ESG: the key to unlocking opportunities in Small Caps

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When investing in small caps, there are three key pillars across which attention must be focused: quality of corporate governance, respect for human capital and shareholder engagement. To this purpose, we believe that it is beneficial to have an internal ESG analysis model, and to build an active ownership strategy. We estimate that by combining a best-in-universe with a best-efforts approach, it is possible to better capture the potential of the small-cap segment, eliminating issues of size and information biases.

In our view, a company with good governance practices is more likely to effectively address the most important risks, including environmental and social issues. A study conducted by ODDO BHF AM over 3 year data ending September 2019 shows that companies in the STOXX Europe 600 Index with the highest corporate governance rating also showed lower volatility compared to those with a lower rating. Since private founders or management tend to hold a significant stake in small and medium-sized companies, this stakeholder alignment traditionally leads to potentially stronger returns.

We consider human capital a key factor in determining the building of sustainable competitive advantages and thus the ability of a company to create value. Indeed, according to our analysis, effective management of human capital has a direct impact on the innovation potential of a company. It is often by investing in small companies that investors can gain exposure to a new technology, or a new market driven by innovation.

Finally, active ownership is about actively exercising shareholder rights in a company, including engaging with management and discussing financial and non-financial ESG factors. That implies the alignment on concrete ESG improvement targets in areas where we expect progress. This is particularly important in the small-cap segment to hopefully track efforts and progress of investees on ESG topics, which often are poorly disclosed externally.