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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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BlackRock

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Benjamin Graham, often called the ‘father of value investing’, gave this advice in his seminal work in 1949: “The intelligent investor is likely to need considerable willpower to keep from following the crowd. The best values today are often found in the stocks that were once hot and have since gone cold.”

It would be fair to say that UK equities, and small caps in particular, have felt the chill over the last decade, suffering record outflows as investors chased the red-hot returns of the US mega-caps. More recently, however, sentiment toward these stock market darlings seems to be starting to cool amid geopolitical and macroeconomic uncertainty.

Meanwhile, UK small caps may have been overlooked by the herd but they’ve often quietly delivered. Most investment trusts in the AIC UK Smaller Companies sector have produced positive (and often substantial) returns over the past five years despite the challenging backdrop.

The UK small-cap sector remains a fertile hunting ground for active stock-pickers: valuations remain well below long-term averages and limited analyst coverage presents mispricing opportunities. Many small caps also boast robust fundamentals with resilient business models, solid cash flows and a clear focus on shareholder value.

As a result, even a modest shift away from US equities could provide the spark that reignites investor interest and a sustained recovery in this underappreciated corner of the market.

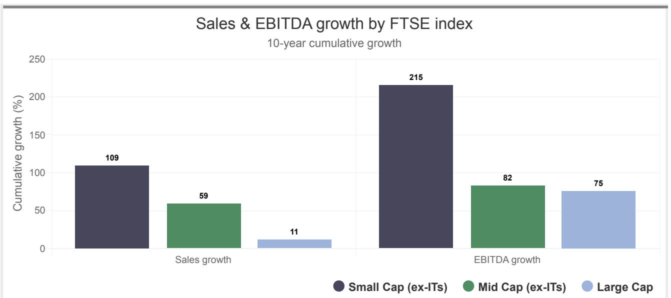
Why invest in UK small caps?

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 is quoted as saying that “elephants don’t gallop” which is a nod to the fact that small caps often outpace their larger-cap peers when it comes to earnings growth.

Fig.1: UK Small Caps Offer Superior Growth Potential



Source: Bloomberg (based on ten years ending 31/12/2024)
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 (ex-investment trusts) Index has far eclipsed both its mid- and large-cap counterparts in terms of sales and EBITDA growth 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 tend to focus on niche or rapidly growing markets that remain under the radar of larger players.

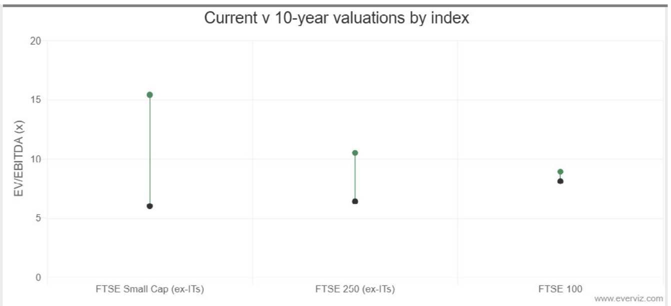
In addition, more entrepreneurial and 'flatter' management teams lend themselves to quicker decision-making, whether exploiting short-term market opportunities or adapting to more challenging market conditions.

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, all three FTSE indices sit below their ten-year averages, but the gap is widest for the FTSE Small Cap (ex-ITs) Index which is currently trading at a 60% discount. If valuations begin to revert to long-term averages, this could present a compelling source of alpha.

Fig.2: Valuations Remain Well Below Historic Averages



Source: Bloomberg (as at 03/06/2025)

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. M&A activity continued apace in 2024 with 1 in 20 of UK-listed companies entering public offer periods.

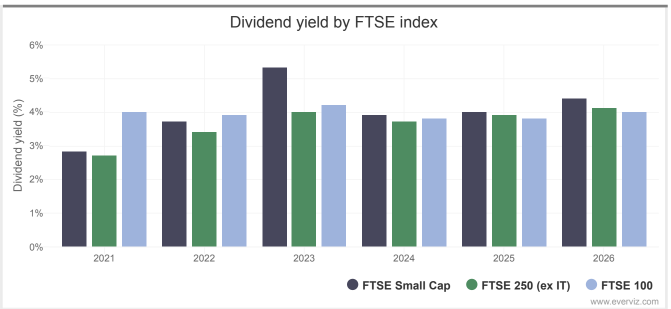
Overseas buyers accounted for more than half of these deals and over 30% of buyers were in the private equity sphere. With an average bid premium nearing 40%, M&A activity has proved a meaningful tailwind for many UK small-cap trusts.

3. Cash generative

There's a common preconception that small caps are more highly leveraged and less financially resilient than their larger-cap peers, which can make them more sensitive to interest rate movements. But the data tells a more nuanced story.

In fact, a number of UK small caps are in net cash positions and the average net debt to EBITDA ratio is currently 2.2 times for the FTSE Small Cap (ex-ITs) Index (as at 03/06/2025), well within the generally accepted sub-3 range.

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



Source: Octopus Investments/Factset (to 29/02/2025, forecast numbers for 2025 & 2026)

These companies are also often highly cash-generative. The FTSE Small Cap (ex-ITs) Index achieved a 700% plus increase in free cashflow in the five years to the end of 2024, compared to 87% and just 30% for the FTSE 250 (ex-ITs) and 100 indices respectively.

This financial firepower is also increasingly translating into income. 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.

4. Large universe for stock-pickers

With over 1,000 small-cap companies listed across the main market and AIM, the UK offers a broad and diverse hunting ground for stock-pickers.

The small-cap sector is also well-diversified: 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 six for the FTSE Small Cap Index, with coverage dropping sharply thereafter.

5. Diversification

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.

6. Superior returns

Fig.4: Track Record Of Outperformance

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

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.

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 cause 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 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

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BlackRock

BlackRock Smaller Companies (BRSC)

Launched: 1906

Manager: BlackRock Investment Management

Ongoing charges: 0.8%

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

Comparative Index: 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.

The manager is a bottom-up stock picker who looks to capitalise on pricing inefficiencies from a lack of research. 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 targets the most under-researched areas of the market which offer the potential to generate alpha over the longer term.

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.

Small caps tend to be more volatile and BRSC's use of structural gearing can amplify returns to both the upside and downside. However, this style of investing has paid off over the long term, with the trust delivering superior returns to its benchmark in the ten years to 28/02/2025.

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 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).

The manager likes companies with strong free cash flow, a proven business model and track record of growth, a strong competitive advantage and a capable management team.

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 100 to 120 holdings. This is currently split by 'core' holdings (accounting for around 75% of the trust's value) with the remaining 25% in 'incubation' holdings.

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%.

7) Does the investment trust have performance fees?

The management fee is 0.60% of the first £750m of total assets less current liabilities, reducing to 0.50% thereafter. 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. The board maintains a strict policy to ensure that the trust's net gearing should not exceed 15% of net assets at the time of drawdown.

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