Long-term investing in small firms can be very rewarding

What lessons can investors learn from 2015? Barry O'Neill, investment director with Carbon Financial Partners in Aberdeen, says last year delivered further proof that small is beautiful

My firm belief is that learning should be a life-long pursuit and we are never too old to process information and adapt our behaviours accordingly in order to benefit.

Last year was a disappointing one for our domestic stock market as a whole, with the index of the largest companies in the UK, the FTSE 100, falling by 1.32% and the broader based FTSE All Share index gaining a modest 0.98%.

But one particular type of company fared significantly better. Academic research has shown that over the long term, the shares of smaller companies do better than those of larger firms.

In its simplest form, this is a risk and return story as the two are inextricably linked – you cannot generally increase one without a corresponding jump in the other.

Smaller companies have a higher cost of capital than larger firms but if they have to borrow, either from banks or by issuing bonds, the return

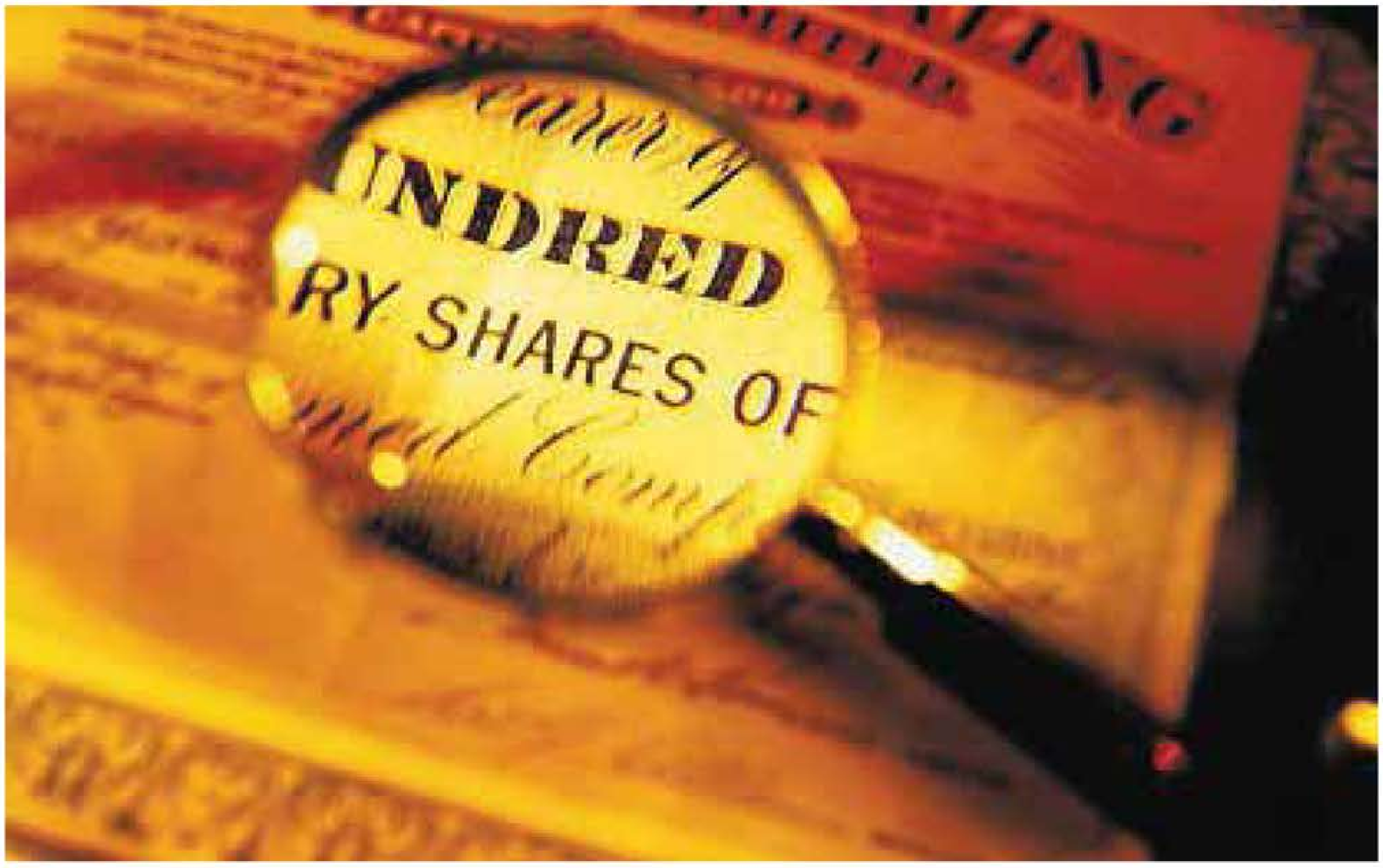
Barry O'Neill

demanded by investors is higher than that demanded of larger businesses as the risk of default is higher.

According to FE Analytics, the equivalent FTSE index of smaller companies in the UK was up by 12.99% during 2015 on a total return basis.

The index of smaller companies has delivered more than the broader Footsie market in six out of the past 10 years.

Data from another smaller companies index over the past 25 years shows the proportion of years where it out-performs the FTSE 100 is exactly the same, 15 out of 25. Investing in smaller company shares is not for



SMALL PRINT: Investing in smaller firms' shares is not for the faint-hearted and can lead to negative returns

the faint-hearted and can lead to very sizeable negative returns in some years.

But if you have a long-term view of investing and understand the additional risks involved, the experience can be very rewarding. If you are looking for an example of success using such an investment technique over the long-term, look no further than Lord Lee of Trafford.

He was dubbed the Isa (individual savings account) millionaire in 2003 when he announced that the £126,000 he had invested over the previous 16 years had rocketed to more than £1million.

He then added a further £24,000 to his portfolio of almost exclusively small companies, which over time has reportedly grown in value to a staggering £4.5million. The true investment lesson to be learned not just from last year but since investing was first practised is that of compound interest and growth. It has been said that "he who understands it earns it and he who doesn't pays it".

Make sure you are the one who earns it.