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Finding a sweet spot

The UK mid-cap sector offers appealing valuations for growth-seeking investors...

Update
13 December 2024

It's fair to say that investors seeking growth-driven returns in the last few years have needed to look little further than the Magnificent Seven, which have propelled the S&P 500 to record highs.

However, this meteoric rise has also sparked concerns that lofty valuations could start to look extended if the US tech giants fall short of punchy earnings forecasts or fail to deliver against the billions poured into AI. While the US mega-caps are likely to merit a healthy allocation in portfolios for some time to come, this may be an opportune time to think about rebalancing allocations.

However, diversification doesn't have to mean sacrificing growth potential. The UK often flies under the radar for growth-focused investors yet the numbers speak for themselves: over the past 25 years, the FTSE 250 (ex-investment companies) index has delivered a total return of more than 600%, not far below the 650% return from the S&P 500. More recently, the UK mid-cap index has returned a healthy 17% over the past year, only slightly below the equal-weighted S&P 500 index at 21%.

Looking beyond the numbers, UK mid-caps offer a sweet spot in terms of innovation and disruption, with higher growth trajectories than many larger-cap peers and lower failure rates than smaller companies. The under-researched mid-cap sector is also a fertile hunting ground for active managers seeking to uncover the rising stars of tomorrow.

A window of opportunity - Macroeconomic tailwinds

Following the shortest and shallowest recession on record, the UK bounced back to positive GDP growth in 2024.

The outlook remains positive, with the UK projected to achieve the third-highest GDP growth among the G7 nations in 2025, trailing only the US and Canada. Compared to its European counterparts, the UK is expected to deliver nearly twice the GDP growth of France and Italy and more than double that of Germany, as illustrated in the chart below.

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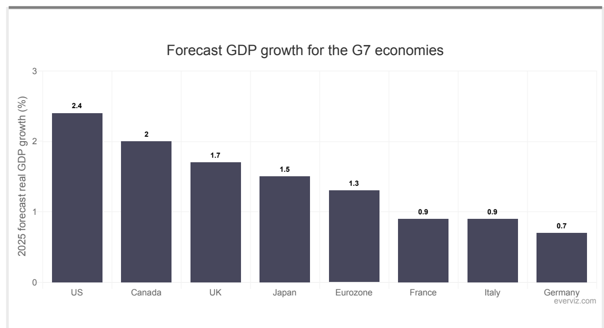
Fig.1: The UK Is Outpacing Many Of The G7 Economies



Source: OECD, December 2024

The macroeconomic backdrop is also looking more supportive for UK equities. Inflation finally dropped to its 2% target in June, enabling the Bank of England to cut interest rates ahead of The Fed and it's worth noting that the FTSE 250 has historically often outperformed in the period following the

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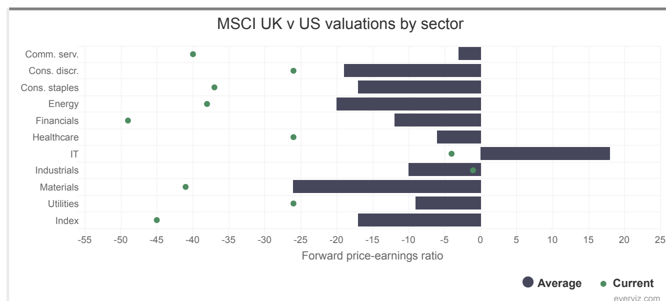
first interest rate cut. In a year in which half of the global population goes to the polls, including the closely-fought US elections, the UK also offers relative political stability.

Snapping up a bargain

Despite the recent rally, valuations of mid-cap UK companies remain below historic averages and their developed market peers. The forward price-earnings ratio for the FTSE 250 (ex-investment trusts) index is more than 20% below its 10-year average and 33% and 56% below the MSCI World and USA Mid-Cap indices respectively.

This UK-US valuation differential is often attributed to a higher weighting of growth sectors in the US but sector-level valuations tell a different story. As shown in the chart below, every sector (other than technology) in the UK trades on a significant discount relative to the US, based on a 30-year average.

Fig.2: UK Sector Valuations Are Significantly Discounted To The US



Source:JPMorgan, average discount from 1995 to present, current discount as at 30/09/2024

Added to this, the forward price-earnings discount is currently well above the 30-year average for every sector bar one, with the financial sector trading at a near-50% discount in the UK to the US at present.

The rise in acquisitions of UK companies by corporate and private equity buyers is also testament to the attractive valuations on offer, with a noticeable rise in bid premiums. In addition, many UK-focused investment trusts are trading at significant discounts, which could provide an extra kicker to returns if sentiment improves and discounts narrow.

Rich pickings

The FTSE 250 provides an appealing universe for stock-pickers, often called the 'Heineken index' as it's constantly being refreshed. While the IPO market may have been subdued, M&A activity creates opportunities for new entrants alongside promotion of faster-growth small-caps and demotion of 'fallen angels' from the FTSE 100 index.

We should also remember that FTSE 250 companies are not 'small' businesses and include household names such as Ocado, Games Workshop and Domino's.

Schroder UK Mid Cap (SCP) takes a differentiated approach by holding a high-conviction portfolio of around 40-50 names, creating potential alpha versus a more diversified strategy which can dilute the impact of 'best ideas'. This concentrated portfolio also enables managers Jean Roche and Andy Brough to have extensive engagement with portfolio companies, meeting management teams prior to investing and at least once a year thereafter.

SCP has a strict sell policy when companies are promoted to the FTSE 100 index, helping to maintain the trust's exclusive mid-cap focus and allowing the recycling of proceeds into potential FTSE 100 companies of the future. The portfolio is also well-balanced in terms of new entrants challenging the status quo and more mature companies with the adaptability and dynamism to respond to such disruptors.

The FTSE 250 index is more diversified by sector than the FTSE 100, providing exposure to a wide range of high-growth secular themes such as cyber security, gaming and fintech. Added to this, the FTSE 250 offers the 'best of both worlds' in terms of a broadly equal split of domestic and overseas revenue, allowing the managers to tilt the portfolio towards the most promising opportunities.

The UK mid-cap sector is also a fertile hunting ground for stock-pickers due to the relative lack of analyst coverage, providing the opportunity to uncover companies with market-leading potential yet to be reflected in valuations. Jean and Andy place a high value on resilience, looking for quality management teams with a strong strategic vision, sustainable business models and robust balance sheets to support capital expenditure and cash returns to shareholders.

SCP also favours companies operating in market niches with strong pricing power, such as top-five holding Games Workshop in the miniature collectibles market. The company recently granted Amazon exclusive rights to adapt the Warhammer 40k universe, providing a significant opportunity to raise its brand exposure in the US.

Another portfolio company, Telecom Plus (which trades as Utility Warehouse) provides a unique multi-service bundled product across the energy, broadband, telecoms and insurance markets, generating double-digit growth in both customers and revenue in its last financial year.

On a final note, it's worth noting that the UK has produced a higher proportion of '30-baggers' (companies appreciating by more than 30 times over 30 years) than the US according to research by Schroders (based on

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the 30-year period to 2022). SCP has had its fair share of 30-baggers, including Renishaw, Cranswick, Grainger, HomeServe and 4imprint to name but a few. With attractive valuations and an improving economic outlook, the UK mid-cap sector looks well-positioned to continue its upward march.

Data as at 11/12/2024 and returns in GBP (unless stated otherwise).

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