When the tough gets going

Why Rockwood's returns have put the Magnificent Seven in the shade...

Update
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Sometimes there's no sugar-coating the truth: the last few months have been particularly challenging for UK equities. A steady stream of negative news from downgraded GDP forecasts to higher-for-longer interest rates has dampened the green shoots of improving investor sentiment towards a beleaguered small-cap sector.

While stock markets don't always move in tandem with the economy, UK small-caps have borne the brunt of the macro gloom and largely flatlined since Labour came into power. Yet it's during the most testing times that active managers can truly prove their worth by delivering standout returns despite the obstacles in their path.

And **Rockwood Strategic (RKW)** certainly fits the bill on that front. Over the past year, it's achieved a share price total return of 33%, far outpacing the 12% gain of the FTSE Small Cap (ex-Investment Companies) Index and the 3% fall in the FTSE AIM All Share. Nor is this a one-year wonder, with Rockwood having topped the AIC UK Smaller Companies sector by share price returns over three years too.

To put this into perspective, Rockwood's one-year return is almost double the 19% return from the S&P 500. The Magnificent Seven may have dominated the financial headlines (and indeed fund flows) but the UK small-cap sector has its share of poster children delivering stellar returns for investors keeping the faith.

The case for active management

The UK small-cap sector is a fertile hunting ground for stock-pickers with more than 700 companies across the FTSE Small Cap, Fledging and AIM All Share markets. However, it also has its fair share of lower-quality, speculative businesses, showing the benefit of active management in separating the wheat from the chaff.

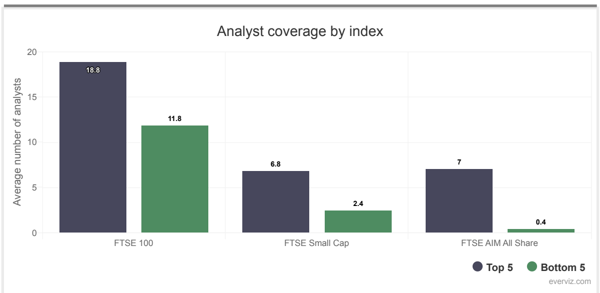
Exploiting market inefficiencies

Unlike many of its peers, Rockwood focuses on the smaller end of the small-cap universe, generally targeting companies with a market cap of up to £250 million. Manager Richard Staveley looks to exploit pricing inefficiencies that arise from limited small-cap research coverage and professional investor attention, meaning that material due diligence can create an information advantage, with additional upside from their illiquidity premium.

Analysts:
Jo Groves
jo@keplerpartners.com

As shown in the graph below, the top five companies in the smaller-cap indices are covered by seven analysts, compared to 19 for the FTSE 100. In addition, research coverage drops steeply thereafter, with less than three analysts covering the five smallest companies.

Fig.1: Small-Caps Have Limited Research Coverage



Source: KTI analysis

High-conviction investing

Rockwood maintains a highly-concentrated portfolio of approximately 20 companies, with the top ten holdings accounting for about two-thirds of the portfolio.

This focused approach allows Richard to back his best ideas with conviction and avoid the dilution of returns from a more diversified portfolio, with individual positions sometimes exceeding 10% of NAV.

In addition, while the de-equitisation of UK stock markets can cause a potential issue for 100-strong portfolios in terms of comprising on quality, Richard looks to source only two to four new ideas a year.

Given the illiquidity of the small-cap sector, Richard has an exit plan in mind when investing and aims to double his money over a three-to-five-year time period. A significant portion of exits are expected to be from M&A activity, with trade and private equity buyers often willing to pay substantial control premiums to snap up UK companies at depressed valuations.

By way of example, Richard (re)purchased a stake in regional media group National World in early 2024, generating a substantial return when the company was acquired later in the year at a 50%-plus premium.

Finding the value

Valuations of UK equities, and small-caps in particular, remain well below their historic averages and peers. Rockwood's value focus is a potential source of alpha generation, focusing on buying attractively-valued businesses and actively engaging with management teams to identify the necessary catalysts to unlock value for shareholders.

Richard looks for companies where self-help can drive profitability irrespective of the wider macro-economic backdrop. Due to the percentage size of its investment stakes in these companies, Rockwood is able to take a private equity style approach in order to influence operational, strategic or management change.

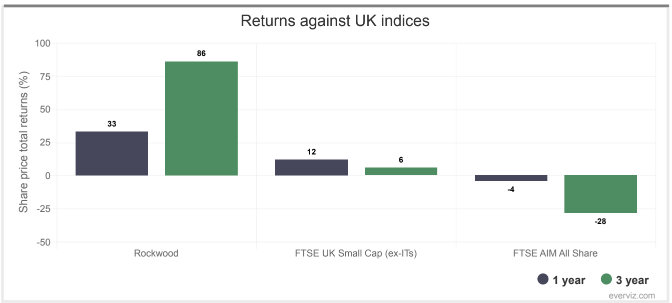
A good example is Funding Circle, which Richard identified as a valuation opportunity due to the company trading well below its net cash position. Rockwood encouraged the company to implement a number of strategic initiatives, including cost-cutting measures, Board evolution and, critically, a substantial share buyback program.

This laid the groundwork for its one-year total return of almost 280% and it is food for thought that this is almost five times the 60% return for NVIDIA (which topped the returns table for the Magnificent Seven).

Building an all-weather portfolio

Richard focuses on absolute returns rather than benchmarking against indices. As shown in the graph below, Rockwood has delivered an 86% return over the last three years, compared to just 6% for the FTSE Small Cap (ex-investment companies) index and a 28% decline for the FTSE AIM All Share.

Fig.2: Rockwood Has Significantly Outperformed The Wider Sector



Source: FE Analytics (as at 26/02/2025)

Richard also seeks asymmetric investment opportunities where the potential upside significantly outweighs the downside risk. Filtronic is one such example, where Rockwood has enjoyed a more than five-fold increase in the company's share price since May 2023, driven by a strategic partnership with SpaceX to supply cutting-edge products for the Starlink satellite network.

Trust the process

With UK equity funds suffering their ninth year of outflows, Rockwood's closed-ended structure allows it to pursue a long-term investment strategy without the pressure of meeting short-term redemption demands, which is particularly advantageous in the illiquid small-cap space. Furthermore, the manager's 1% personal stake in Rockwood ensures his interests are closely aligned with investors.

While many investment trusts are trying to close wide discounts, Rockwood has been able to increase its share capital by 50% since May 2023 thanks to strong demand for new shares from investors. In addition, institutional demand may potentially rise when the trust's NAV moves above the £100 million investment threshold.

Looking ahead, legendary investor John Templeton famously said, "The time of maximum pessimism is the best time to buy." If macroeconomic conditions and investor sentiment begin to improve, this could provide an additional boost to stock-specific returns. Until then, Rockwood has consistently demonstrated its ability to deliver strong returns even when the tough gets going.

All data is at 26/02/2025 unless otherwise specified.

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