Just a cloud away

How UK small-caps have defied the gloom to deliver some eye-catching returns...

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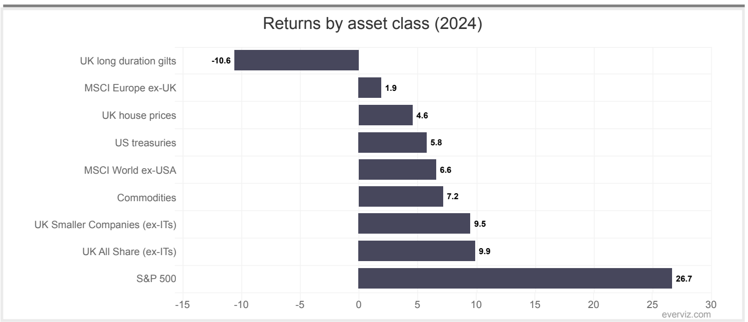
As Winston Churchill famously observed, "The British never see the sunshine without thinking of the clouds". While self-deprecation may be one of our more endearing national traits, it would be fair to say that UK equities have struggled to shake off the lingering cloud of investor pessimism.

Yet the numbers suggest a rather sunnier picture: yes, US equities had a barnstorming 2024 but UK equities have quietly outperformed many asset classes despite the persistent macroeconomic headwinds.

As the chart below shows, the 10% return from the two UK indices comfortably outpaced global commodities (no mean feat given that gold climbed to record highs), as well as beating the returns from bonds, UK residential property and the MSCI World ex-USA Index in 2024.

Fig.1: UK Equities Delivered Solid Returns In 2024



Source: FE Analytics & ONS. Returns in GBP, based on Vanguard UK Long Duration Gilt, Bloomberg Commodities and Deutsche Numis All Share (ex-investment companies) indices & iShares 1-3 year US Treasury Bond ETF

Beneath the index averages, the story for stock-pickers was even more compelling. Large-cap enthusiasts would have enjoyed near-100% gains in IAG, NatWest and Rolls-Royce, while mid-caps such as CMC Markets and Metro Bank delivered even higher returns.

But the real standouts came at the smaller end of the market-cap spectrum. Funding Circle, for example, posted a total return of 235% in 2024, almost four times the average return from the Magnificent Seven. And it wasn't the only UK small-cap to eclipse the 176% return from stock market darling NVIDIA, with Filtronic and Helium One amongst the other names to make the cut.

Could investors be missing a compelling opportunity in their home market given that perception has diverged from fundamentals? It's still early days but a rotation away from US equities could be the long-awaited catalyst to shift the cloud of negative investor sentiment hanging over UK equities.

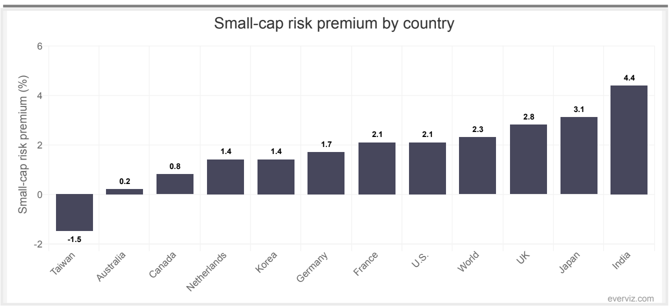
Looking at the bigger picture

While the benefits of long-term investing are regularly extolled, recent fund flows highlight the lure of chasing short-term returns. Although the past decade has undoubtedly been challenging for UK equities, this may prove an anomaly when viewed through a longer-term lens.

Recent research by Deutsche Numis reveals that the Deutsche Numis Small Companies (ex-investment trusts) Index has delivered a 9.0% annualised total return over the last 70 years (from 1955 to 2024, adjusting for the pre-launch period to 1987). This sits comfortably above the respective 6.9% and 6.3% returns for US and global equities.

The UK has historically offered one of the highest risk premia for taking small cap risk (the extra return implied on offer relative to investing in large-caps) among its peers. Since 2000, UK small-caps have delivered an average annual risk premium of 2.8%, well ahead of less developed markets such as Taiwan and Korea, as well as closer neighbours such as France, Germany and the Netherlands. It is true though, that this premium has turned negative over the past ten years, as small caps have underperformed, but historically they have been a powerful growth market in a global context.

Fig.2: The UK Offers One Of The Highest Risk Premia



Source: Deutsche Numis, based on small-cap risk premia from 2000 to 2024

A decade in the 'unloved' category has also left UK small-caps trading on attractive valuations. The MSCI UK Small-Cap Index currently trades at a forward price-earnings ratio of 13.4x, more than 10% below the European equivalent and nearly 40% lower than the MSCI World Small Cap Index (asat 31/03/2025).

Investors may have been sitting on the sidelines but trade and private equity buyers have been lining up to acquire UK companies at depressed valuations. The value of M&A deals involving UK companies soared by 44% in 2024, according to Experian MarketIQ, with deal volumes hitting their highest level since 2018.

Keeping active

With over a thousand small and mid-cap companies listed on the London Stock Exchange, the UK offers a broad and diverse hunting ground for active managers.

BlackRock Smaller Companies (BRSC) targets companies with a sub-£2 billion market cap, where limited analyst coverage creates pricing inefficiencies and opportunities to uncover undervalued growth stocks.

One example is Funding Circle, an online loan platform for small and medium-sized UK businesses. Trading below its net cash position in early 2024, the company has achieved a one-year total return of more than 80% following an exit from its loss-making US business and substantial share buyback programme.

A key strength of BRSC is its disciplined investment process: the team conducts extensive due diligence, often meeting management multiple times before investing. The trust's focus on strong balance sheets and self-funded growth also improves resilience, particularly during rate hiking cycles when external financing becomes more expensive.

Another strong performer is long-standing holding Bloomsbury Publishing. While perhaps best-known for its Harry Potter franchise, the company has pursued an active diversification strategy into new markets and geographies in recent years, underpinning a 5-year total return of almost 200%.

Thanks to its high-quality, cash-generative portfolio, BRSC also offers an attractive income stream in a typically growth-oriented space. The trust currently yields just under 4% and is an AIC 'Dividend Hero' with 21 consecutive years of dividend increases.

Looking ahead, the current dislocation between investor sentiment and the underlying fundamentals could provide a fertile hunting ground for active managers with the discipline to identify tomorrow's winners. As investor sentiment cools toward US equities, a swing back into favour for UK equities could provide the missing catalyst for a period of outperformance.

While the macro backdrop remains challenging, UK equities have already shown their ability to outperform despite the headwinds. But the last word on this topic goes to Winston Churchill: "A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty."

All numbers as at 25/04/2025 unless stated otherwise.

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