition of the stock market is dynamic. Every year new companies join while some previously listed companies leave. The net impact of the arrivals and departures provides the end-of-year stock of companies from which a rebalanced NSCI index is derived. We examine the influence of the new entrants on the NSCI in Section 3. Here we look at the longer-term trends in acquisitions both within, and outside, the NSCI.

M& activity occurs in waves

Figure 9 shows that M&A activity tends to occur in waves. An increase in corporate activity often follows periods of strong equity markets and/or economic recoveries. Over the lifetime of the index, there have been four peaks in NSCI acquisition activity. These occurred around 1960, 1968, 1986, and 1999 and followed periods of strong equity market returns. Apart from in 1960, 9% or more of the start-year NSCI was acquired, both in terms of number of companies and value. The most recent peak for total acquisitions occurred in 2007, when the majority were AIM listed. Since 2007, the absolute number of NSCI, AIM and larger, fully-listed, non-NSCI companies being acquired has fallen.

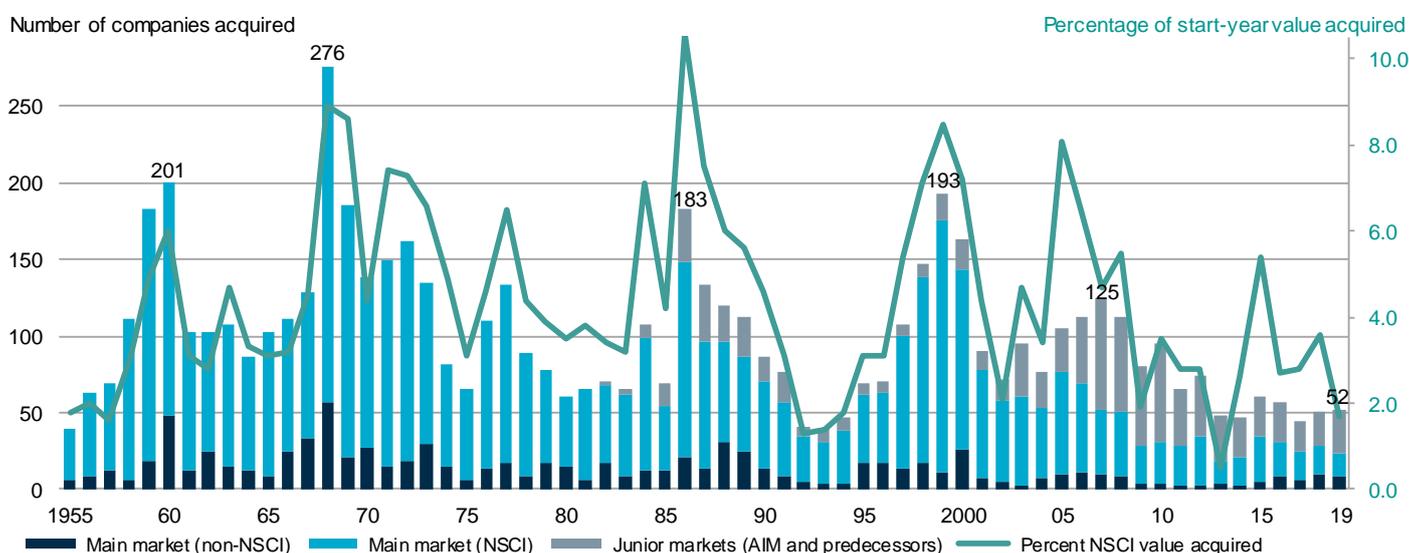
2019 was a subdued year

Despite some high-profile companies being bid for in 2019, a total of 52 completed acquisitions meant it was a relatively quiet year for corporate activity. For the NSCI the number of acquisitions was at its lowest since the index began with just 14 completed transactions by the year-end. This compares to a long-term average for the NSCI of 72. Even including the 29 AIM acquisitions and nine mid-caps, the total number of 52 acquisitions in 2019 was well below the long-term average for all market segments.

1.7% of NSCI acquired in 2019

As previously highlighted, the number of companies listed on the London Stock Exchange has been steadily declining. For comparative purposes, we have also calculated acquisition figures as a percentage both of the start-year number of companies and the start-year value. The line plot in Figure 9 shows the value of NSCI acquisitions each year as a percentage of the index start-year value. The peaks in value correspond to the peaks in the numbers of acquisitions. The picture is very similar if we plot the percentage of the start-year number of companies. In 2019, the total value of NSCI companies acquired was just 1.7% of the index. This is the third lowest since 1955 and well below the long-term average of 5%. The inclusion of junior market stocks does increase the total acquisition rate over the period. But with AIM company acquisitions in 2019 amounting to 3.3% of the value of the Alternative Markets index (compared to the longer-term average of 4.7%), 2019 was not a stand-out year for acquisitions on any measure.

Figure 9. Acquisitions in the UK, 1955-2019



Source: Scott Evans and Paul Marsh, Numis.

Acquisitions, bid premiums and impact on returns

Arrivals and departures

For investors, the main interest in takeover activity relates to bid premiums. Companies usually attract sizeable bid premiums relative to their pre-offer price unless they are in financial distress. For investors running concentrated portfolios, a takeover of a single constituent can have a significant impact on portfolio return. Bids for high profile companies can also be glamour events, leading to expectations of further bids, which can push up valuations of similar companies, or even the entire market.

Some high bid premiums in 2019

Of the companies acquired in 2019, the majority were purchased at premiums to their pre-bid price. Calculating the exact bid-premium can be difficult as it is not always obvious what date to use for the “pre-bid” price. A company may have been subject to numerous bids or bid rumours, and much of the price appreciation may have occurred before the official bid announcement. With that caveat in mind, Figure 10 ranks the top 15 bid premiums for NSCI plus AIM acquisitions completed in 2019. The range of premiums was substantial from almost 400% for Earthport, to 40% for EU Supply. Excluding FlyBe and Bonmarche, distress situations that attracted negative premiums, the other acquired companies below the top 15 enjoyed an average premium of 23%.

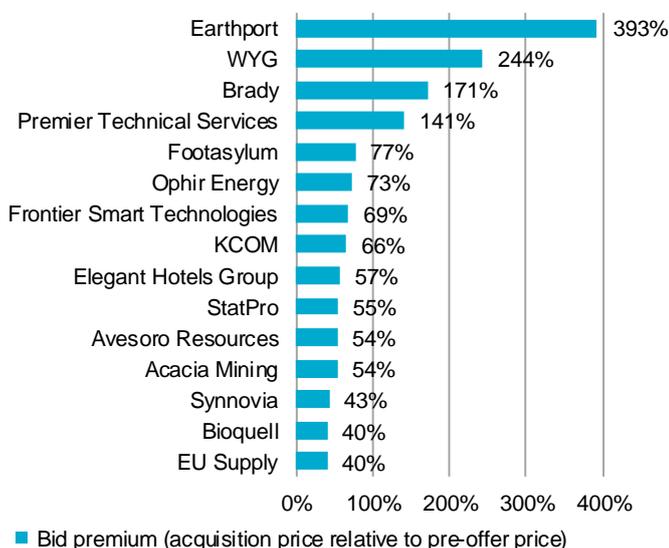
Overall impact on index is limited

While bid premiums can be high, the overall impact on the index is usually quite modest. This is because acquisitions typically account for only a small proportion of the index’s value, and the largest premiums are usually associated with the smallest companies. In 2019, acquisitions accounted for less than 2% of the NSCI by value, so despite some significant bid premiums, the overall impact on the NSCI was just 0.8%. Figure 11 plots the annual returns for the NSCI plus AIM index for the past 20 years along with the impact of acquisitions. The largest impact was in 2009, when acquisitions contributed 2.4% to the index return of 61.4%. On average, acquisitions added just 1.1% to index returns and the impact was small relative to index return. However, compared to a future expected size premium of 1–2%, the contribution of acquisitions to the premium is more material.

More acquisitions in 2020?

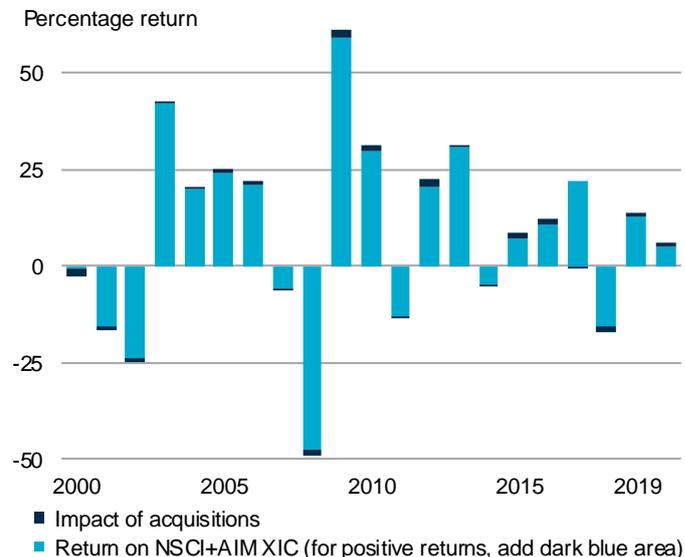
Although the direct impact of acquisitions has been limited, a pick-up in takeovers can be an indication that corporate buyers see more value in the market than institutional investors. This can have a positive impact on the market. With a strong equity market performance behind us in 2019, and possibly a more stable political and economic future ahead, maybe we can expect a rebound in acquisition activity in 2020.

Figure 10. Largest 15 bid premiums in 2019; NSCI plus AIM



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

Figure 11. Impact of acquisitions on returns: NSCI plus AIM



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

Factors investing seeks to harvest long run premiums

Style investing within small-caps: an update

Factor investing remains in vogue. It aims to harvest the long run factor premiums revealed by academic research. We regularly analyse the performance of factors within the NSCI XIC, focusing on value, size (within small-caps), income, momentum and low risk. Figure 12 shows the long-run premiums over the life of the NSCI. Size gave the smallest premium with smaller-smalls beating larger-smalls by 0.8% per year. Next, all with similar premiums of around 3½%, value has beaten growth, high yield has beaten low yield, and low specific risk has beaten high risk. Momentum gave the largest premium, with winners beating losers by an annualised 17.4%, but this is a risky trading strategy with high turnover and costs.

Momentum and low risk enjoyed large premiums in 2019

Figure 13 shows factor performance in 2019. Momentum and low risk performed very well, with winners beating losers by 46.8% and low specific risk stocks outperforming high risk stocks by 20.4%. Momentum was clearly the stand out winner, but the caveats above apply. The success of the low risk strategy was helped by its relationship with company size. Specific risk tends to be higher, the smaller the company. The low specific risk portfolio thus benefitted from the inclusion of more mid-caps from the better performing top-end of the NSCI, while the high specific risk portfolio contained more minnows.

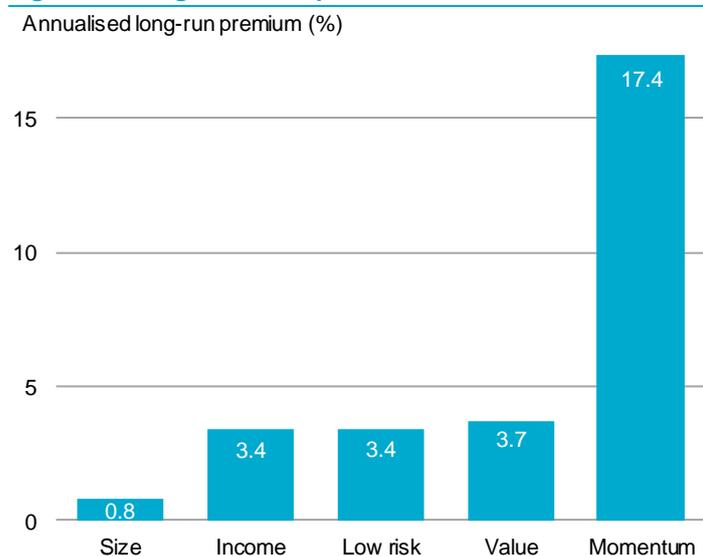
Smaller-smalls underperformance linked to illiquidity concerns

Value, size and income all had negative premiums, a reminder that premiums vary greatly from year to year, and can be negative, even over long periods. The size premium of -9.2% is large in a historical context. The underperformance of smaller-smalls may be related to investor and regulatory concerns over liquidity in the wake of Woodford Investment Management. Smaller-smalls may have de-rated in order in a higher required premium for illiquidity. If so, this is an opportunity for those funds most able to bear illiquidity, as it holds the promise of higher expected future returns from smaller-smalls.

Value remains in the doldrums

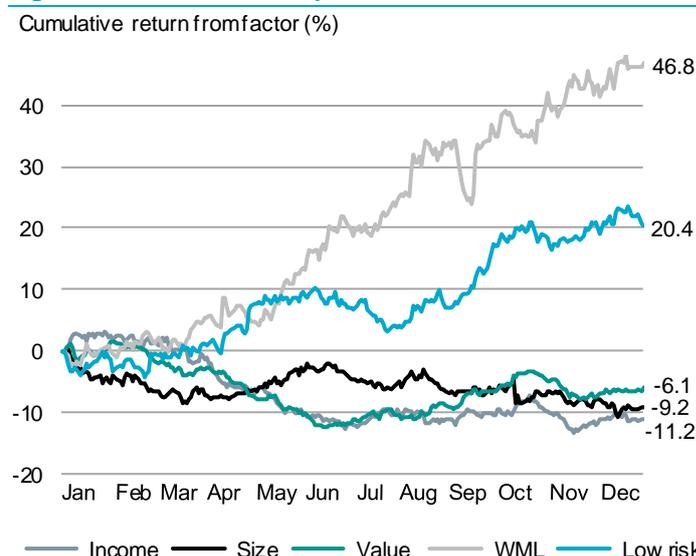
Value has now suffered over a decade in the doldrums. A brief pick-up and glimmer of hope in mid-2019 faded in Q4. Why is value out of favour? The pessimistic view is that there was never a sound theoretical reason for the value premium in the first place. (This is true of many other factors). If it arose for behavioural reasons, such as investors falling in love with, and overpaying for, growth, then maybe investors have now learnt, and the premium has disappeared. However, this would imply a zero premium, not prolonged underperformance. Value will have its day in the sun again, but no one knows when. But will there be a long run value premium over the next 65 years? That is more debatable.

Figure 12. Long-run factor premiums



Source: Scott Evans and Paul Marsh, Numis

Figure 13. NSCI XIC factor performance in 2019



Source: Scott Evans and Paul Marsh, Numis

Overseas sales, currency and the NSCI in 2019

Volatile currency in 2019

2019 was a tumultuous year for sterling. Political stalemate and Brexit led to a 11% peak-to-trough depreciation, followed by a 10% appreciation in the final quarter. For companies with a large overseas exposure, such currency swings can have a major impact on valuation. In this section we examine the relationship between overseas sales and returns for both the NSCI and the overall UK market.

Overseas sales exposure

Using data for all fully listed UK companies (XIC), we used the percentage of UK sales as a proxy for each company's exposure to currencies other than sterling. We calculated market capitalisation weighted measures of overseas exposure for the Numis and FTSE indices (all XIC) which we show in Figure 14 below. It shows that in aggregate, overseas exposure declines with company size. The large-cap companies of the FTSE 100 have, in aggregate, a 73% overseas exposure, compared to 36% for the FTSE Small-Cap. Similarly, the Numis Mid Cap has a 51% exposure compared to 41% for the NSC 1000.

Domestics vs overseas

We then ranked all NSCI companies by their percentage of sales derived from the UK. We allocated all those with 100% UK exposure to the "domestic" group. This accounted for 41.5% of the NSCI's value. To define the "overseas" group, we worked upwards from zero exposure to the UK until we had created a group that also accounted for 41.5% of index value. This conveniently comprised companies with a non-UK sales exposure of 50% or more. We used these same sales exposure breakpoints for the total market.

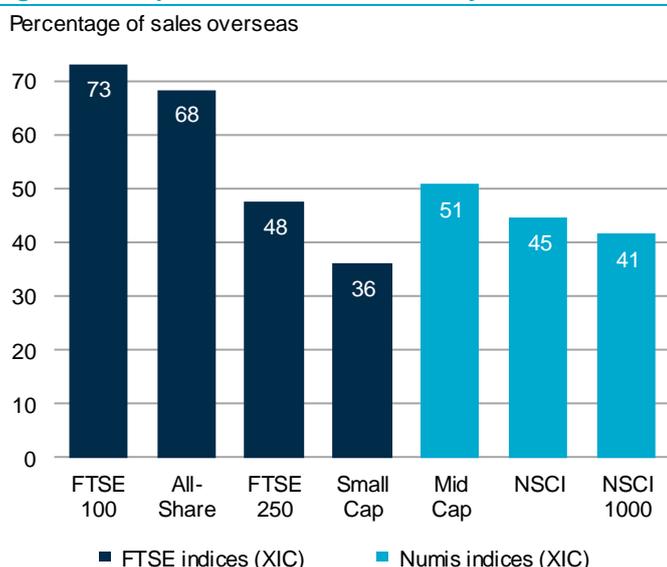
Volatile currency in 2019

Figure 15 plots the performance of domestic relative to overseas companies for both the NSCI and the total UK market. For both, the performance of domestic companies was initially strong, then relatively weak in the second and third quarters, which was the period when sterling was weakest. From the low-point in August, domestics recovered strongly in line with the currency appreciation, leading to the domestics outperforming over the year by almost exactly the amount that sterling appreciated in the fourth quarter.

Size, liquidity and sector effects

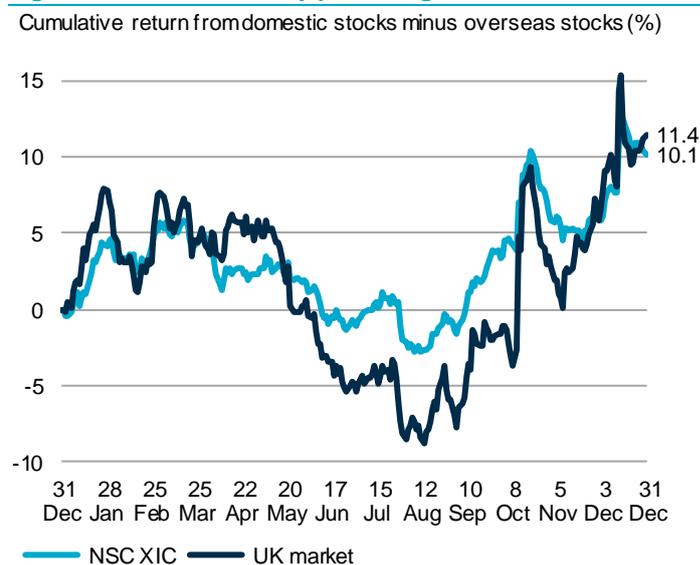
Concluding that currency had a such a direct impact is not so straightforward. One issue is that the overseas group of NSCI consists of companies that are on average smaller than those in the domestic group. We know the smaller-smalls underperformed last year and so we may just be picking up a size and/or liquidity effect. Likewise, the overseas group of the total market has a very high exposure to oil and mining companies. While currency and overseas exposure may have been a significant contributor to performance in 2019 it is hard to disentangle it from the competing effects of size, liquidity and sector.

Figure 14. Proportion of overseas sales by index



Source: Scott Evans and Paul Marsh, Numis

Figure 15. Performance by percentage of domestic sales



Source: Scott Evans and Paul Marsh, Numis

Global small-cap performance

UK in an international context

To place the performance of UK small-caps in an international context, we examine the world's largest equity markets, defined as those with more than a 1% weighting in the FTSE World index at the start of 2019. This gave 15 countries which make up over 90% of the 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 FTSE All-Share to proxy large-caps.

Compare returns for 15 countries

Figure 16 plots the 2019 returns (blue bars) and size premiums (line plot) for the 15 countries. It shows that small-cap returns were positive for all countries apart from Korea and India. In absolute terms, the best performing markets for small-caps were the Netherlands (35%), Germany (32%) and Switzerland (30%). The UK ranked in sixth position in between the US (27%) and Canada (25%).

UK has done well

Relative to large caps the story is quite different. The line plot in Figure 16 shows that the size premium was negative in all but five countries. Given the positive absolute returns of small-caps in most countries, the negative size premiums, especially in countries like the Netherlands is more indicative of a particularly strong year for large cap stocks rather than a bad year for small-caps. Those countries where small-cap premiums were positive were Germany, the UK, Canada, Spain and Switzerland, albeit the latter was only marginally above zero. In an international context, therefore, UK small-caps may not have been the best for absolute returns but relative to large-caps put in a very creditable performance.

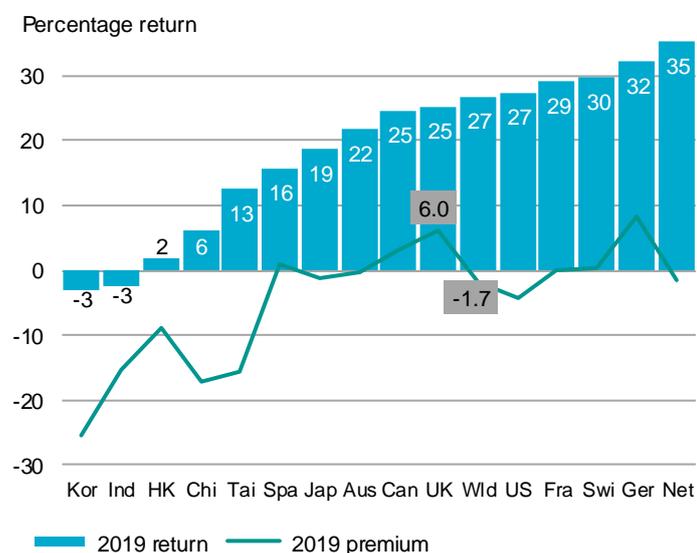
Correlation related to location

An interesting feature of returns in 2019 is a degree of geographical clustering. Ranking by premiums reveals the worst performances came from the US and from the Asian countries of Korea, India, Hong Kong and China, and - with the exception of Canada - the best came from European countries, namely, Germany, the UK and Spain. We have examined the correlations between size premiums in previous editions of this Review and found that with the exception of the US, correlations tend to be higher the closer together countries are located. This observation appears to be borne out by the 2019 performance.

Size premium has been positive in most countries since 2000

Figure 17 shows the 20-year premiums since start-2000 for all 15 countries. This is the longest period for which we have comparable data on total returns for international small-caps. Despite negative premiums recorded in many markets in 2019, Figure 17 shows that long-run premiums remain positive in all but Taiwan and Hong Kong.

Figure 16. Global small-cap performance in 2019



Source: Scott Evans and Paul Marsh, Numis

Figure 17. Global small-cap premiums since 2000



Source: Scott Evans and Paul Marsh, Numis

1. Index overview

by Scott Evans and Paul Marsh

A good start to the year

Describing the performance of the NSCI in 2019 is like describing many of the classic literary novels. A good start, and an excellent finish, but rather tough in the middle. For the Numis indices the year started well with positive returns in January ranging from 4.4% for NSC 1000 (XIC) to 7.5% for Numis Mid Cap index (XIC). Progress started to slow in the following months and despite the positive start, all but the mid-caps had underperformed the larger companies of the FTSE All-Share by the half-year stage.

A classic finish

By the fourth quarter the mood had changed. A good November followed by an excellent December resulted in the NSCI recording a total return of 22.3%, beating the FTSE All-Share by 3.1%. After removing the contribution of investment companies (holdings of which tend to be dominated by larger companies), the NSCI XIC return was higher at 25.2%, a 6% outperformance relative to the FTSE All-Share. On the 27th December the NSCI closed at an all-time high.

Mid-Caps are the star performers

The star performer of the year was the Numis Mid Cap index XIC. Apart from some underperformance in the volatile summer months, mid-caps were ahead of the FTSE All-Share for most of the year. By year end, the Numis Mid Cap XIC index had returned 29.7%, 10.5%, ahead of the FTSE All-Share and 12.4% ahead of the FTSE 100.

More difficult year for the smaller of the smalls

It was a less good year for the smaller NSCI companies. The NSC 1000 XIC, which covers the bottom 2% of the market on an XIC basis, lagged the market for most the year. The strong rebound in Q4 helped its absolute performance, but it still underperformed the FTSE All-Share by 4%. Similarly, the Numis Alternative Markets index, which currently comprises all AIM stocks, and thus mostly contains even smaller-smalls, underperformed the FTSE All-Share by 4.5%, with an annual return of 14.7%.

Cut-off for inclusion in the NSCI is £1,678 billion

After a good year for small- and mid-cap performance, the NSCI enters 2020 with a combined market capitalisation of £261 billion. The cut-off for inclusion has increased to £1,678 billion, but the total number of companies has fallen slightly to 696. Of the new entrants; just 19 were IPOs during the year, two transferred from AIM to the main market and 15 were previously too big for inclusion prior to rebalancing. 655 companies of the 696 that make up the NSCI at the start of 2020 were in the index last year.

Start-2020 valuation ratios

After re-balancing, the NSCI and NSCI XIC start 2020 with a dividend yield of 3.07% and 3.16% and PE ratios (excluding loss makers) of 18.13 and 14.90 respectively.

Table 1. The Numis indices during 2019

	Start-2019	End-2019	2019 High	2019 Low	All-time High
Total return index					
NSCI	17839.75	21812.83	21881.60 (27 Dec 19)	17839.75 (31 Dec 18)	21881.60 (27 Dec 19)
NSCI XIC	19296.02	24153.03	24215.54 (27 Dec 19)	19296.02 (31 Dec 18)	24215.54 (27 Dec 19)
NSC 1000 XIC	18291.28	21085.48	21085.48 (31 Dec 19)	18159.69 (9 Oct 19)	22319.39 (21 May 18)
Numis Mid Cap XIC	19712.22	25571.59	25805.27 (27 Dec 19)	19612.02 (3 Jan 19)	25805.27 (27 Dec 19)
Numis Alt. Markets	1921.10	2203.52	2204.83 (30 Dec 19)	1921.10 (31 Dec 18)	5403.42 (10 Mar 00)
FTSE All-Share	6577.39	7837.96	7933.43 (27 Dec 19)	5919.68 (3 Jan 19)	7933.43 (27 Dec 19)
Capital gains index					
NSCI	6491.48	7681.00	7705.59 (27 Dec 19)	6491.48 (31 Dec 18)	7705.59 (27 Dec 19)
NSCI XIC	6974.29	8448.81	8470.98 (27 Dec 19)	6974.29 (31 Dec 18)	8558.13 (22 May 18)
NSC 1000 XIC	8547.36	9539.75	9539.75 (31 Dec 19)	8274.96 (9 Oct 19)	10620.30 (21 May 18)
Numis Mid Cap XIC	6794.00	8533.25	8611.31 (27 Dec 19)	6758.75 (3 Jan 19)	8611.31 (27 Dec 19)
Numis Alt. Markets	1051.39	1186.32	1187.06 (30 Dec 19)	1051.39 (31 Dec 18)	3898.22 (10 Mar 00)
FTSE All-Share	3675.06	4196.47	4247.59 (27 Dec 19)	3657.52 (3 Jan 19)	4324.41 (22 May 18)

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

NSCI size cut-off is £1,678 million

The extensive family of Numis indices is designed to monitor the performance of the smaller companies sector. The main version of the NSCI covers the bottom tenth by value of the UK equity market. The NSC plus AIM brings Alternative Investment Market securities into the index if they are below the NSCI's market-capitalisation limit. The NSCI XIC is the version of the NSCI index that omits investment instruments. In order to cover one-tenth of the value of the UK equity market at the start of 2020, the market capitalisation cut-off for the NSCI was set at £1,678 million. The largest company in the index as at the rebalancing date (close of business on 30 December 2019) was Worldwide Healthcare Trust, an investment company first listed in April 1995.

This cut-off is the upper limit on market-cap for the 2020 NSCI indices. The rebalanced NSCI now contains 696 companies and 732 underlying securities. The rebalanced NSCI XIC now has 346 constituent companies and the same number of underlying securities.

NSC 1000 cut-off is £582 million

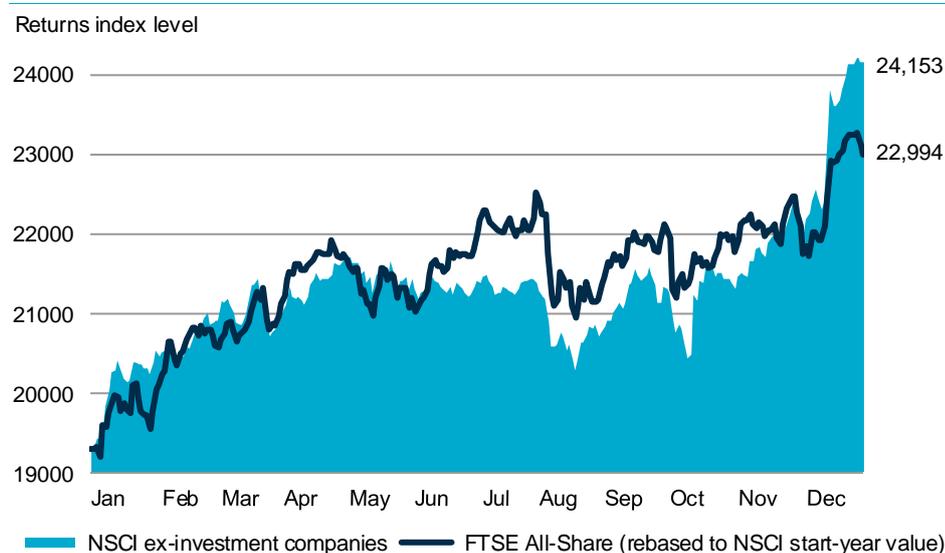
The NSC 1000 targets "minnows" covering the bottom 2% by value of the UK equity market (where, in this case, the value excludes investment companies). When we first launched the index, the 2% cut-off rule gave rise to exactly 1000 constituents, including investment companies, hence the index name. For some years, the number of constituents was rounded to precisely 1000 companies. However, from 1998, we reverted to the strict 2% rule. As we enter 2020, this rebalancing rule gives an NSC 1000 cut-off of £582 million; the rebalanced NSC 1000 now has 536 companies and 571 underlying securities.

NSCI worth 2.8x 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 inception, the FTSE SmallCap has shrunk from covering around 10% of the UK equity market – the same as the NSCI – to just 3.6% today. If it were rebalanced at the same date as the NSCI, the largest FTSE SmallCap constituent would have been worth £675 million (this being the 351st ranked FTSE-eligible company), which is above the cut-off for the NSC 1000 (£582 million) but far smaller than the NSCI cut-off (£1,678 million).

In the following section we look in more detail at the performance of all the Numis indices over 2019. This is followed by a detailed analysis of the characteristics of the indices as we enter 2020. Section 4 then updates the long-term performance record.

Figure 18. The NSCI XIC during 2019



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