

Capturing the Small Cap Effect

Mines & Money Conference

Gervais Williams
November 2009



Agenda



- Who we are
- Current portfolio positioning of large cap Fund Managers
- Reasons why Small Caps have been out of favour
- Reasons why smaller stocks will perform from here
- Active management vs passive
- Has the best of the opportunity been missed?
- Conclusion

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Gartmore UK Small Cap Team

Large & Experienced



Gervais Williams

- Head of award-winning UK Smaller Companies Team¹
- 22 years experience in smaller companies, 14 years at Gartmore
- Strong stock selection and analytical skillset
- Formidable long-term track record



Rob Giles

- Senior Investment Manager, joined Gartmore in 2002
- Lead Manager of Award winning Hedge Fund²
- 19 years investment experience
- Particular expertise in aggressive small & mid cap portfolios



Adam McConkey

- Senior Investment Manager, joined Gartmore in 2000
- Holt CFROI valuation & behavioural finance specialist
- Particular expertise in concentrated portfolios & special situations
- PhD in International Relations, Loughborough University



Harmesh Suniara

- Joined Gartmore in 2007
- 11 years experience sell side Research Analyst & Corporate Finance
- 3 years experience as LIFFE derivatives trader
- Background in Physics and Theoretical Physics



Jamie Brooke

- Joined Gartmore in 2007
- 10 years private equity experience
- Qualified Chartered Accountant



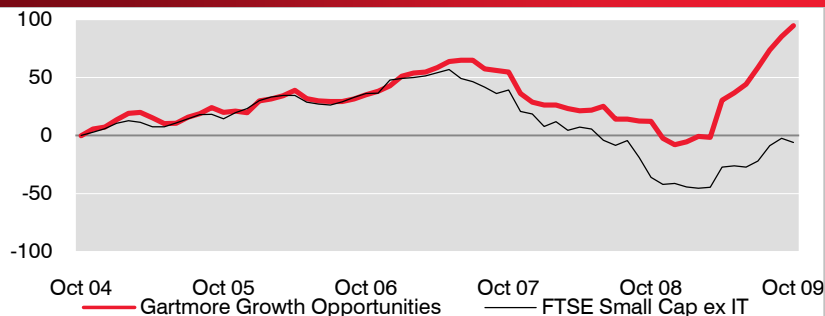
¹Gartmore UK and Irish Smaller Companies, Investment Excellence UK Smaller Companies Sector 2005 May 2005 , Every Investor 2005

²AlphaGen Volantis Fund – Fund of the Year 2003 – Specialist European Equity Category, EuroHedge Awards 2004, AlphaGen Volantis Fund (Class A) – Top Performing Newcomer Single Manager Funds, Hedge Fund Review European Performance Awards 2004, AlphaGen Volantis Fund – New Fund of the Year – Long/Short Equity, EuroHedge Awards 2003

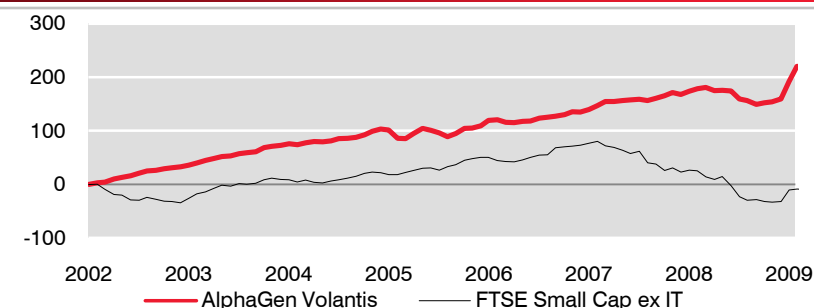
The Gartmore UK Small Cap Team



Gartmore Growth Opportunities Fund¹

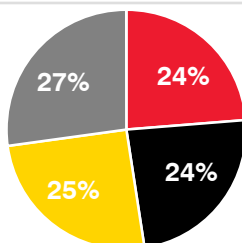


AlphaGen Volantis²



Team AUM: £854m³

- Long/Short
- Segregated Pension
- Pooled - OEIC
- Investment Trust



- Top 3 Manager of UK Small & Micro Cap Assets
- £854m AUM³
- Long established award winning team & track record proven in different products & different market cycles
- Expertise in both public & private markets
- Manage Long/Short funds in addition to Long-Only
- Active portfolio management and corporate engagement
- Depth of resource
 - 5 Investment professionals
 - Dedicated dealing & infrastructure
- Meet c.1,200 companies p.a.

Source: Gartmore/Thomson Datastream/Lipper/HSBC, as at 31st October 2009

¹ Fund Basis: NAVs, in Sterling. Inception date: July 1991

² Fund basis: Net of performance and management fees, Sterling 'C' Share Class.

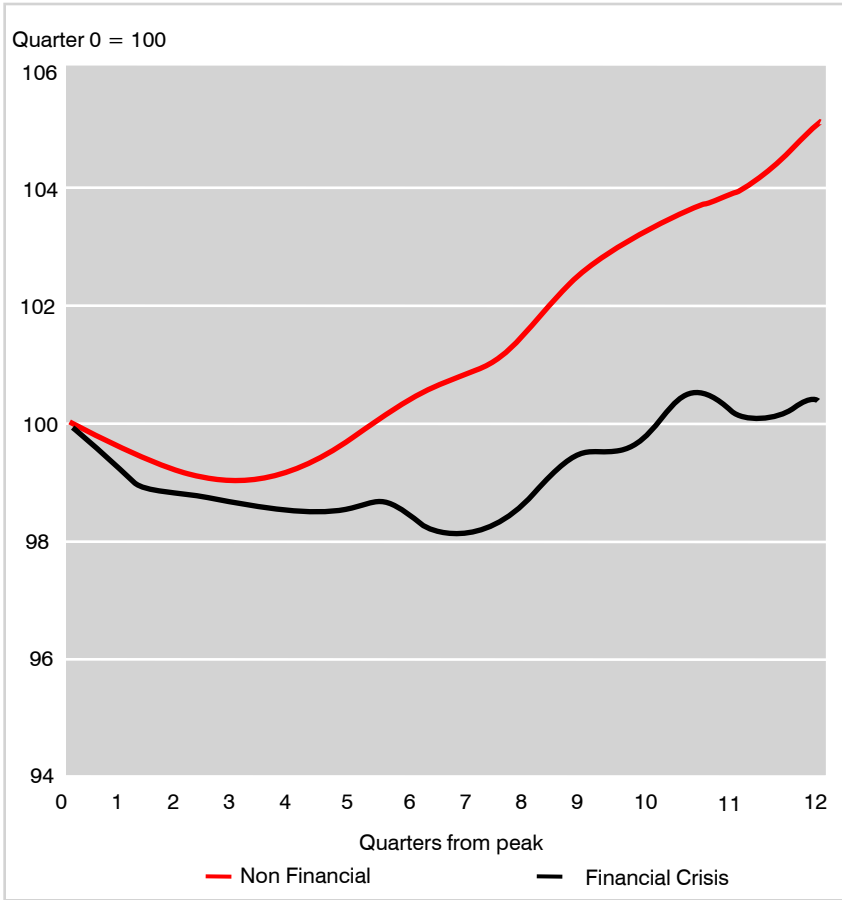
Inception Date: 30th April 2002

Index basis: Total return

³Source: Gartmore, as at 30th September 2009

Economic Growth Likely to be Sluggish at Best

GDP by type of recession



Source: IMF, as at June 2009

- Following financial crises economic growth tends to be tepid at best
- Position of UK economy not greatly different from Europe etc.
- Assumption that large cap stocks normally struggle to grow much faster the rate of economic growth

Institutional Assumptions Highlighted by Small Cap Investment Trust Valuations

Sector Discount

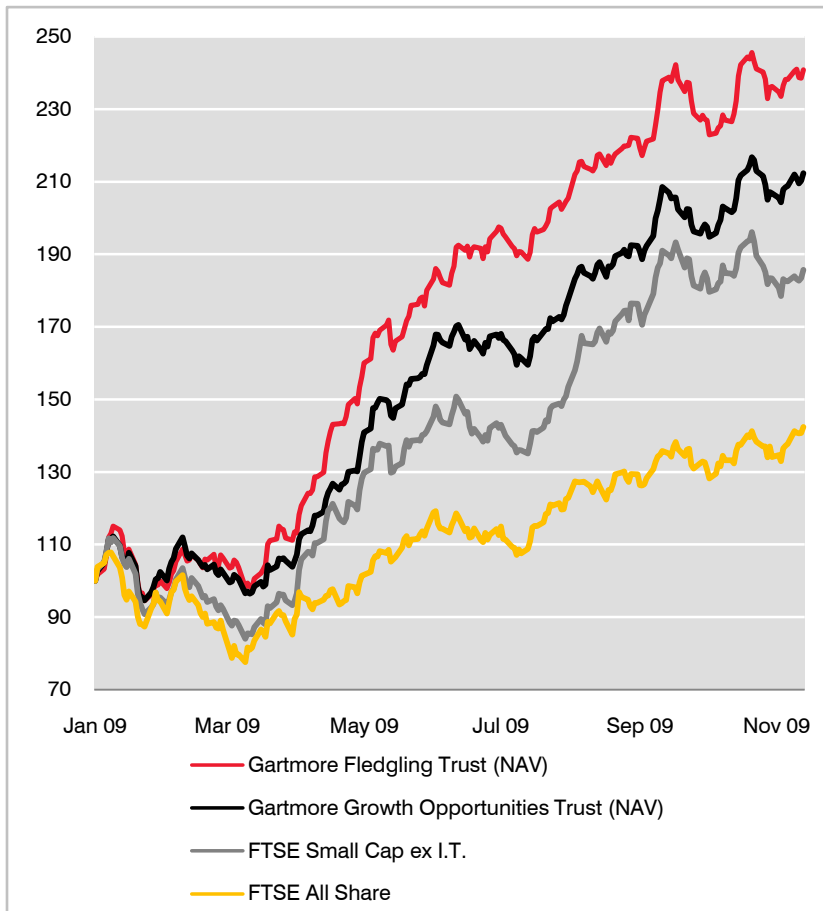


Source: Thomson Datastream, as at 13th November 2009

- Investment Trust discounts on UK Small Cap sector have been in place for an extended period
- Suggests that institutional investors are comfortable to be largely out of the sector
- Note that the average discount has persisted even during the recent equity market recovery in spite of many institutional portfolios having excess liquidity
- Suggests that there has been little asset allocation to the sector even in a period of rising markets

Small Cap Recovery is Widely Seen As Not Sustainable

Small & Micro Cap Performance – Year to Date

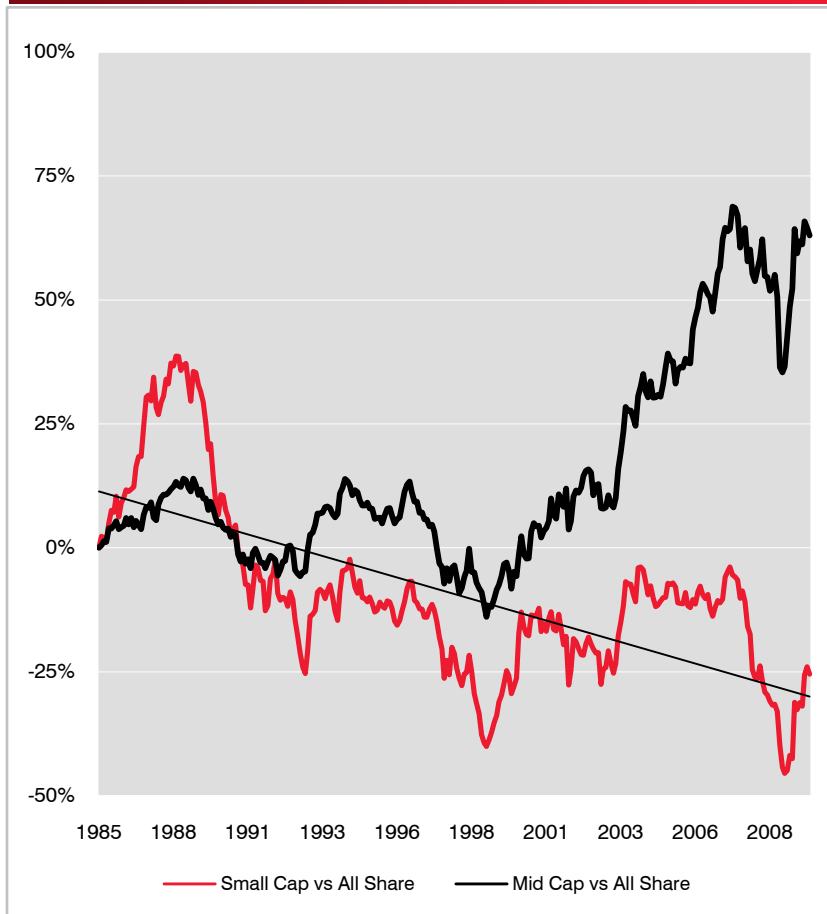


Source: Thomson Datastream, as at 13th November 2009

- After the climatic sell off in small and micro caps abated at the end of 2008, share prices have recovered
- The Fledgling Index (ex Investment Companies) has recovered over 100% in this year to date
- The FTSE Small Cap Index is up over 60% in the year to date
- Mainstream institutional investors have largely missed these returns
- Widely assumed that small cap bounce is over and normal trends will resume

Namely That Small Caps are Perennial Underperformers

FTSE Small Cap ex IT vs FTSE All Share

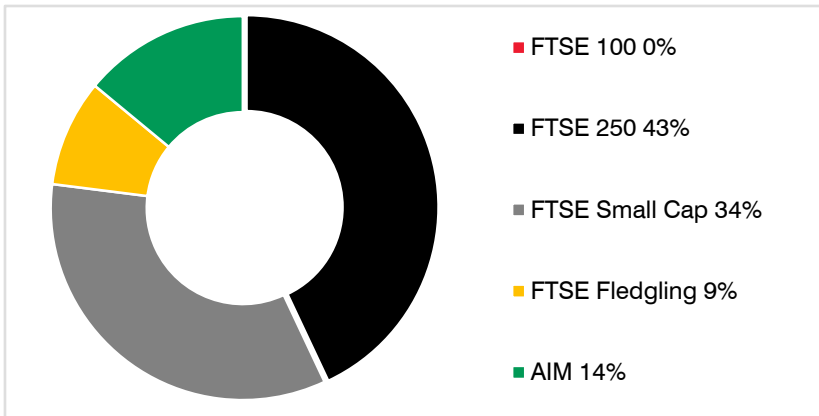


Source: Thomson Datastream, as at 31st October 2009

- FTSE Small Cap (ex IT) has underperformed for over 20 years
- Institutional investors have learnt several good reasons for avoiding the sector
 - Illiquid
 - Largely outside FTSE All Share Index
 - Poorly researched
- Most institutions are comfortable in the knowledge they can out make good returns by holding a short portfolio of 40 or so investments, including a few Mid Caps

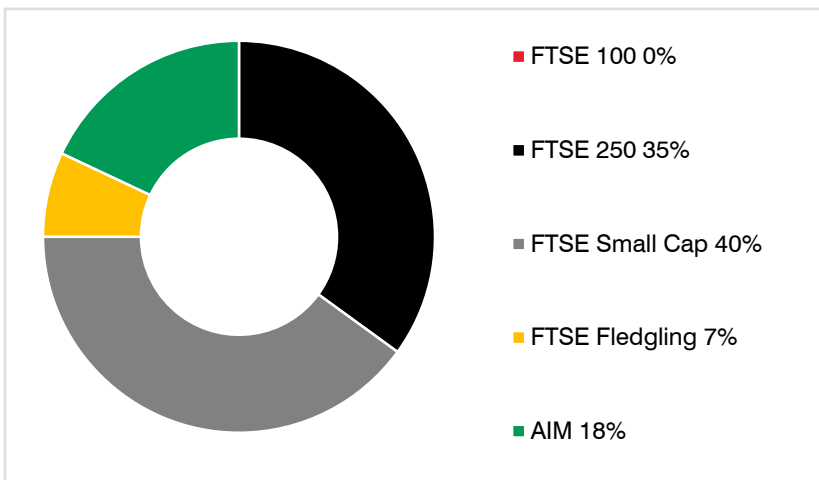
Even the Small Cap Investment Trust Managers are Underweight Small & Micro Caps

Small Cap I.T. Exposure (2009)



- Even most small cap managers have reduced their exposure to small and micro caps!
- Given the good performance of the FTSE 250, most smallcap funds are heavily weighted in the FTSE 250
- Many have increased their weighting in the FTSE 250 over the past year
- Few funds have a significant weighting in the Fledgling or AIM markets

Small Cap I.T. Exposure (2008)

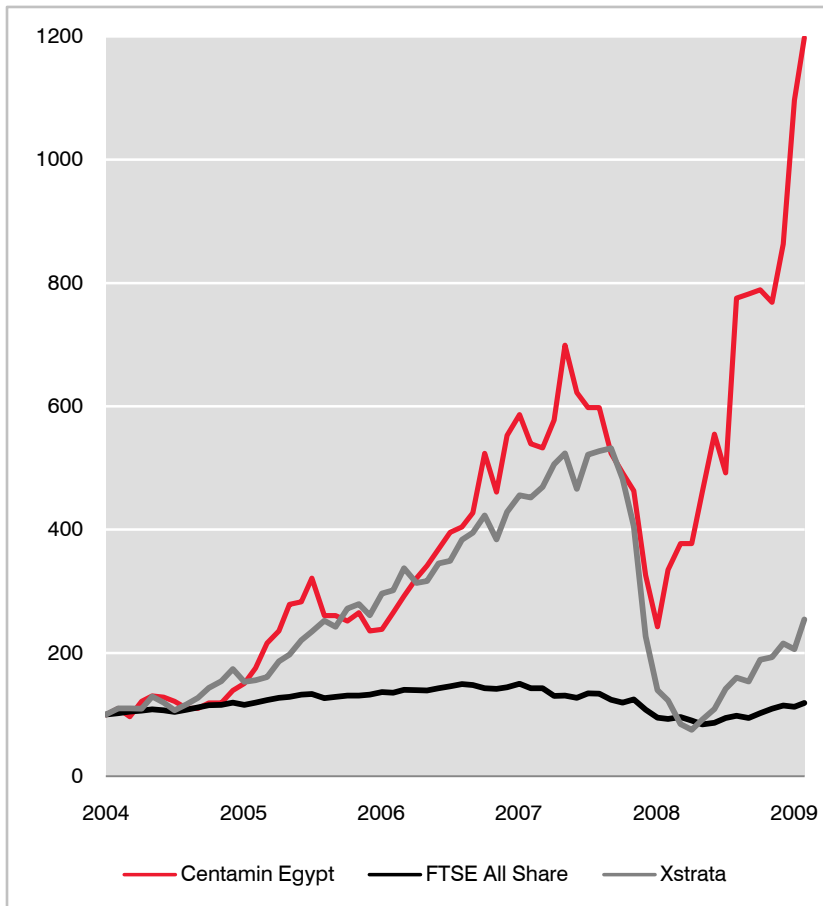


Source: Cenkos, as at 30th June 2009

Differences in Relative Performance Substantial



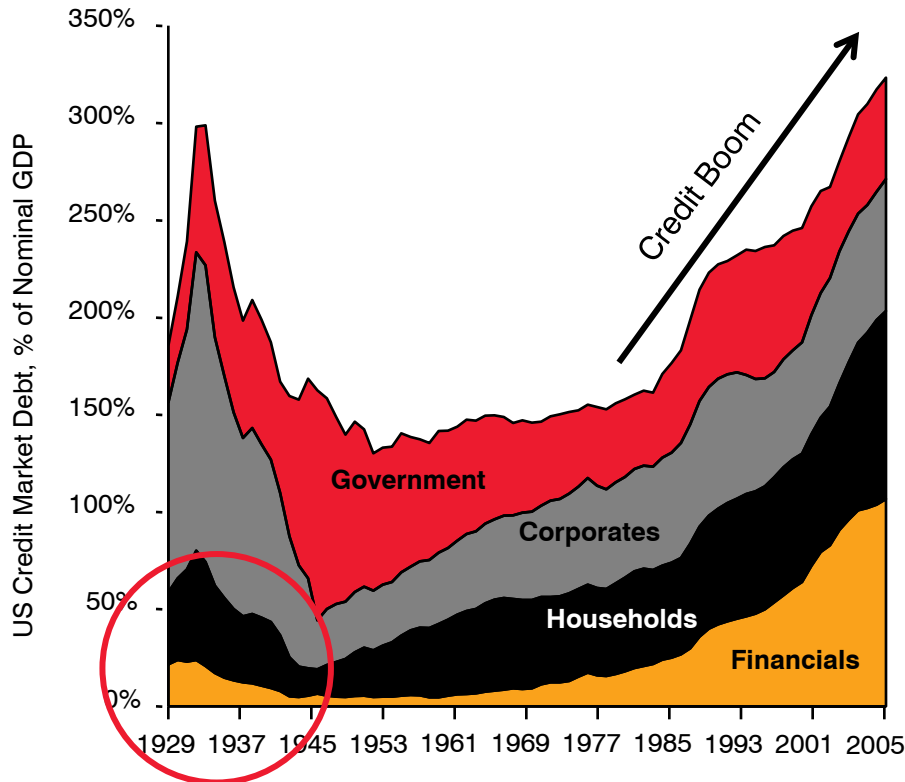
Comparative Returns of Small Cap Stocks



Source: Bloomberg, as at 25th November 2009

- The performance of a good small cap stock is radically different to that of the equivalent larger company
- This differential is hardly new news
- How can it be that institutional investors have positioned their portfolios into an overweight position in largecap stocks, and out of small and microcap stocks?

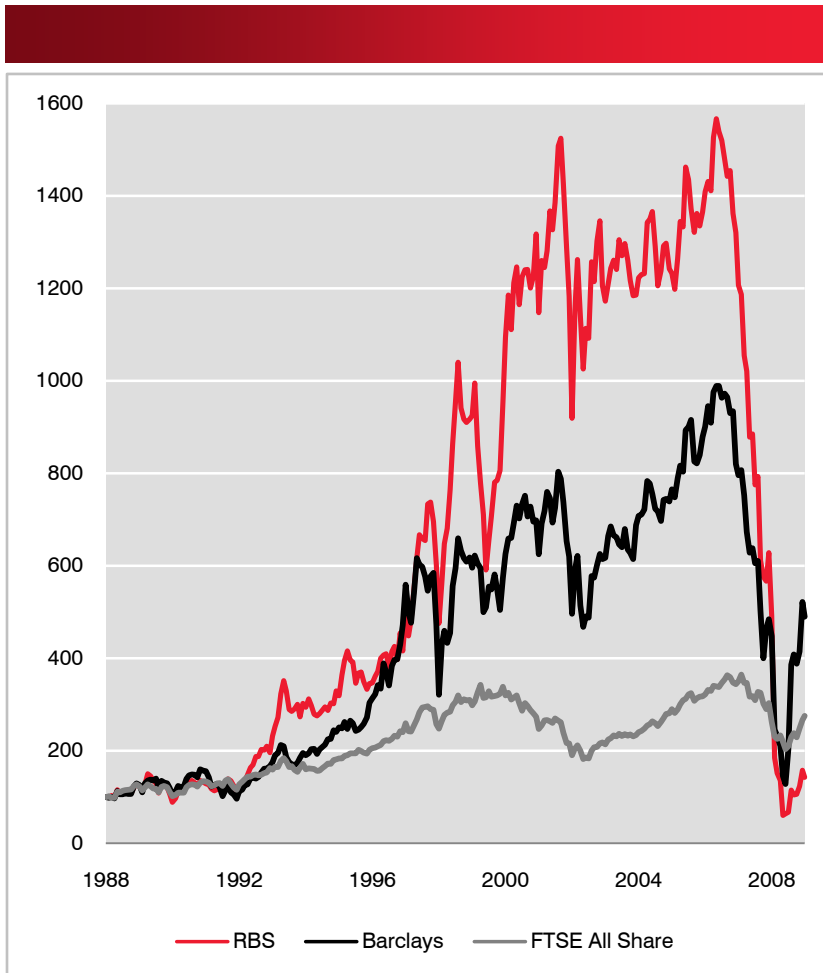
Why have Large Caps Outperformed?



Source: Morgan Stanley Research, Bureau of Economic Analysis/Bloomberg/The Statistical History of the US: From Colonial Times to Present, as at October 2008

- The long credit cycle led all corporate capital structures to over optimise
- This trend was highly beneficial to the financial sector who grew their earnings and dividends particularly rapidly
- The extended period of the credit cycle progressively led to institutional investors moving a higher and higher proportion of their portfolios into large cap stocks

Large Cap Financials Did Particularly Well



Source: Bloomberg, as at 25th September 2009

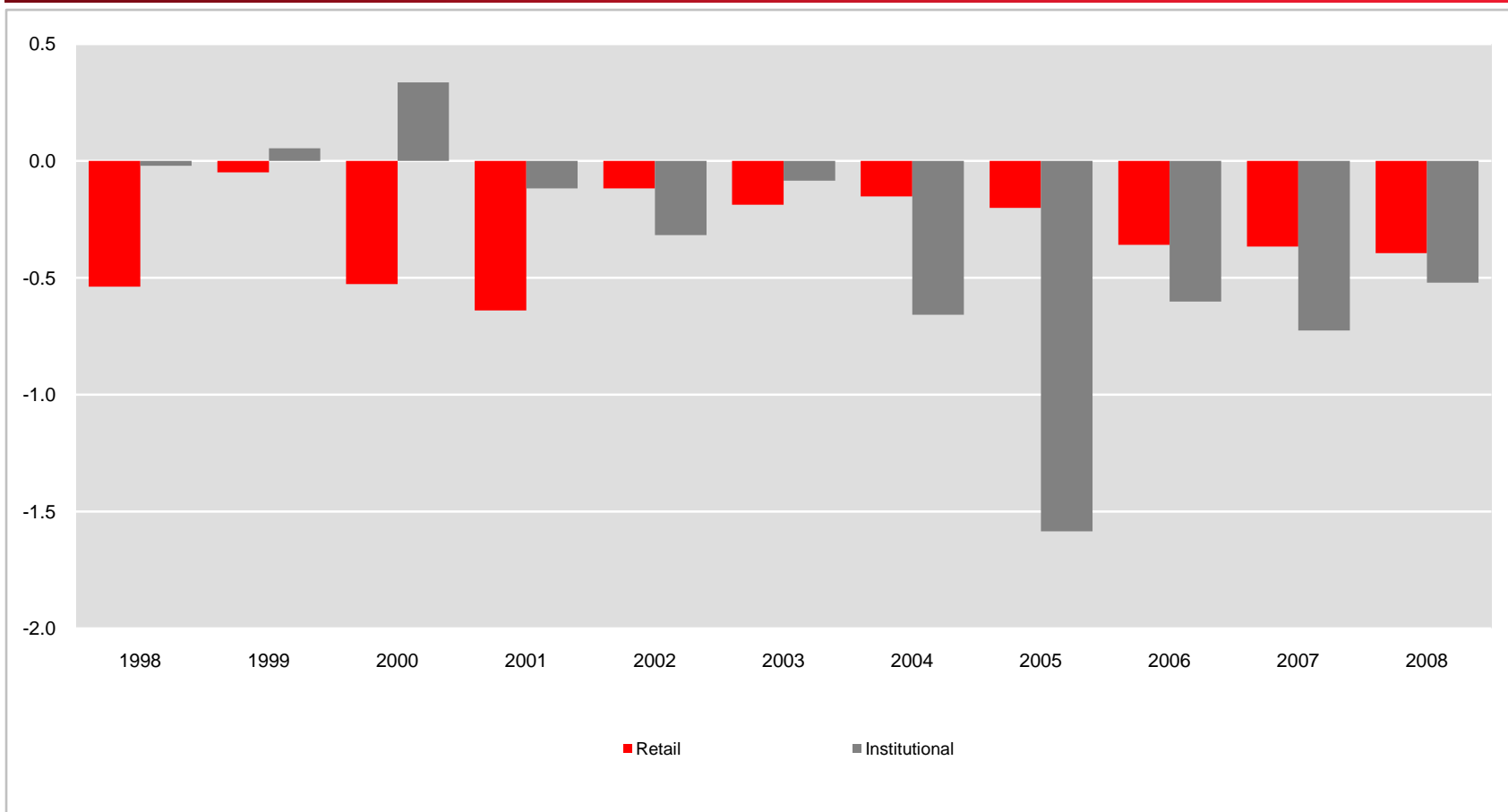
- Large Cap stocks do not normally sustain growth much ahead of the economy in general
- But with credit boom financials sustained exceptional growth and this enhanced the FTSE All Share Index performance
- With credit constraint this sector is likely to be constrained as the excessive debt of the past is unwound
- Overweighting of large cap holdings will take some time to unwind

Trends in Capital Allocation to UK Smaller Companies

Professional investors withdrew from small/microcaps every year post dot com



UK Smaller Companies Annual Net Sales (£bn)



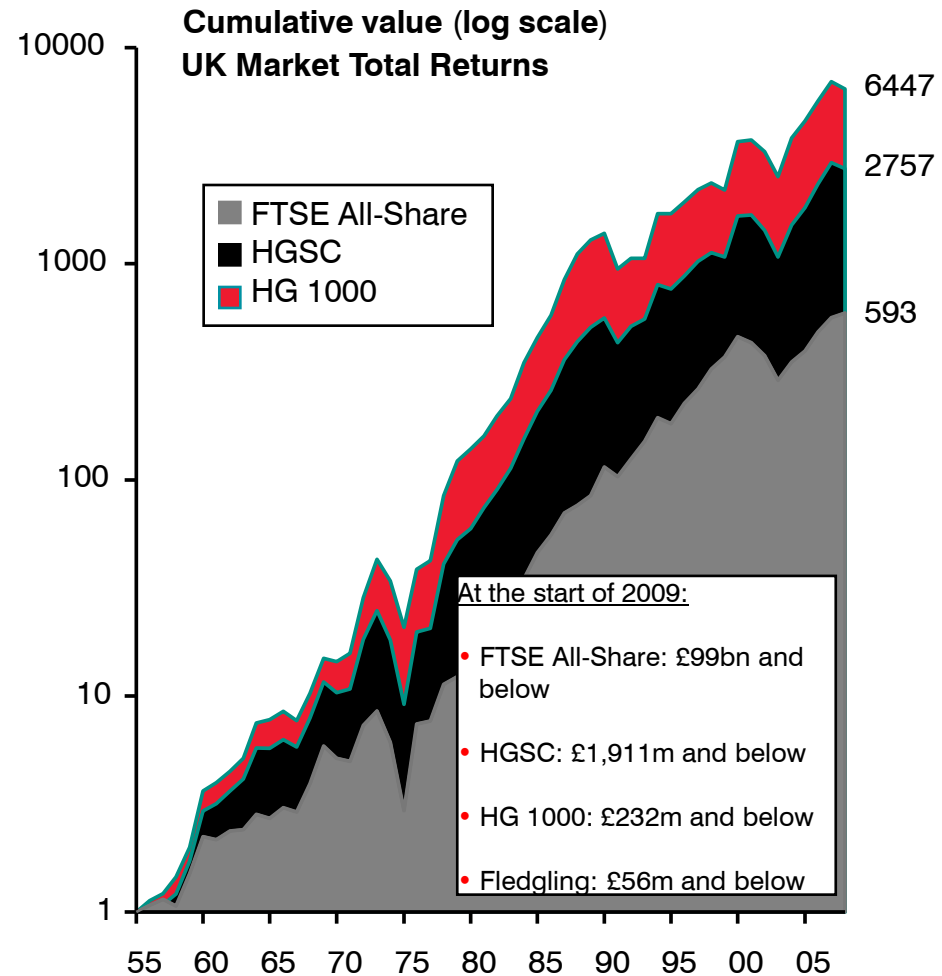
Source: Investment Management Association, as at February 2009

Note: 2008 does not include December

Basis: UK Smaller Companies are funds which invest at least 80% of their assets in UK equities of companies which form the bottom 10% by market cap

The Traditional Pattern Where Small Caps Outperform May be Expected to Resume

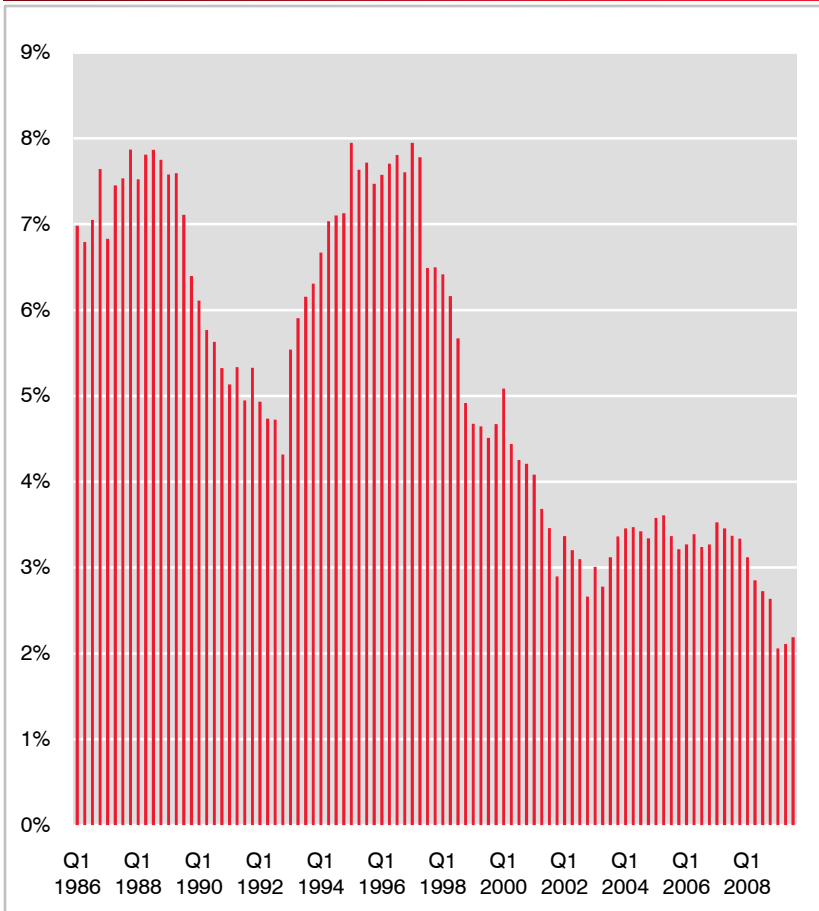
- During the credit boom leveraging up of large caps obscured the small cap effect
- Normally small caps grow faster than large caps
- Typically, the smaller the stock the better the performance



Source: ABN AMRO/London Business School, Paul Marsh and Elroy Dimson. As at 1st January year end. Years 1955 to 2008

Institutional Investors Could Find Themselves Consistently Being Surprised by the Strength of SmallCap

FTSE All Share minus FTSE 350 as % of All Share



Source: Thomson Datastream, as at 30th June 2009

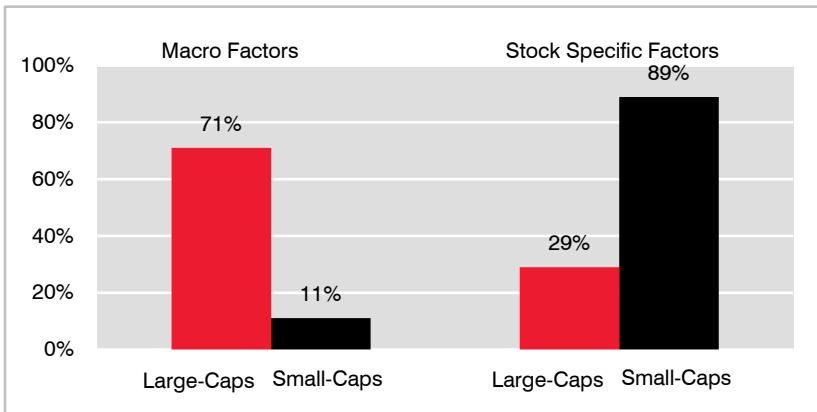
- Initially smallcap/microcap outperformance related to recovery from oversold position of small cap after 20 year period of underperformance
- Secondary phase as small cap portfolios rebalance from FTSE 250 into micro caps to chase outperformance
- Ultimately asset allocators are likely to rebalance portfolios from midcap into microcap to close underweight position
- Further period of smallcap/microcap performance related to sustained increase in dividend yields, and willingness of income investors to back these businesses
- Further period of outperformance related to large cap buying small caps, in paper transactions to reduce debt, add growth and yield cost saving on a consolidated businesses
- At the end of the period the smallcap weighting could be well above its current percentage

Why Active Managers Add Value at the Bottom End

Capture the Small Cap Effect



Stock Selection Key to Higher Returns



Source: Citi Investment Research, as at 30th June 2008

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- The small cap effect
 - Scale of change in a small company is much greater than a large company
- Perception
 - Small companies most sensitive to macro variable
- Reality
 - Company specifics the most important driver of stock returns

➤ Identify companies where there is a significant scale of change

➤ Identify companies where market perception of business is far removed from business reality

Institutional Investors May Grow to Appreciate Actively Managed Small Cap Trusts in Preference to Index Stocks & ETFs



Performance			
As at 31st October 2009	Gartmore Growth Opportunities %	FTSE Small Cap ex IT %	Relative Performance %
1 Month	1.81	-3.82	+5.86
3 Months	19.07	20.22	-0.96
6 Months	36.69	28.70	+6.21
1 Year	67.35	46.66	+14.10
3 Years	38.83	-31.01	+101.23
5 Years	74.99	-6.07	+86.31
10 Years	179.54	-6.09	+197.68
15 Years	354.50	39.33	+226.19

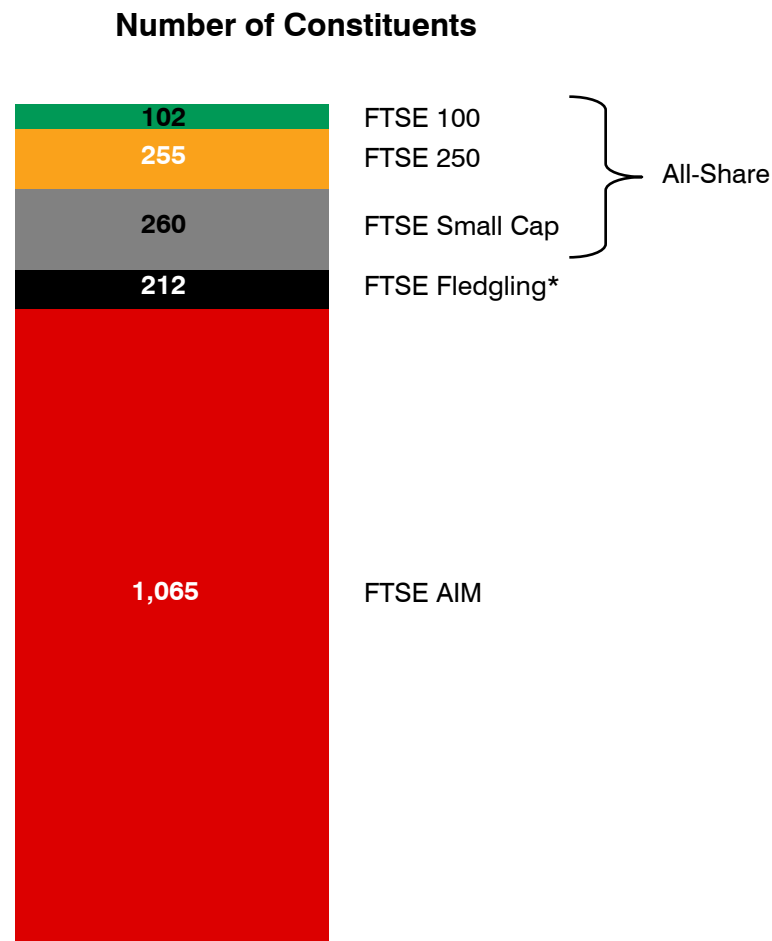
- FTSE Small Cap (xIT) Index has made little return in the last 15 years
- However the scope for added value in the small cap sector is better than most others

Source: Gartmore/Lipper/Thomson Datastream, as at 31st October 2009
 Basis: All fund returns calculated in Sterling on NAV at par. All index returns are capital only

Institutional Investors May Learn to Value Diversification Away From the Relatively Few Largest Stocks



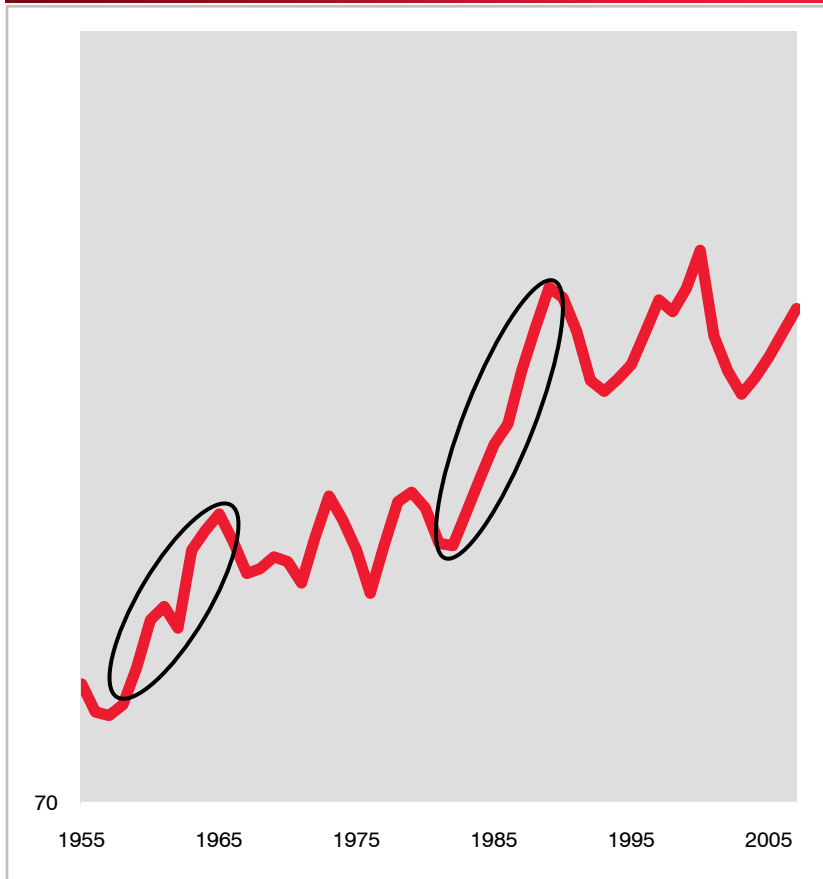
- Large Caps not particularly well placed to benefit from the trend
 - Valuations not especially cheap
 - Widely owned already
- Microcap stocks in particular are under researched and under owned
- Few teams have experience with microcap and AIM stocks



Source: Gartmore, London Stock Exchange as at 13th January 2009
* FTSE Fledgling ex IC Index

Premium Growth of Smallcap Dividends has Happened in the Past and May Happen Again

Real Dividend Income of HGSC



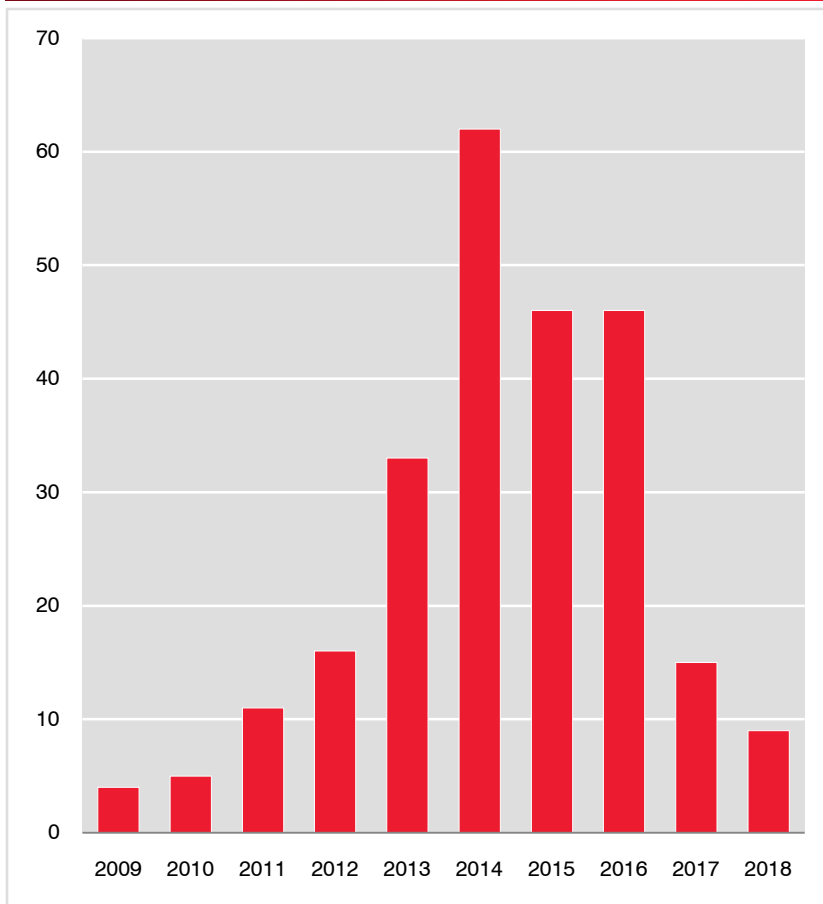
- Many AIM stocks have been advised that dividends are irrelevant to investors and don't pay a dividend yield
- Investors attitudes are changing and so will those of the quoted business sector
- Two periods of rapid real dividend growth in the last 50 years
- In those two periods small caps outperformed large caps for a multiyear period

Source: Thomson Datastream, as at 3rd November 2008
Basis: Log Scale

The Opportunity

Have we missed the best of it?

Maturity Profile of European LBO Debt



Source: Gartmore, as at 30th June 2009

- Nearly 1,700 companies listed in UK with a market cap of less than £100m
- Smaller companies operate in niche markets and subsectors
 - Winners easier to identify and likely to win disproportionately
 - Smaller companies offer greater earnings power in a slow growth environment
 - Income is a scarce asset, there is scope for dividend growth to exceed earnings growth
 - The M&A cycle is only just restarting
- Despite the recent stock markets rise funding difficult for those in need
 - Banks want to reduce exposure, charging higher margins and reluctant to take on new clients
 - Institutional investors remain heavily influenced by the macro backdrop
- Passive investors are unlikely to yield the same value from the same opportunities
 - It requires the capability and wherewithal to negotiate with banks, management teams, drive and monitor change and structure deals
- Access to capital is a long term not a short term problem
- Returns for those with the ability to deploy capital should be disproportionate

Small/Micro Cap Valuations Remain Compelling



Performance				
Market	Fwd PE ex-loss	Fwd PE Growth %	12M Fwd Div Yld	Fwd DPS Growth %
FTSE 100	12.0x	-4.4%	3.9%	1.0%
FTSE Mid 250	12.5x	-1.3%	2.9%	2.3%
FTSE Fledgling	8.1x	2.9%	3.0%	-0.4%
AIM All Share	8.0x	27.1%	1.7%	9.3%

- Even after the rise of micro cap valuations remain inexpensive
- Businesses that are likely to be successful in a flat economy are typically those exposed to a niche market that continues to grow
- Not all small caps are the same. Stocks in the FTSE 250 are very differently valued from the smaller quoted business

Source: Altium Securities, as at 1st September 2009

Capturing the Small Company Effect

Conclusions



- Institutional investors are typically wedged up in large cap holdings
- For many years capital has been withdrawn from the small micro cap parts of the market
- But the trends appear to be changing with small cap stocks well positioned to perform strongly
- This new trend could be in place for a number of years

The News Headlines

'Rights issues contain the seeds of their own success ... improving [balance sheet] prospects will see a significant improvement in the share price' - Adam McConkey, March 09

'Small companies are embarrassingly cheap' - Gervais Williams on AIM, Mar 2009

'The differences between perception (fear) and reality are extended, even extreme. So too are the returns from investment decisions that capture that difference' - Adam McConkey, March 09

'In a small cap universe of more than 3000 stocks, there are many businesses in control of their own destiny, and they're even growing. The exciting part is that their known characteristics are so fundamentally mispriced' - Adam McConkey, March 09

'In a sense we are not overly concerned whether or not we have seen a broader market bottom. Things we can be more certain about are the things that interest us, and these occur at the company level. Its all about there being enough certainty in a business for us to invest in a business and profit from it and in this respect the UK smaller companies market is providing ample opportunity' - Gervais Williams, May 2009

The Informational Advantage

Use the Tools of the Trade



- Industry
 - PEST – Secular growth drivers
 - Porters 5 Forces – Secular return drivers
- Franchise assessment
 - Market position
 - Brand Value
 - Scale economies
 - Network effects
- Management Quality
 - Track Record
 - Incentive structures
 - Hubris & over confidence
- Returns profile: understand the business economics
 - Operational gearing
 - Asset utilisation
 - Working capital cycle
- Balance Sheet Analysis & Cash Flow Analysis
- Valuation
 - Proprietary models
 - The right home (private equity, trade sale)
 - CFROI

“It’s not what you do...”

The Analytical Advantage

Think like an owner



- Different value drivers for different lifecycles

Life Cycle	Value Drivers	Research Assessment	Benefit/Objective
Growth	Pace and duration of growth	Industry Assessment	Capture Positive Earning Surprise
	Operational Gearing	Returns Assessment	
Value	Market position or assets valuable to others	Franchise Assessment	Capture Re-rating
	Management engaged incentivised to extract value	Management Assessment	Avoid Value traps
Special Situations	• Financial Restructuring	Balance sheet Assessment	Capture normalisation of risk attitudes
	• Operational Restructuring		
	Management Experience	Management Assessment	Capture earnings turnaround and rating upgrades
	Peer group return profiles	Returns Assessment	Avoid serial value destroyers
	Industry pressures...are they too great?	Industry Assessment	

“...it is how it is applied”

Active Engagement

Acting like an owner enhances returns



The Life Cycle of Engagement

- Facilitative
 - Light touch, right management, right approach
 - Typically a growth company
- Constructive
 - When the value drivers shift so must management focus
 - Typically a value investment
- Cathartic
 - Recognise in existing or new positions that special situations require special and different operational, financial and negotiating skill sets
- Applying private equity skillsets in public markets
 - Proactive strategic agenda setting, prepared to instigate change
 - Right management for right business lifecycle
 - Right incentive structures for management teams
 - The right home for the business and/or its subsidiaries (private, public, trade)
 - Introduce the right advisors, not those with vested interests
 - Engage directly with other stakeholders (shareholders, customers, suppliers, bankers, alternative capital providers)

“...with the appropriate pressure”

Important Information



Past performance is not a guide to future performance.

The value of investments and the income from them may go down as well as up and you may not get back your original investment.

Investment trusts can borrow money to make additional investments on top of shareholders' funds (gearing). If the value of these investments falls in value, gearing will magnify the negative impact on performance. If an investment trust incorporates a large amount of gearing the value of its shares may be subject to sudden and large falls in value and you could get back nothing at all

Net Asset Value ("NAV") performance is not the same as share price performance and investors may not realise returns the same as NAV performance

Funds investing in overseas securities are exposed to and can hold currencies other than Sterling. As a result, exchange rate movements may cause the value of investments to decrease or increase.

Smaller companies are riskier and less liquid than larger companies, which means their share price may be more volatile.

Funds with an emphasis on a particular sector or geographical area are exposed to a higher risk of volatility than a fund which is more broadly diversified.

Investors should note that inflation may occur over the duration of their investment. This may affect the future buying power of your capital.

Telephone calls may be recorded for monitoring and training purposes.

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