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Investing in UK micro-caps with investment trusts

Why investment trusts are uniquely positioned to unlock the long-term growth potential of UK micro-caps...

IN ASSOCIATION WTIH

ROCKWOOD STRATEGIC

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The saying ‘mighty oaks from little acorns grow’ captures the essence of investing in micro-caps as well as any. The Magnificent Seven may now boast $3 trillion-plus titans amongst its ranks but it’s easy to forget that Netflix began its public journey as a micro-cap (by US standards) and Amazon floated at a modest $440 million.

For growth-focused investors, micro-caps offer the chance to unearth the ‘mighty oaks’ of the future ahead of the crowd, with the potential for superior long-term returns relative to their larger-cap peers.

And the UK market, in particular, stands out as a fertile hunting ground for micro-cap managers, offering pricing inefficiencies from a persistent lack of research coverage and valuations that remain well below long-term averages.

As Howard Marks, co-founder of Oaktree Capital, observed: “Inefficiency is a necessary condition for superior investing. I should limit my efforts to relatively inefficient markets where hard work and skill would pay off best.”

What is a micro-cap?

Micro-caps sit at the lowest end of the market-cap spectrum. Definitions can vary but the MSCI UK Micro Cap Index has an average market cap of around £100 million versus £1.4 billion for the MSCI UK Small Cap Index (with the largest constituents being over £540 million and almost £6 billion respectively).

Investment trusts targeting UK micro-caps generally invest in companies worth between £20 and £250 million, though successful holdings can grow well beyond this range. Notably, many small-cap trusts have moved up the market cap scale in recent years, making dedicated micro-cap strategies a distinct and often underexplored alternative.

Why invest in UK micro-caps?

The UK micro-cap sector provides a compelling opportunity for growth-seeking investors, as we explore in more detail below.

1. High growth potential

Put simply, smaller companies often grow faster than their larger counterparts. Starting from a smaller base, they benefit from a greater scope to expand revenues and earnings in the earlier phases of their life cycle. They also tend to be more agile with flatter management structures that can be quicker to adapt to change and exploit market opportunities.

According to Bloomberg forecasts (in October 2024), companies in the MSCI UK Small Cap Index are forecast to increase earnings by 17% in 2025, significantly in excess of the 5% forecast growth for their large- and mid-cap equivalents.

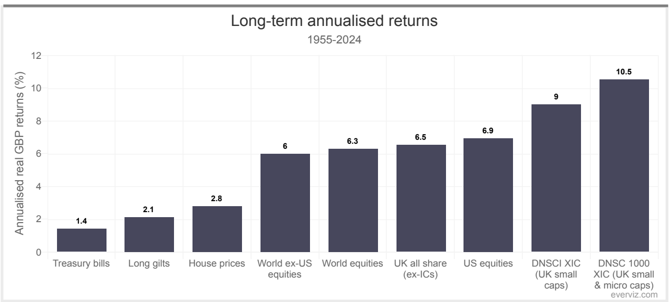
2. Track record of superior returns

History shows that UK micro-caps have outperformed their larger-cap peers over the long term due to this superior growth potential.

As shown in the chart below, the Deutsche Numis Smaller Companies (ex-Investment Companies) Index (which covers the bottom 10% of the UK market by value and is most commonly used by UK small company funds) topped the table with an annualised return of 9% from 1955 to 2024.

However, the Deutsche Numis Smaller Companies 1000 (ex-Investment Companies) Index (which represents the bottom 1,000 or 2% of the main UK market by value) delivered an even higher annualised return of more than 10%. This illustrates the 'small companies effect' whereby an even better performance has been delivered historically by the very smallest micro-caps.

Fig.1: UK Micro-Caps Have Outperformed Over The Long Term



Source: Deutsche Numis, 2025 Annual Review

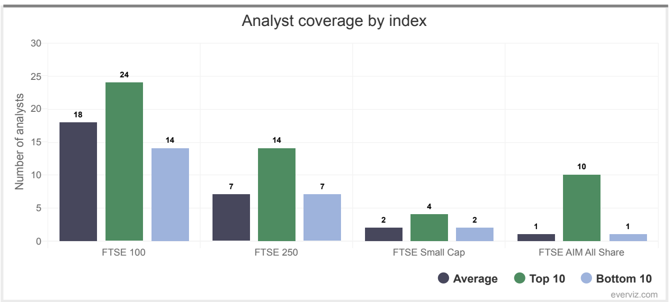
Past performance is not a reliable indicator of future results

Putting these returns in context, they easily outpaced not only bonds, house prices and global indices but even the 7% return from US equities, which is no mean feat given the stellar performance of US equities over the last decade.

3. Pricing inefficiencies

The UK micro-cap sector is among the most under-researched corners of the market. On average, the top ten companies in the FTSE Small Cap Index are covered by just four analysts, compared to 24 and 14 respectively for the FTSE 100 and 250 indices, as shown below.

Fig.2: UK Micro-Caps Receive Little Attention From Analysts

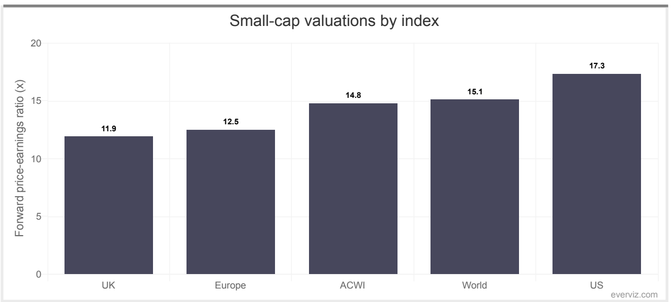


Source: Bloomberg

As a result, many UK micro-caps have no analyst coverage at all, which allows active stock pickers to exploit pricing inefficiencies at the smaller end of the market. This is achieved through building a knowledge, insight or information edge through in-depth work known as 'due diligence' and enables the identification of mispriced equities.

4. Attractive valuations

Fig.3: UK Small-Caps Trade At A Substantial Discount To Peers

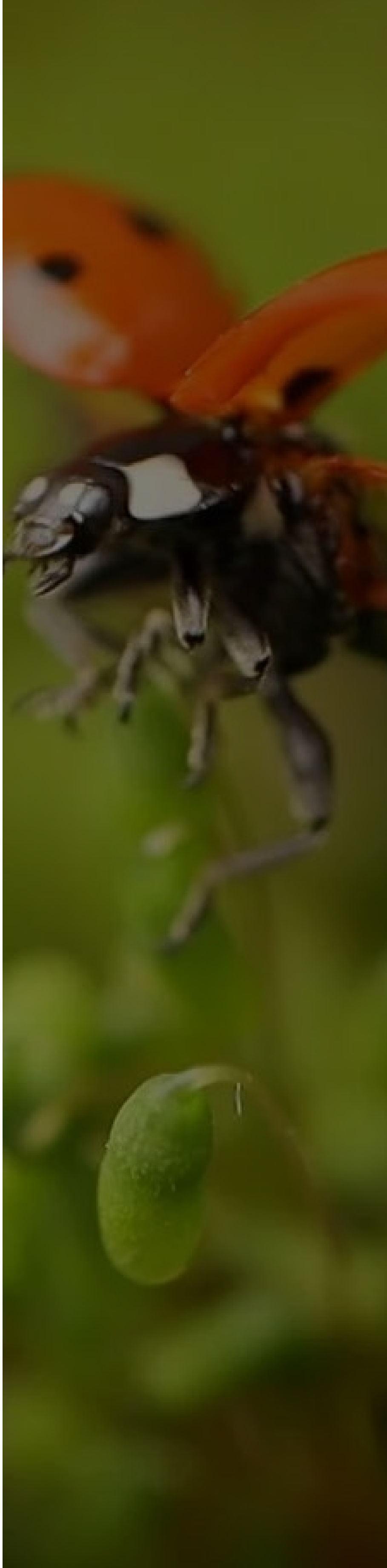


Source: MSCI factsheets (as at 30/04/2025)

Valuations of UK small-caps remain below their long-term averages and global peers. While smaller caps typically trade at a discount to larger caps, the MSCI UK Small Cap Index currently trades at the lowest forward price-to-earnings ratio among its global small-cap peers and nearly a third cheaper than its US equivalent.

Disclosure – Non-Independent Marketing Communication.

This is a non-independent marketing communication commissioned by Rockwood Strategic (RKW). The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.



Attractive valuations have also prompted a sustained period of bargain hunting by overseas buyers with Peel Hunt reporting that 5% of UK public companies were in offer periods in 2024, the highest since 2019. The average premium was 36% in 2024, which demonstrates the potential upside in current valuations.

5. A broad and diverse universe

The universe of micro-caps is sizeable, with around 600 sub-£150 million companies across the main market and AIM.

Micro-caps can provide more diversity than the larger-cap end of the market, with the top ten stocks accounting for around 10% of the MSCI UK Micro Cap Index, compared to 39% and 57% in the mid- and large-cap indices respectively (as at 30/04/2025).

Sector exposure also differs meaningfully: micro-caps lean towards high-growth industries such as technology, industrials and consumer discretionary, with less weight in mature, large-cap staples such as financials, energy and healthcare.

In addition, there is a lack of passive funds in this space due to the challenges of illiquidity, wide spreads and high tracking costs. This presents a prime opportunity for skilled stock pickers to identify future winners with strong leadership, sound balance sheets and long growth runways.

6. Portfolio diversification

Finally, the UK micro-cap sector provides the opportunity to diversify portfolios by market cap and geography. Micro-caps are often viewed as domestically-focused but some companies generate a significant proportion of their revenue from overseas.

While there is some correlation between small- and large-cap equities, the latter tend to be driven more by broader macroeconomic conditions than company-specific factors, which again favours an active strategy.

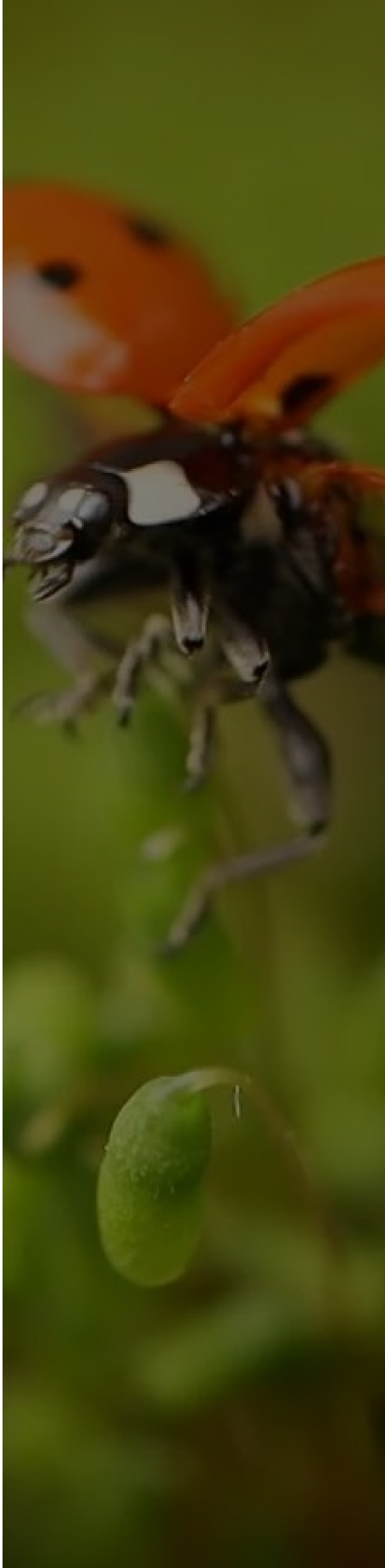
Research by Cheol S Eun, Wei Huang and Sandy Lai revealed that stock-specific factors accounted for “more than 50% of small-cap fund variance but less than 5% of large-cap fund variance”. As a result, micro-caps could help to insulate a portfolio from macroeconomic headwinds, as well as offering a potential source of alpha generation.

How difficult is it to invest in UK micro-caps?

Investing in individual micro-cap companies can be difficult for private investors due to the lack of research coverage and the more speculative nature of some micro-caps.

Given that micro-caps have more limited access to external financing than their larger peers, investors need to evaluate their financial and competitive positions, the quality of management teams and operational strengths and weaknesses which can be challenging via desk-top research.

As a result, active fund managers often take a private equity style approach to investing, based on specialist due diligence and direct engagement with company boards, in addition to working closely with management teams to help shape future strategy and unlock shareholder value.



Another challenge in the micro-cap sector is illiquidity, which often results in a wide buy–sell spread and even the inability to buy or sell shares through standard retail channels. This can present a hurdle for retail investors looking to buy individual company shares.

It's also worth noting that the micro-cap sector tends to experience higher volatility than larger-cap sectors due to the smaller trading volumes and greater sensitivity to investor sentiment. As such, it is more suited to a longer-term investment horizon. However, it is this attribute which actually contributes meaningfully to the outperformance of the smallest companies. As they grow in size, the liquidity improves and the 'size' discount unwinds as this 'risk' dissipates.

Why invest in UK micro-caps with investment trusts?

Investment trusts are a type of fund that enables investors to gain broad exposure to the UK micro-cap sector while managing some of the risks mentioned above. By buying shares in the investment trust, investors have exposure to a diversified portfolio of assets held by the trust, rather than investing in individual companies.

There are currently 22 trusts in the AIC UK Smaller Companies category, although only a handful focus on the micro-cap sector. The scope varies by trust, with some trusts investing in a more concentrated portfolio of companies while others take a broader approach. Some trusts also take stakes in private companies that are not accessible to individual investors.

Many of these managers have extensive expertise and experience of investing in micro-caps. By way of example, the manager of **Rockwood Strategic (RKW)** has over 25 years of experience in UK small-cap equities and takes an active private equity style approach to investing in micro-caps.

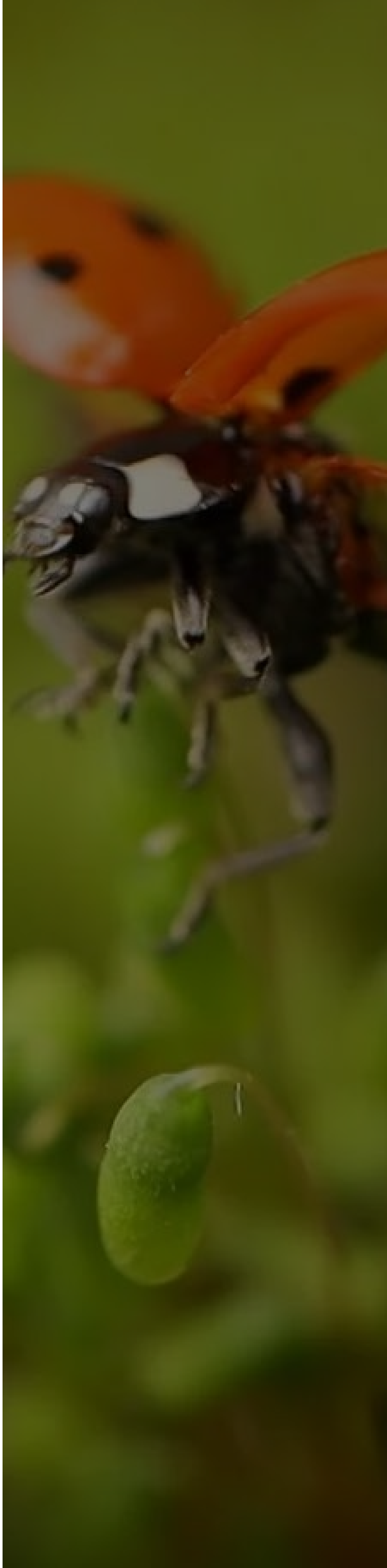
Rockwood carries out extensive due diligence and engagement with key stakeholders prior to investment. Its concentrated portfolio of around 20 companies allows active engagement on an ongoing basis and the manager works closely with management teams to identify the key catalysts to unlock shareholder value.

Investment trusts vs open-ended funds

It's fair to say that some of the benefits mentioned above, whether a diversified portfolio or manager expertise, also apply to open-ended funds. However, investment trusts have some unique attributes which may help them deliver superior returns compared to their open-ended peers.

Firstly, open-ended funds are not publicly traded (unlike investment trusts), meaning that the size of the investable fund will rise and shrink with the purchase and sale of units in the fund. This means that open-ended funds typically have to be very mindful as to how they will meet short-term redemption requests from investors: this limits their ability to invest in less liquid stocks such as micro-caps which may not be able to provide liquidity when cash-calls arise. Open-ended fund managers can therefore be nudged into highly diversified portfolios in order to improve the chances of accessing liquidity when required.

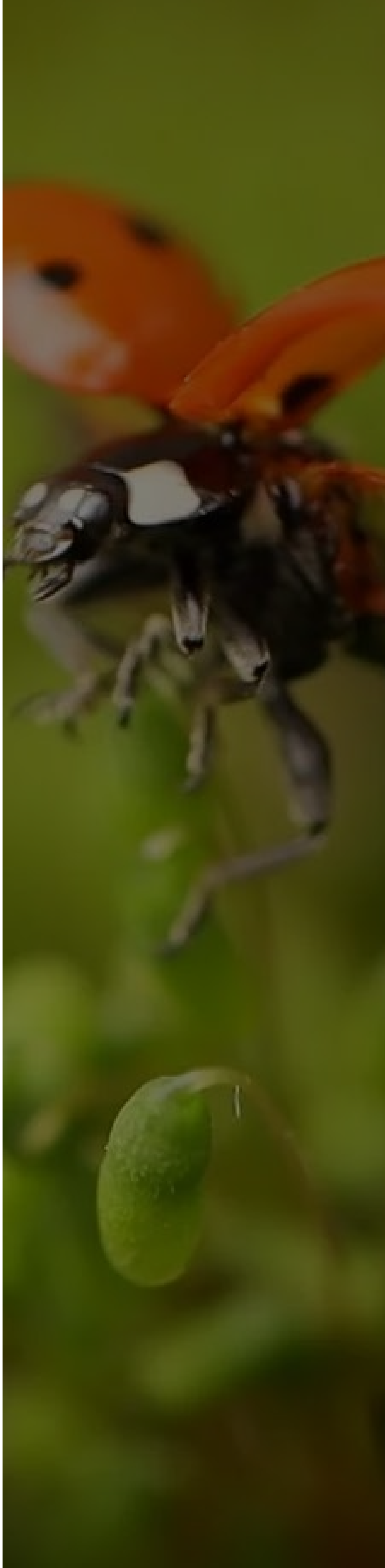
Investment trusts do not have this problem as publicly traded companies. The buying and selling of shares in the investment trust does not impact the size of the investable



fund and, as trusts are not required to keep cash for redemptions, this allows a longer-term investment horizon in smaller companies. The manager can also construct the portfolio to balance return and risk, with lower liquidity considerations.

Another factor is gearing, whereby the trust can borrow money with the goal of enhancing returns (although it can also increase losses). Trusts are typically able to borrow up to a certain percentage, for example, 20% of the assets under management, whereas open-ended funds are not able to deploy gearing.

Lastly, investment trusts can use capital reserves to pay dividends (if required). This can provide income for investors in a sector which is more growth- than income-focused.



Case Study

Rockwood Strategic

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Launched: 2015

Manager: Harwood Capital

Ongoing charges: 1.83%

Investment policy: The trust aims to invest in securities under £250 million that the manager believes can generate a 15% IRR (internal rate of return) over the medium to long term.

Comparative Index: FTSE Small Cap (ex-Investment Trusts) Index, FTSE AIM All-Share Index

Rockwood Strategic (RKW) aims to deliver long-term growth for shareholders by investing in a concentrated portfolio of UK smaller companies.

Manager Richard Staveley is a bottom-up stock picker with a value-oriented approach. He looks to capitalise on pricing inefficiencies from a lack of research, with a particular focus on companies with a sub-£150 million market cap but can invest up to £250 million.

Rockwood has a highly concentrated portfolio of around 20 companies (currently 24), split between 'core' and 'springboard' positions, which is a key differentiating feature of the trust. Core investments generally comprise a position of 5-15%, with a smaller holding of 2-4% for springboard positions, which in the future may become 'core'.

Richard takes a private equity style approach to managing portfolio companies with a typical holding period of three to five years. Portfolio companies are typically turnaround or recovery situations where operational, strategic and/or management changes can improve profitability and shareholder value.

Turning to the exit thesis, Richard believes that 75% of the portfolio will ultimately be acquired by a trade or private equity buyer, if the stock market fails to rerate the shares on delivery. As the fund grows to its capacity of £250 million, the proportion of exits will reduce as market sales become easier due to improved stock liquidity. Rockwood has received a number of offers for portfolio companies in recent years and acquisition premiums have been a boost for returns due to the concentrated portfolio.

In the five-year period to 20/05/2025, RKW has delivered a share price total return of more than 200%, one of the highest in the AIC UK Smaller Companies sector and well ahead of its AIC peer group average of 56%.

1) What is the investment trust's goal?

Rockwood's goal is to deliver long-term capital growth for shareholders by investing in listed UK small caps capable of delivering a 15% IRR over a three-to-five-year time period.

2) What kind of stocks does the manager like?

The manager is predominantly a bottom-up stock picker with a universe of around 500 companies across the FTSE Small Cap and AIM indices, excluding biotechnology, early-stage resources and unproven technology businesses. The manager can invest up to 15% in unlisted companies although this is currently zero and not a primary focus for the manager.

The manager focuses on companies with a sub-£250 million market cap which are often overlooked by investors due to their size. He looks for companies with strong free cash flow, a proven business model and identifiable assets at attractive valuations.

3) Are investment decisions driven by a particular investment style?

The manager has a value-oriented investment style, which differentiates the trust from its quality growth-oriented peers. The manager looks for attractively valued companies with material scope for earnings growth, often through turnaround or recovery opportunities.

The manager will identify the catalysts for an improvement in profitability and shareholder returns and actively engage with management teams to execute the necessary operational, strategic and management or board evolution.

The manager develops an exit thesis prior to investment, which seeks to mitigate the illiquidity issues of smaller-cap companies. The trust will typically hold investments for three to five years to allow time for strategic or operational changes to be executed and a corresponding rerating in valuation.

4) How many stocks does the investment trust typically hold?

The trust holds a concentrated portfolio of around 20-30 stocks, split between 'core' holdings (5-15% stake) and 'springboard' holdings (2-4%). It is expected that there will be 5-10 core holdings and then 10-20 springboard holdings.

5) What is the investment trust's dividend policy?

RKW pays out at least 85% of net income received after expenses.

6) What are the investment trust's ongoing charges?

The investment trust's ongoing charges are 1.83%.

7) Does the investment trust have performance fees?

The management fee is 1% of net asset value. There is also a performance fee of 10% based on net asset value returns over a 6% annual absolute hurdle rate, with a high watermark. Total fees are capped at 3% when net assets exceed £100m.

8) How much attention does the manager pay to the index, and to what extent are absolute returns important?

The manager takes a highly active, benchmark-agnostic approach. The stated goal is to invest in companies with the potential to achieve a 15% IRR over three to five years and this goal is the sole focus.

9) Does the investment trust use gearing and, if so, is it structural or opportunity-led?

The manager can use gearing up to 25% of net asset value although there are currently no plans to utilise this in the foreseeable future.

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