"All Small Companies shares are extremely illiquid"

"Any company that is paying a dividend yield of 7% must be going bust"

The above phrases are often bandied around by investors and journalists commenting on the smaller companies market. Like any general market comment they are of course just that, being generally true about most of the companies at some point but not wholly true about all of the companies all of the time.

Smaller companies shares are generally more illiquid than their larger brethren but periodically around the two reporting periods in each year investor interest increases and liquidity soars. However the time for exploiting pricing anomalies is during the periods of little trading when the share price appears to be frozen on the screen and presents opportunities for severe pricing anomalies and the chance to pay 75p in the pound for good assets.

It appears, to someone working exclusively in small companies, that larger funds and large company funds appear to have an almost obsessive fixation on liquidity of their whole portfolio. The price of course of the comfort of liquidity is correctly priced assets. With large well-researched companies and large daily volumes of shares traded the inevitable consequence is that pricing anomalies are ironed out.

Everybody, well almost everybody, has heard of Warren Buffet, his iconic status, enhanced recently by giving away most of his fortune. His folksy style and long term investment approach has been held out as the gold standard of successful investment management. However his returns have been left standing by the performance of the Yale Endowment Fund. This fund managed by David Swenson has produced compound returns over the past 20 years of 16pc per year.

This stellar performance has been achieved by diversification of the portfolio into different pots that other professionals deem both too illiquid and too risky. Guy Fraser-Sampson, author of Multi Asset Class Investment Strategy, believes that the pension funds caution is because there is a "fetish for liquidity". Pension fund managers, despite investing for the very long term, routinely overestimate their need for quick access to funds – the price they pay is underperformance.

3i has shown over a long period, now almost 60 years, that a large portfolio of highly illiquid, but high yielding assets becomes more liquid as time passes. This is caused by ageing, mortality, greed and boredom of the shareholder/managers. In the meantime, 3i has enjoyed steady, growing annual return through the dividends produced by the companies.

Small companies whose shares are less than liquid often find that their share prices drift down on small selling and therefore begin to produce a dividend yield that is seen by some as impossible to sustain. The reality of course is that profitable, cash generative companies can generally sustain dividends for many years without compromising the fabric or growth prospects of the business.

The investment returns delivered by high and steadily growing dividends has been extremely well researched in a number of excellent studies. The evidence put forward in the seminal work "Triumph of the Optimists: 101 Years of Global Investment Returns" by Dimson, Marsh and Staunton for the period between 1953 and 2000 showed that high yielding shares outperformed lower yielding shares.
The other annual report by Barclays Equity/Gilt study emphasises these findings with the example that £100 invested in the stock market in 1899 would have turned into £13,311 by the end of last year. If, however all of the dividend income had been reinvested the £100 would now be worth £1.56m, evidence of the power of compounding!

Being “paid” 5% - 7% in dividends by a company to hold the shares whilst the company rehabilitates itself and repositions itself to be attractive to other investor’s means that one is able to take a longer view on when the capital growth manifests itself.

Therefore the conclusion is that with a part of your portfolio buying illiquid assets with a high running yield can provide, in time, a welcome diversification and wealth driver!