

OUT OF OUR MINDS

Small Caps: Adventures in Fundamental Research

by Jafar Rizvi, CFA

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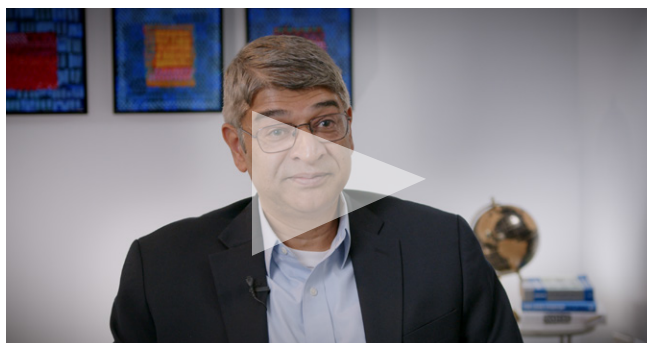
Jafar Rizvi, CFA, has co-managed the International Small Companies strategy at Harding Loevner for a decade and the Global Small Companies strategy since it launched more than four years ago. He shares the joys and challenges of searching for quality in a corner of the market that lacks an investor roadmap.

How do you begin to research a company when so little information is readily available beyond a name and a set of regulatory filings? This is the challenge that defines small-cap investing, an asset class that invariably entails an adventure in fundamental research.

The superheroes of the stock market—mainly US corporations valued at or close to a trillion dollars—tend to dominate investment news and research. And yet little-known small companies—often based outside the US—that never generate a headline remain some of the most vibrant sources of innovation. If the biggest large caps sell the finished products that investors and consumers know well, small caps often occupy a small niche along the global supply chain, providing a critical piece of technology known only to its intended audience.

Because small companies solving esoteric problems usually aren't well-covered by outside analysts or journalists, building a deep understanding of their businesses requires starting from scratch. For some investment firms, this lack of information

means the foray into small-cap territory demands an entirely different way of thinking and working. But for Harding Loevner, it's why small caps are a natural fit.



[Watch to learn about the little-known Swiss company that produces a critical component for Tesla vehicles.](#)

Our firm's investment philosophy is based on the premise that we cannot forecast the direction of stock prices, but that through bottom-up analysis of the more durable aspects of companies we can identify the most exceptional among them. We look for strong competitive advantages, sound finances, and capable leaders, with the belief that companies possessing these attributes can be reasonably expected to produce superior growth and weather unforeseen events better than the average company, which will eventually be reflected in their stock prices.

For small companies especially, what this research process means in a practical sense is spending a great deal of time with engineers in manufacturing and R&D facilities, seeing the guts of machinery and the software that forms the mainspring of a company's growth and competitive advantage. At times, our team has been the first to request a meeting with a small company's management, never mind visit its factory. We must develop our own expertise—whether it be learning the ins and outs of recycling technology (to determine TOMRA's role in meeting European climate-change directives) or the intricacies of atmospheric sensors (to understand why customers would choose Vaisala's for their biolabs, air-traffic control, or space missions).

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One challenge of investing in small caps is trying to ascertain whether a company's niche is one that can provide growth for a very long time. Another is that the barriers to entry are far from assured. Small companies that don't continually innovate risk ceding their competitive advantage to rivals, particularly when larger, well-capitalized companies take an interest in the same area. Our on-site visits and discussions with suppliers and customers help us gauge R&D initiatives and product launches



Watch as Harding Loevner portfolio manager Jafar Rizvi discusses why small companies are the unsung heroes of the economy.

to make sure that our companies are investing appropriately to protect their turf.

Some investment firms keep small-cap teams separate from the rest of their analysts, a potential limitation to collaborating on bottom-up research. Our small-cap strategies are instead directly supported by Harding Loevner's global research platform in the same way as all our other strategies. This helps us to understand small companies in the context of their broader industries and develop a more complete view of their supply chains and competitive position relative to rivals of all sizes.

Getting to know businesses and their managements intimately through a systematic process can also tip off investors to disconcerting traits long before routine financial reports do. For example, when the parking lot of one company that wasn't yet generating free cash flow looked like a Maserati dealership, we suspected management had its priorities wrong and steered clear of the stock; it's nearly worthless today.

Throughout my ten years managing the International Small Companies (ISC) strategy, most of the entrepreneurs I have encountered didn't have ambitions of becoming the next celebrity CEO. Or driving a supercar. They mainly want for their businesses to be the best in their niche, and because of that, they tend to face less pressure to expand beyond those core competencies than large companies do. We consider such clear focus to be a hallmark of good management.

As a result, small companies can be quite skilled at what they do. Take Uno Minda, which produces automotive components such as alternate fuel systems used in electric vehicles. Years ago, the Indian company adopted Japanese techniques such as *kaizen* to supercharge its manufacturing processes and growth. Now, Uno Minda's Japanese partners visit its factories to learn how to improve their own operations.

With so little of what small companies do visible to the outside world, they aren't well-understood by markets—and may not be for some time. It requires

What is a Small Cap?

Different asset managers have different answers. For some, a small cap is defined by a rigid view of market capitalizations. For example, any company less than US\$2 billion may be eligible for a small-cap strategy, and any company that eventually exceeds US\$3 billion in market value must be sold. The trouble with using such blunt thresholds is that they fail to take into account a general increase in markets.

Other firms may set a market-cap limit for only the initial purchase. But this is how a “small-cap portfolio” can end up rather awkwardly holding lots of companies with lofty US\$25 billion market caps.

Our definition says small is relative. It starts with the parameters set by the index provider MSCI, which considers a small cap to be any investable company that falls below the 85th percentile of market caps. We then consider the market cap ranges of companies in the MSCI All Country World ex US Small Cap Index (for our international strategy) or the MSCI ACWI Small Cap Index (for our global strategy) and their weighted average market caps relative to the index. This combination ensures that we steer clear of tiny, illiquid holdings as well as companies too large to fit the small cap label.

We like this approach because it allows for different ranges for different equity markets around the world, and because the most reasonable definition of a small cap is one that changes over time. What is “small” today would’ve been considered huge 50 years ago. When the international index launched in 2007, the largest members were valued at less than US\$5 billion. Today, they are more than twice as big. Don’t be surprised if in another 50 years a US\$25 billion company truly is a small cap.

investors to take a long-term view, another way in which small caps are particularly suited to our firm’s philosophy. But as much as we’d like to hold onto the best small caps forever, the bittersweet reality is that those are the companies most likely to move on from the asset class. Some get acquired. Others graduate out of the portfolio because they grow *too* valuable to fit the definition. (In just the last year, several of our ISC holdings—including Chr. Hansen, Dechra, EMIS Group, and Network International—have received takeover offers from strategic buyers or private equity firms.)

Some people enjoy covering the superheroes. But after getting to do both, for me there is nothing like the joy of discovering the greatest small companies most investors haven’t yet heard of.

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