



The comeback kid

Why UK small-caps are finally back in the game.

Update
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It's been a long time coming but the tide may finally be turning for UK equities. While US stocks have soared, UK small-caps have endured a bruising run that's been worse than Brexit, the pandemic and even the global financial crisis.

But, as the pendulum begins to swing away from the US, global investors are eyeing the UK once again. Allocations to the UK in July's Bank of America's Fund Manager Survey were at their most constructive in over a year, alongside improving sentiment towards Europe more broadly.

And with pain comes opportunity: valuations still look compelling. The MSCI UK Small Cap Index is trading on a forward price-earnings ratio of just under 13 (as at 31/07/2025), 33% cheaper than its US counterpart, 23% below the global equivalent and at a discount even to 'unloved' Europe.

A spate of bad news may have delayed the recovery but a reversal in global fund flows could be the missing catalyst for UK equities to shine. Institutional allocations often lead the way, and in the less liquid UK small-cap market, even modest retail flows can have an outsized impact.

Back to basics

Look beyond the headlines and the issue becomes clear: it's about flows, not fundamentals. According to Morningstar, UK small-caps have seen 14 consecutive quarters of outflows, with £150 billion pulled from active UK equity funds since 2016.

This persistent selling pressure has weighed on valuations, which have become increasingly detached from underlying fundamentals. And, away from the spotlight, many UK small-caps have quietly delivered strong results.

As the chart below shows, UK small and mid-caps have delivered impressive growth in revenue and profits since 2019, outpacing even the high-growth S&P 500 and MSCI USA Small Cap indices.

Post-pandemic, the sector has emerged leaner and stronger, with many firms recapitalising and reinforcing their balance sheets. Both the FTSE 250 and Small Cap (ex-ICs) indices have forecast net debt/EBITDA ratios of 2 or lower for 2025, with around a third of constituents now in net cash positions.

Meanwhile, private equity and overseas buyers have taken the opportunity to snap up UK-listed names at bargain prices. Peel Hunt reports 30 bids this year alone for UK-listed companies valued above £100 million, with the average premium rising to

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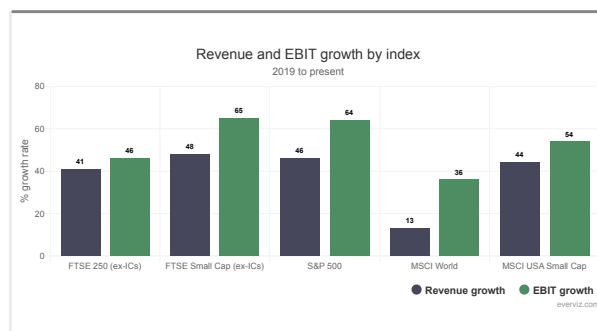


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40-60% since the pandemic, well above the long-run average of 30-50%.

Fig.1: UK Small And Mid-Caps Offer A Sweet Spot For Growth



Source: Bloomberg (cumulative growth from 01/01/2019 to 01/07/2025)

Past performance is not a reliable indicator of future results.

M&A has provided a boon for many small-cap managers. **BlackRock Smaller Companies (BRSC)**, for example, received a takeover offer for restaurant chain Loungers from US private equity firm Fortress at a 37% premium (to the pre-offer share price). Another holding, GlobalData, also attracted private equity interest before talks ended, providing a timely reminder that the corporate world, at least, sees value in UK assets.



We're a country of spenders (in disguise)

The British public may be spenders at heart but they've been channelling more money into the bank than the shops since the pandemic. The household savings rate climbed to 12% in 2024, comfortably in excess of the long-term average of 8%. Lured by higher interest rates, households are holding nearly £2 trillion in cash, according to the Bank of England.

But momentum is shifting. The base rate has already fallen from 5.25% to 4.0% and mortgage rates have declined in anticipation of further easing.

With the Monthly Asda Income Tracker hitting a decade high earlier this year, there's plenty of consumer firepower but the missing piece of the puzzle has been confidence. Encouragingly, the GfK Consumer Confidence Index recorded its second consecutive monthly improvement in June, suggesting that confidence is starting to return.

Riding the tailwinds

UK small-caps tend to outperform when interest rates fall, thanks to cheaper capital and renewed investor appetite for risk. While the rate path remains uncertain, markets are currently pricing in another further cut this year, which could provide a cyclical tailwind.

On the retail side, falling rates could also prompt savers to look beyond cash in search of superior returns. According to the FT, UK households have the lowest appetite for investing among their G7 peers, with just 8% of their wealth in equities compared to 33% in the US. Speculation around potential reforms to cash ISAs could also give retail demand a much-needed boost.

Meanwhile, structural reform is also underway on the institutional side. The Mansion House Accord includes a pledge from UK pension schemes to invest an additional £25 billion in domestic assets by 2030, which should provide long-term support for UK equity valuations.

Tapping into the opportunities

One of the advantages of active management is the ability to tilt portfolios towards the most promising opportunities. BRSC's Roland Arnold has been increasing exposure to consumer-oriented stocks in the expectation that rising confidence and rate cuts could unlock consumer demand.

One area of focus is fintech, with holdings PayPoint and Boku exemplifying this theme. PayPoint taps into everyday

consumer spending, handling bill payments and parcel collections across a nationwide network of convenience stores. Its shares have risen strongly in recent months, supported by resilient results, a higher dividend and an extended buyback programme.

Meanwhile, Boku's share price has rallied by 45% since early April. The mobile payments company enables people to pay for digital services such as in-app purchases or gaming via their phone bill or digital wallet rather than a credit card. With partnerships spanning Meta, Amazon, Netflix and Alphabet, it offers scalable exposure to the global shift towards online and mobile spending.

While UK small caps aren't always seen as income plays, many of BRSC's holdings are highly cash generative, underpinning the trust's AIC Dividend Hero status. The trust's consistent approach, trimming winners and adding on short-term weakness, also reinforces its ability to deliver returns across the cycle.

UK small caps may have spent years in the wilderness but the ingredients for a sustained recovery are falling into place: improving fundamentals, cheap valuations, looser monetary policy and early signs of investor re-engagement. For high-conviction investors, this could finally be the moment the Comeback Kid steps back into the ring.

All data as at 18/08/2025 unless otherwise specified.

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