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Investing in UK small caps with investment trusts

Investment trusts provide a simple way to access the high-growth potential of the UK small-cap sector.

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Legendary investor Howard Marks observed "The best opportunities are usually found among things that others won't do. After all, if everyone feels good about something and is glad to join in, it won't be bargain-priced."

It's fair to say that UK equities, and small caps in particular, have spent much of the last decade in the cold, suffering record outflows as investors chased the stellar returns of the Magnificent Seven. But 2025 marked a distinct turning point as investors started to cool on punchy valuations and eye-watering capex across the US mega-caps.

UK large-caps were flavour of the year, with the FTSE 100 chalking up a 26% return. While the stardust didn't fully settle on smaller companies, the FTSE Small Cap Index still beat the S&P 500 with a 14% return to the S&P 500's 9%, with a weaker US dollar eroding GBP returns for UK investors.

But that's just the headline indices. UK small caps may have been overlooked by the herd, yet many have delivered strong returns on the back of solid fundamentals. In fact, 27 companies across the FTSE Small Cap and AIM All Share indices have delivered five-year returns in excess of the Magnificent Seven (excluding NVIDIA).

This persistent mismatch between sentiment and fundamentals continues to create a fertile hunting ground for active stock-pickers. Valuations remain attractive relative to developed-market peers and long-term averages, while the recent wave of takeover bids suggests that corporate buyers, if not investors, have spotted the opportunity for that bargain-hunting that Marks referred to. As a result, even a modest rotation away from US equities could provide the catalyst that reignites investor interest and a sustained recovery in this underappreciated corner of the market.

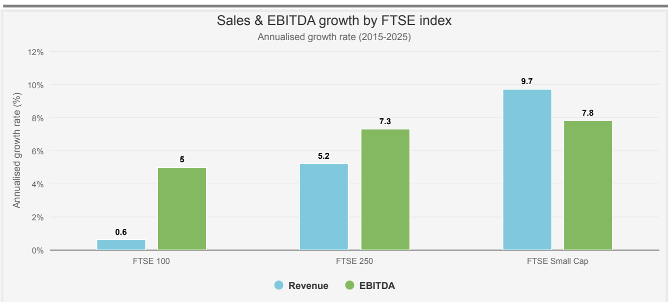
Why invest in UK small caps?

We look at six potential reasons for investing in the UK small-cap sector (which is generally defined as companies with market caps between £250 million and £2 billion).

1. Superior growth potential

Veteran investor Jim Slater once remarked that "elephants don't gallop", a nod to the fact that small caps often outpace their larger-cap peers when it comes to earnings growth.

UK Small Caps Offer Superior Growth Potential



Source: Bloomberg (based on ten years ending 31/12/2026), based on FTSE Small Cap ex investment trusts

Past performance is not a reliable indicator of future results

The numbers back this up: the chart below shows that the FTSE UK Small Cap Index has far eclipsed both its mid- and large-cap counterparts, with annualised revenue and EBITDA growth of 10% and 8% respectively over the last decade.

Beyond the simple arithmetic advantage of being easier to double revenue of £50 million than £5 billion, earlier-stage companies often enjoy a longer growth runway. Small caps also often focus on niche or rapidly growing markets that remain under the radar of larger players.

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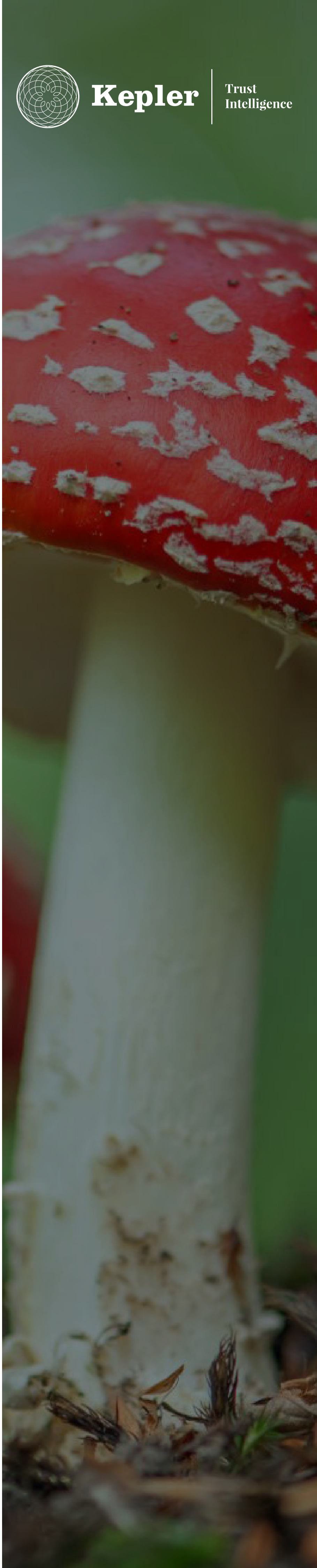


In addition, more entrepreneurial and 'flatter' management teams lend themselves to quicker decision-making, whether exploiting short-term market opportunities or adapting to more challenging market conditions.

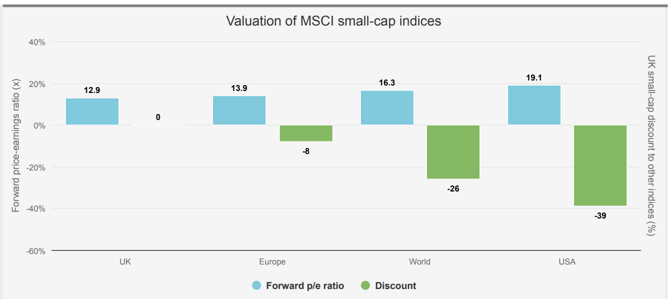
2. Attractive valuations

The UK small-cap sector has suffered a double whammy, with UK equities trading at lower valuations than global peers and small caps also trading at the steepest discount to long-term valuations.

As the chart below shows, the MSCI UK Small Cap Index is sitting at a much lower valuation than its developed market counterparts, being at a 10% and 50%-plus discount to the Europe and USA indices respectively.

If valuations begin to revert to long-term averages, this could present a compelling source of alpha.

Fig.2: UK Valuations Remain Well Below Developed Market Peers



Source: MSCI (as at 31/07/2026)

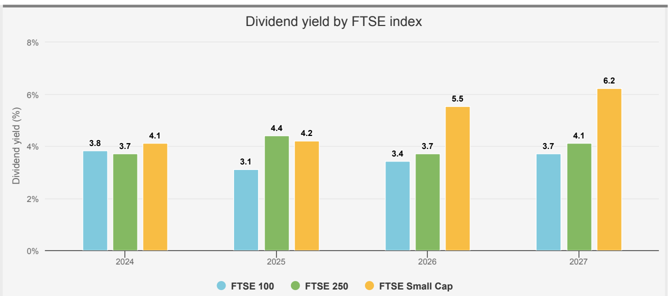
Whilst investors have largely eschewed UK small caps, depressed valuations have certainly attracted attention from potential acquirers. According to Peel Hunt, 10% of the FTSE Small Cap Index was acquired in 2023 alone, with M&A activity continuing apace in 2024 and 2025. With an average bid premium of more than 40% for UK companies in 2025, M&A activity has proved a meaningful tailwind for many UK small-cap trusts.

3. Strong income credentials

A number of UK small caps are in a net cash position, as well as showing strong earnings growth that drops through into cash-flow generation.

As a result, UK small caps are increasingly challenging traditional equity income markets such as the FTSE 100. As the chart below shows, dividend yields for the FTSE Small Cap Index have risen steadily over the past six years and it's forecast to offer the highest yield of the three indices over the next two years, which may broaden its appeal to income-seeking investors.

Fig.3: Small Caps Currently Offer A Higher Dividend Yield Than Larger Caps



Source: Bloomberg, forecast numbers for 2026 & 2027

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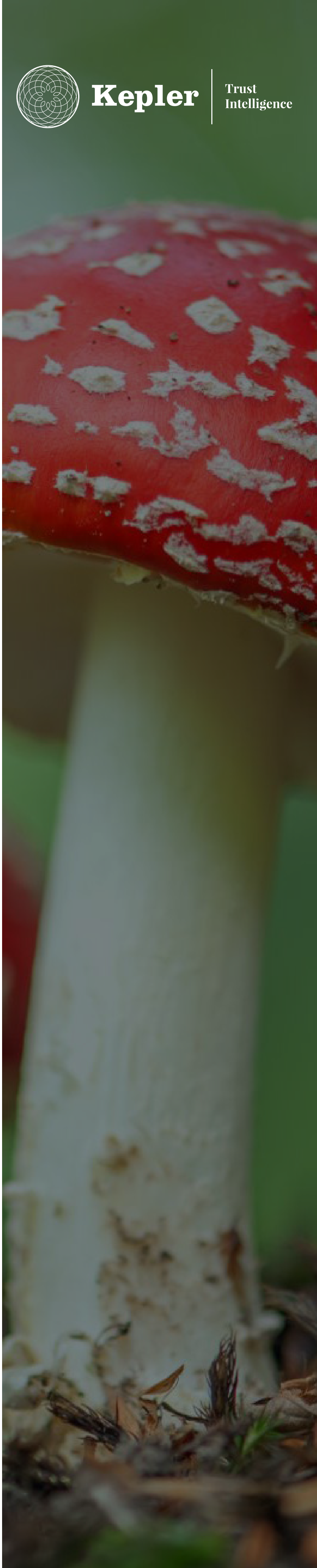
4. Large universe for stock-pickers

With more than 1,000 small-caps listed across the main market and AIM, the UK offers a broad and diverse hunting



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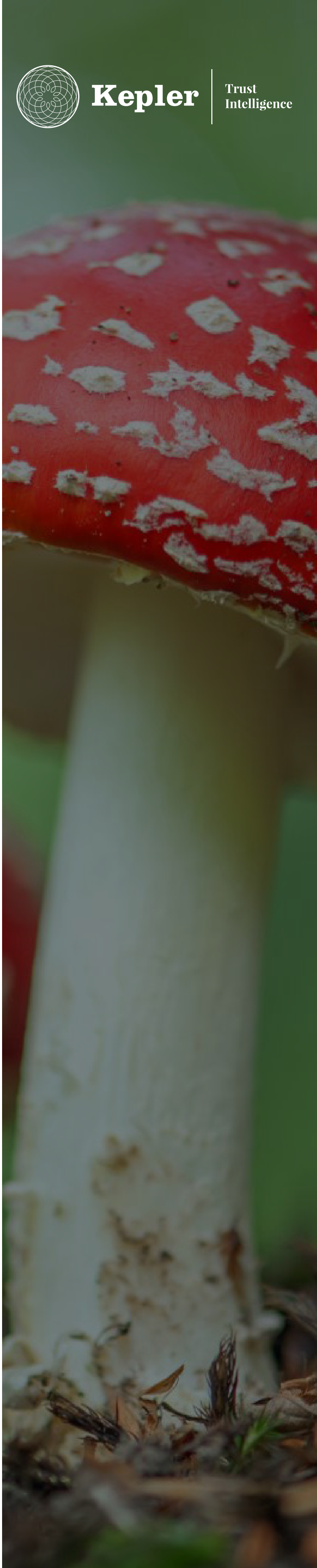


ground for stock-pickers. It's also more diversified than the FTSE 100, both in terms of concentration and sector.

The top ten companies account for less than 20% of the FTSE Small Cap Index by market capitalisation, in contrast to more than 40% for the FTSE 100. It also leans more heavily toward high-growth sectors such as technology, consumer discretionary and industrials.

In addition, the UK small-cap sector is less widely covered by analysts, leading to pricing opportunities for active managers. The average number of analysts covering the ten largest FTSE 100 companies (by market cap) is 24, compared to less than five for the FTSE Small Cap Index. Coverage also drops sharply thereafter, with almost 20% of companies having coverage by only one analyst, or none at all.

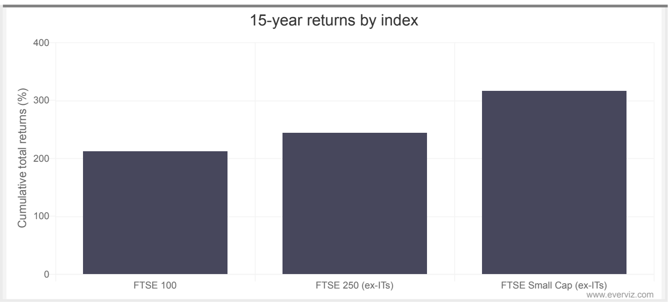
The UK small-cap sector offers a source of diversification by both market cap and geography: many companies in the sector are internationally-focused, reducing reliance on the domestic economy.

Performance is also more often driven by company-specific factors, whereas large caps are typically more exposed to macroeconomic swings. This can provide a valuable counterbalance in portfolios and a potential source of alpha for active managers.

5. Superior returns

Due to the reasons discussed above, UK small caps have outperformed their larger-cap peers over the long term, as shown in the chart below. The FTSE Small Cap (ex-ITs) Index has delivered a total 15-year return of more than 310%, well ahead of the 240% and 210% respective returns for the FTSE 250 and 100.

Fig.4: Track Record Of Outperformance



Source: Bloomberg (as at 03/06/2025)
Past performance is not a reliable indicator of future results

How difficult is it to invest in UK small caps?

Investing in individual small-cap companies can be difficult for private investors due to the lack of research coverage, as mentioned earlier. This requires investors to carry out their own assessment of a company's financial and competitive position, in addition to the quality of the management team, which can be difficult using desktop research alone.

A lack of liquidity can also present a challenge in terms of wide buy-sell spreads and difficulties in buying some shares through standard retail channels.

Active fund managers generally conduct in-depth due diligence and engage with management teams prior to investing. Some take more of a private equity style approach by working with management teams to help direct future strategy and improve shareholder returns.

However, the sector is better suited to a longer-term investment horizon due to its more cyclical nature and higher sensitivity to investor sentiment.

Why invest in UK small caps with investment trusts?

Investment trusts are a type of fund that offers investors access to a diversified portfolio of UK small-cap companies whilst managing some of the potential downside risks mentioned above.

There are currently around 20 trusts in the AIC UK Smaller Companies category, although the remit varies widely with some trusts targeting the larger end of the sector and others focusing on micro-caps (typically below £250 million). There is also a range of portfolio sizes, with some managers running a high-conviction portfolio of 10-20 stocks, while others hold in excess of 100 companies.

Many managers have extensive expertise and experience of investing in small caps. By way of example, the manager of **BlackRock Smaller Companies (BRSC)** has over 20 years of experience in the sector with a focus on high-quality UK companies at the smaller end of the market cap spectrum.

The trust focuses on companies offering high-quality management, a strong market position and track record of growth, sustainable cash generation and well-capitalised balance sheets. These are often capital-light business models with high recurring revenue and cash generation that underpin long-term growth.

Investment trusts vs open-ended funds

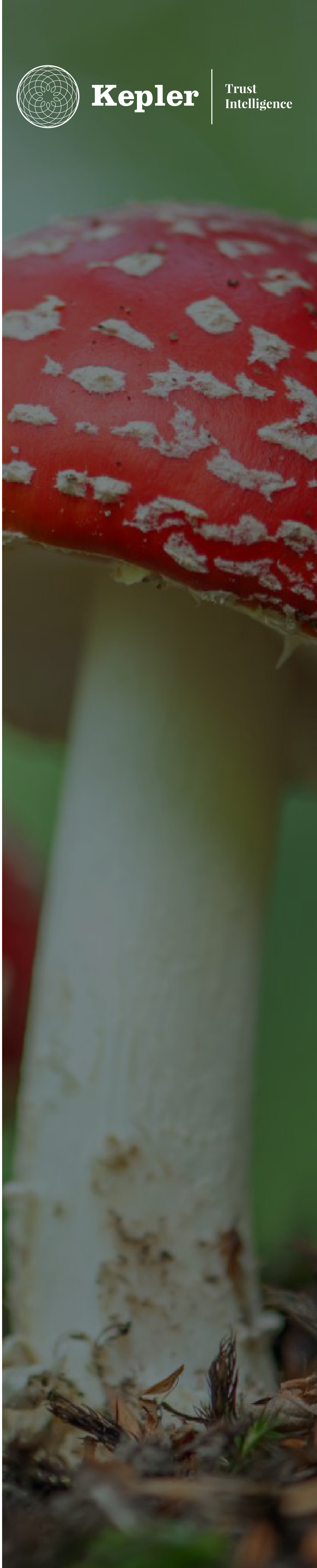
It's fair to say that some of the benefits mentioned above also apply to open-ended funds. However, investment trusts have some unique attributes which may help them deliver superior returns to their open-ended peers.

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 hold a sizeable proportion of cash in reserve in order to meet redemption requests from investors, which can create a 'drag' on returns, and also limits their ability to invest in less liquid stocks such as small caps.

Investment trusts do not have this problem as publicly traded companies, meaning that the buying and selling of shares in the investment trust does not impact the size of the investable fund. As trusts are not required to keep cash for redemptions, this can boost returns for investors and allow longer-term investment in smaller companies.

Another factor is gearing, whereby the trust can borrow money with the goal of enhancing returns (although it can also amplify losses). Trusts are typically able to borrow up to a certain percentage, for example, 25% 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), which can provide income for investors in a sector which is more growth than income-focused.



Case Study

BlackRock Smaller Companies (BRSC)

Launched: 1906

Manager: BlackRock Investment Management

Ongoing charges: 0.8%

Investment policy: The trust aims to deliver long-term capital growth, principally through investment in smaller UK-quoted companies.

Comparative Index: Deutsche Numis Smaller Companies plus AIM (ex-Investment Companies)

BlackRock Smaller Companies (BRSC) aims to deliver long-term growth for shareholders by investing in a diversified portfolio of UK smaller companies. Manager Roland Arnold has worked at BlackRock for 25 years and has managed the trust since 2018.

1) What is the investment trust's goal?

BRSC aims to deliver returns by investing in high-quality UK companies with superior growth prospects.

2) What kind of stocks does the manager like?

The manager is a bottom-up stock picker who looks to capitalise on pricing inefficiencies from a lack of research in the UK small-cap sector. The trust has a broad remit and typically invests in companies with a sub-£2 billion valuation, which provides the flexibility to invest both at the smaller end of the benchmark, as well as larger mid-cap companies.

Roland is predominantly a bottom-up stock picker from a universe of more than 1,000 companies across the Numis Smaller Companies plus AIM index (excluding Investment Companies).

Roland focuses on high-quality companies with superior growth prospects that are able to shape their success irrespective of broader macroeconomic conditions. These are principally companies with strong earnings growth, robust balance sheets with good cash generation and quality management teams.

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

BRSC is a growth-oriented trust with a focus on superior earnings potential. However, there are no restrictions on the portfolio's construction and the manager primarily focuses on fundamentals, resulting in a stylistically diversified portfolio.

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

Due to the higher-risk nature of small caps, the trust has a diversified allocation of around 80 holdings. This is currently split by 'core' holdings (accounting for around 75% of the trust's value) with the remaining 25% in 'incubation' holdings.

Post the recent merger, BRSC has the flexibility to have an allocation of up to 15% in global small caps, with the potential for additional diversification and enhanced returns.

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

BRSC has a primary focus on capital growth, rather than any particular income target, but its focus on cash-generative businesses generates an income stream. As a result, BRSC has qualified as an AIC 'dividend hero' thanks to an increase in dividends for more than 20 consecutive years.

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

The trust's ongoing charges are 0.8%, though this is expected to fall to approximately 0.63% post the merger.

7) Does the investment trust have performance fees?

The management fee is 0.50% of the first £500m of net asset value, reducing to 0.475% between £500 million and £750 million, and 0.45% in excess of £750 million. There is no performance fee.

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

The manager takes an active, benchmark-agnostic approach. The manager is conscious of the need to deliver outperformance against the benchmark, but this does not drive investment decisions.

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

BRSC uses structural gearing to enhance the long-term growth potential that smaller companies can offer across the market cycle, though this can amplify returns to both the upside and downside. The trust can gear up to 20%, though this is expected to be no more than 15% in normal market conditions.

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