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The Small-Cap Odyssey

After a decade adrift, could small cap discounts be the next trade?

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Greece became one of the hottest topics of the summer on the back of Christopher Nolan's *The Odyssey*, which retold the story of Odysseus' ten-year return journey home from the Trojan War. The summer also saw another, rather less cinematic, journey hit the ten-year mark, with 2026 marking a decade since the UK's Brexit referendum. This event is often pointed to as the starting point of the struggles for UK markets, most notably amongst small caps which have now endured a decade of headwinds and rough seas.

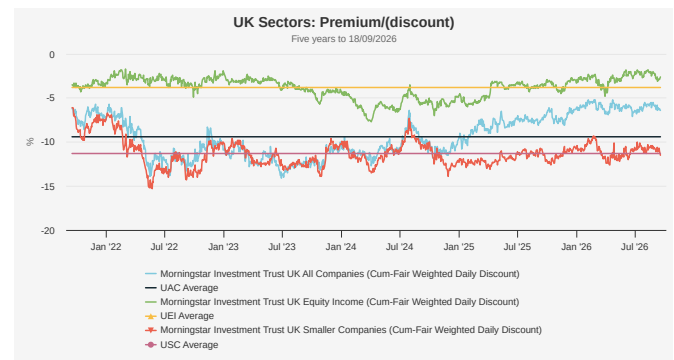
However, there are signs that conditions are improving. The UK has recently produced some decent economic data, the country's headline market, FTSE 100 Index, has delivered outperformance against developed market peers, and discounts have narrowed in two of the three UK-centric investment trusts sectors. However, the outlier in this tale remains the smaller companies sector, which has continued to lag, both in terms of capital returns versus its larger peers, and in terms of its rating, with the AIC sector continuing to languish at a wide discount. However, with the underlying data starting to move in an encouraging direction, we believe this could be the beginning of a period of recovery for small caps, which may provide an attractive opportunity for those looking to join the journey.

UK weakness

Whilst the starting point for UK's travails is often given as 2016, the country has faced numerous challenges over the past decade that have affected returns. These includes the Covid-19 pandemic, the period of high inflation and interest rates, and the repeated political turmoil catalysed by these challenges. These have all had their impact on both sentiment and markets, although the high interest rate period has had arguably the most lasting effect, particularly amongst

investment trusts. This can be seen in the performance of the discounts across the three UK-focused sectors: UK Equity Income, All Companies and Smaller Companies, all of which saw discounts widen in the period.

UK SECTOR DISCOUNTS



Source: Morningstar

Past performance is not a reliable indicator of future results.

This chart shows that the average discounts on the UK equity income and all companies sectors have narrowed since their troughs and are now back above their long-term averages. In fact, both are trading at narrower levels than even their ten-year averages too, reflecting better sentiment towards the sectors now than over much of the past challenging decade. However, the smaller companies sector continues to languish. Whilst discounts began to narrow in line with its larger peers in mid-2024, this proved short-lived and the sector has since detached from the narrowing trend and remains wide. In fact, the UK smaller companies sector is the only sector where the current discount is wider than both its five-year and ten-year averages as we show below.

HISTORIC DISCOUNT AVERAGES

DISCOUNT LEVELS	ALL COS	EQUITY INCOME	SMALL COS
Current (21/09)	6.4	2.6	11.5
Five-year average	9.4	3.8	11.3
Ten-year average	8.2	3.8	10.4

Source: Morningstar, to 21/09/2026

On top of the sector trading at a discount, valuations across the asset class are also depressed. On a forward price/earnings (PE) basis, smaller companies are trading considerably below their long-term averages, and at the bottom of their interquartile range. In addition, the absolute PE level is only marginally above the equivalent PE of large caps, despite smaller companies typically having much better growth prospects and therefore historically trading at higher valuations. For context, UK large caps are trading close to their median average, demonstrating this is very much a case of small caps being lowly valued, rather than large caps seeing a strong rally, and in fact, large-cap UK stocks still trade at a discount to their international peers.

The extent of how depressed UK small cap valuations are is also apparent in other metrics, such as the yield of the asset class, with the Deutsche Numis UK Smaller Companies ex AIM ex Investment Companies Index currently yielding above that of the large cap market. This anomaly has only occurred a few times in the past thirty years and has often been followed by a prolonged period of small cap outperformance. However, as the past few years have proven, being attractively valued is not reason enough to cause a rally. A catalyst is required, and this has so far proved elusive. However, recent economic data could be the spark the sector needs.

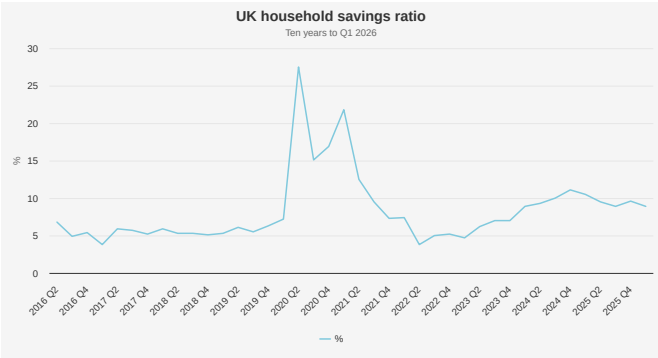
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The UK has posted strong GDP growth for the first half of 2026, revealing it as the fastest-growing economy amongst G7 peers in the period. This was followed by a particularly strong growth figure for July of 0.4%, showing good momentum despite the impact of the war in Iran. On top of this, productivity, which has been touted as a long-standing weakness of the UK economy, has been better than initially thought following changes in the methodology. This has

particular importance for smaller companies as they are more exposed to the domestic economy, compared to larger companies which are more exposed to international markets. Therefore, as the economic picture in the UK has improved, so too has the outlook for domestically focused firms.

Adding to this is the position of the average UK consumer which is surprisingly resilient. Outside of the pandemic, when spending was effectively banned, the household savings ratio is at its highest level in a decade, showing that investors have enough free cash each month to put around £9 of every £100 earned into savings. Helping this has been wage inflation, which has seen real growth in every quarter since April 2023. This has also contributed to falling household debt, which has fallen steadily over the past decade, from 87% of GDP to 72% in Q1 2026. As such, whilst uncertainty is leading to caution, UK consumers are better paid, have good savings and lower debt than at any point in the past ten years. This should provide a good platform for a potential recovery should sentiment improve, which in turn would likely have a very positive impact on UK small caps.

UK SAVINGS



Source: Office for National Statistics, Q1 2026
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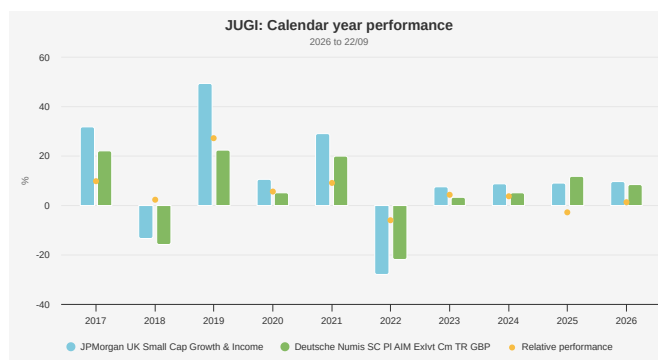
Not only could the UK's G7-leading growth figures inspire a domestic recovery, it may also encourage international investors to return to the country. One of the factors that contributed to small cap weakness has been investment flows, as both international and domestic investors have been reducing their exposure to the country, something we recently discussed in [a previous article](#). Should the encouraging economic data lead to a pick-up in inflows, the impact on smaller companies would be considerably higher due to the lower liquidity at this part of the market.

Options limited

However, if investors want to capture the recovery in UK small caps, investment trusts are arguably the best vehicle for this. Not only does the closed-ended structure work well for lower liquidity, but with most trusts trading at a discount, they have the potential to compound shareholder returns as both the deeply discounted valuations recover and discounts narrow. Furthermore, there are few passive options for accessing the asset class, with those that do exist tracking an index with a heavy bias to large caps. In fact, the top ten holdings of the MSCI UK Small Cap Index which the ETFs track are all FTSE 100 companies and therefore investors in these would have very limited exposure to the potential small cap recovery.

One trust that investors may consider is [JPMorgan UK Small Cap Growth & Income \(JUGI\)](#). Managers Georgina Brittain and Katen Patel have delivered impressive performance over the long term, beating their benchmark, the Deutsche Numis Smaller Companies plus AIM ex Investment Companies Index, in eight of the past ten years, including 2026 to date (22/09/2026).

JUGI PERFORMANCE



Source: Morningstar

Past performance is not a reliable indicator of future results

Supporting this performance has been their approach of targeting three key factors; quality, value and momentum, based on a process that has been honed over three decades. It is the latter factor, momentum, which is particularly interesting at this juncture, due to the potential UK small cap recovery. The portfolio has on aggregate seen earnings upgrades from its holdings, which contrasts with aggregate downgrades from their benchmark. One example has been Applied Nutrition. The managers first initiated a position at IPO in 2024, and have benefited from solid earnings upgrades since, which has led to good share price returns. With the company having proved itself, they have added to their position recently. The firm has also recently announced an agreement with Mondelez in the US which it is hoped will have a material impact on future earnings and therefore continue to provide positive contribution to the trust, with shares having already doubled since IPO.

Alongside most of its peers, JUGI trades at a discount, although the current level of c. 7.4% is narrower than the five-year average of c. 11%. JUGI's discount has been volatile though, with sharp rallies seen a number of times in the past five years as the outlook for the asset class has improved, demonstrating good investor appetite for the strategy should conditions improve and arguably reflecting the managers' good track record in outperforming rising markets.

The trust has recently announced a planned combination with peer Aberdeen UK Smaller Companies Growth (AUSC). Should this be approved by shareholders, it would increase the scale of JUGI and therefore liquidity, potentially putting it

on the radar of a wider investor base. In addition, JPMorgan has proposed a reduction in the management fees for both sets of shareholders, which will likely result in the trust being one of the most cost-effective in the wide peer group.

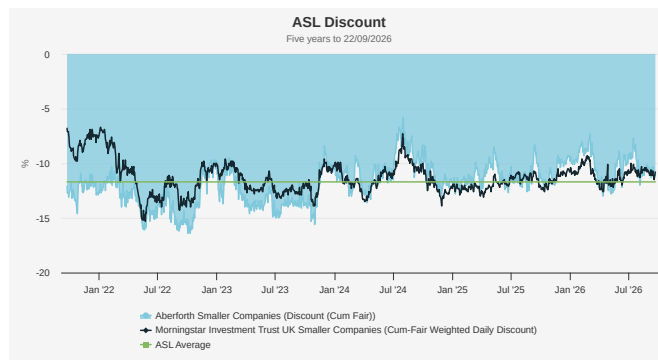
Another trust that already offers scale is [Aberforth Smaller Companies \(ASL\)](#). With net assets of c. £1.5bn, the trust is the largest in the peer group by a considerable margin. The six-strong management team also exercise a tried-and-tested process which has been in place since inception in 1990, to identify out-of-favour, undervalued companies and either wait for the market to reappraise them and valuations to recover, or to work with them over time to improve and unlock the value on offer. The strong focus on valuations helps the trust stand out from the peer group as the trust with the highest exposure to the value style, meaning it is likely to be one of the first options investors turn to should a recovery be apparent. This would not only compound returns from the likely discount narrowing, but also support NAV performance as a positive style tailwind, as it has been for much of the past five years during the higher interest rate environment.

It has also contributed to the trust having an impressive M&A hit rate, with over 20 holdings bid for in the past five years, from a portfolio of between 70 and 80 holdings. These takeovers have come in at significant premia to undisturbed prices, with an average value of 15x on their preferred EV/EBITDA metric, versus 7.1x average for the remaining portfolio. This effect has been supportive to relative performance, with ASL having delivered a NAV total return of 29.7% to 22/09/2026, compared to 20.8% for its benchmark. The peer group average, though, returned just 5.2%.

Despite this, ASL continues to trade at a wide discount to NAV of 11%, broadly in line with its five-year average of 11.7% and with the sector average of 10.8%, despite the significant

outperformance over this period. As such, we believe the rating, combined with the value approach which is arguably well-placed to benefit from a wider market recovery, could make for a very compelling entry point to capture a potential recovery in the asset class.

ASL DISCOUNT



Source: Morningstar

Past performance is not a reliable indicator of future results.

Conclusion

The recent recoveries seen in the discounts of both the UK All Companies and Equity Income sectors are arguably signs investors are putting the past travails of the UK market behind them, and getting ahead of a nascent economic recovery. Whilst valuations versus international peers remain compelling, leaving plenty of upside potential on the table, the smaller companies sector looks particularly interesting in our view, having been notably left behind. This is most apparent in the current discount, which is below its five- and ten-year averages. Smaller companies often do best in periods of market recovery, and with economic data looking supportive, the recovery may be closer than we think.

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