



# Phoenix from the ashes

**RIII looks well positioned if the stars align for small caps.**

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According to legend, the phoenix was a mythical, eagle-like bird that lived for 500 years or more before, and when it became old and tired, it travelled from Arabia to Heliopolis in ancient Egypt, where it built a nest of spices on top of the Temple of the Sun. When the sun set the nest ablaze, the old phoenix died and a new, young phoenix rose from the ashes and flew back to Arabia to live another 500-year lifecycle.

The UK stock market certainly hasn't had a 500-year lifecycle, but it looks to be rising from the ashes, with the FTSE 100 returning a magnificent 31% from the start of 2025 to 10/03/2026, outperforming the all-conquering S&P 500's c. 18% return.

That said, the UK smaller companies complex remains a relative laggard versus its large-cap counterpart, with the Deutsche Numis Smaller Companies ex Investment Trusts Index (DNSCI) having returned c. 10% over the same period, extending UK smaller company underperformance that started around mid-2021. Since 31/08/2021, the FTSE 100 is up 71% versus just 6.5% from the DNSCI.

Looking ahead, it's only a matter of time before UK small-cap underperformance reverses, in our view. We've seen anomalous periods like this before. After previous spells of underperformance versus large caps, smaller companies have gone on to make up all their lost ground and then some.

The underperformance between 30/05/1994 and 06/01/1999, for instance, was similar in both length and scope as we're seeing today. Over the next eight years, the DNSCI went on to return 222.7% versus just 39% from the FTSE 100.

A similar magnitude of underperformance came during the financial crisis, albeit in a much shorter period (17 months); again, the DNSCI returned almost 300% over the next seven years, versus c. 100% for the FTSE 100.

As well as good old mean reversion, there are a few other reasons why we think smaller companies around the world, but especially in the UK, look particularly attractive at this juncture.

## Small-cap premium

The small-cap premium is one of the best-known phenomena in stock markets: numerous studies have shown that over long investment timeframes smaller companies on average outperform large firms. The smaller the stock market index, the larger the premium.

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Indeed, between 1955 and 2025, UK micro-cap stocks returned 15.6% a year, small caps gained 14.1%, mid-caps 13% and large caps 11.2%, according to Deutsche Numis.

**Fig.1: A Long History Of Superior Returns**



Source: Scott Evans and Paul Marsh, Deutsche Numis

**Past performance is not a reliable indicator of future results.**

The premium makes sense: the smaller a company is the nimbler it can be. Massive corporations, for example, often have lots of different layers and hoops through which they must jump before implementing big, strategic pivots. In addition, it's easier to grow smaller revenues, or profits, quickly than it is larger revenues, or profits.



The small-cap effect has taken a backseat for the past few years. However, we don't think this will endure and suspect that at some point the small-cap premium will re-emerge.

## Paid to wait

One interesting feature of UK smaller companies today is that they now offer a higher dividend yield, on average, than larger companies – the first time this has happened for 20 years, according to Deutsche Numis.

The smallest 10% of companies by size in the UK main market yielded an average 3.4% in January, while the largest companies had an average yield of 3%, Deutsche Numis said.

We've outlined why we think the odds are tilted in favour of a period of small-cap outperformance, but it's impossible to time when this period will start. The fact that you get an attractive yield means you essentially are getting paid to wait if you're a little early jumping on the bandwagon.

It also brings the smaller companies segment of the UK market onto the radar of investors who may not have expected to be fishing there. If a UK equity income fund manager, for example, can find attractive smaller companies with the potential for capital gains but that also have a yield on par with some of the large-cap firms they own, it makes sense that they will start to increase their weightings to smaller companies. Even a small rebalancing could set off a powerful domino effect.

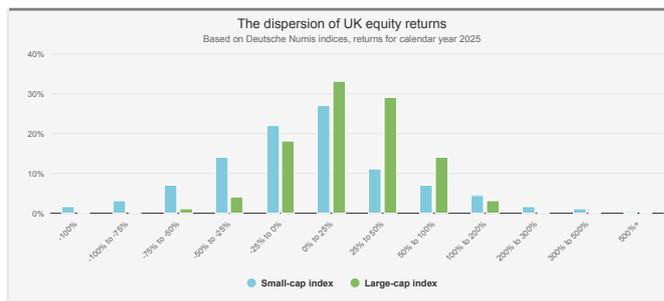
## Moonshot chances

The UK smaller companies space provides a higher dispersion of returns than the large-cap space. This is an anomaly that active stockpickers can exploit over time. If an index has a high dispersion of returns, it essentially means that there's a greater spread of returns within the individual components of the index. In an index with low dispersion of returns, returns are clustered around a narrow band.

As you can see from the chart below, during 2025, the returns of 62% of FTSE 100 companies were in the 0% to 50% range, versus c. 38% of companies in the DNSCI. Only c. 3% of FTSE 100 firms generated returns higher than 100%, versus c. 7.2% for the DNSCI.

This, of course, works at the other end of the scale, too: just 1% of FTSE 100 companies lost more than half of their value, versus c. 11.5% for the DNSCI.

**Fig.2: Alpha Potential In Small Caps**



Source: Scott Evans and Paul Marsh, Deutsche Numis  
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This provides good fund managers with opportunities to show their quality – there's a much larger pool of companies with the ability to make multiples of invested cash.

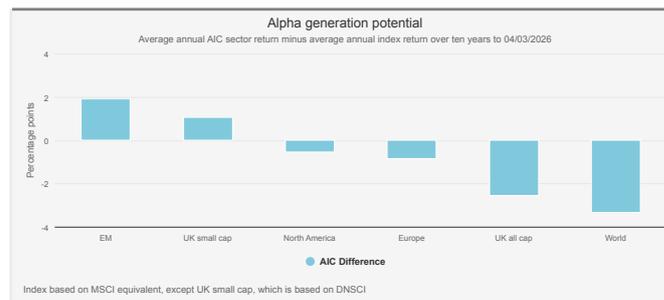
## Alpha generation

The UK smaller companies space is a real fertile hunting ground for active fund managers, particularly within the investment trust universe. Famously, over long periods of recent history, tracking an index has proven more fruitful than paying a more expensive stockpicker, especially within large and well-covered markets such as globally and in the US.

However, the reverse tends to be true in some parts of the market – especially UK smaller companies. The chart below takes the return of the average fund in each regional AIC sector and subtracts the return of the relevant index comparator over the ten years to 04/03/2026. If a number is negative, the index has beaten the average fund; if the number is positive, the average fund has returned more than the index.

You can see that the average UK small-cap trust produces an annualised alpha over the DNSCI of c. 1 percentage point per year, showing the benefits of employing a stockpicker in less efficient parts of the market.

**Fig.3: Where Active Management Pays Off**



Source: FE fundinfo  
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In any case, passive UK small-cap funds are few and far between, given many companies in this segment of the market are illiquid.

## Putting the world to rights

For investors keen to increase their exposure in anticipation of a small-cap recovery, the investment trust universe provides plenty of options, particularly since the structure lends itself well to the asset class.

**Rights & Issues (RIII)** stands out as an interesting option for a few fundamental reasons. Manager Matt Cable has a highly active approach to exploiting the inherent inefficiencies within the smaller company space, some of which we've highlighted above.

Matt looks to generate significant alpha over the long term by identifying companies with overlooked growth prospects and backing them with conviction. This results in a highly concentrated portfolio of between 20 and 25 stocks, where each holding can have a material impact on performance.

The quality of the portfolio is high, yet it trades on an attractive valuation, shown by the fact that RIII has seen several bids for its holdings, which has supported returns.

As well as the latent value in the portfolio, RIII offers a modest yet attractive 2.1% dividend yield, with dividends per share having grown by 36% over the past five years, although these are not guaranteed.

An extra layer comes in the shape of the discount which, unlike peers, has notably widened over the past 12 months, to sit at 15.3% as of 05/03/2026. We suspect that the key factor behind this was the fact that a resolution authorising the board to buy back RIII's own shares was defeated.

We understand that the board is trying to resolve this and if they're successful, we believe it could be a driver for the discount to narrow sharply.

Turns in stock market leadership are difficult to call and it's been a long and arduous road for UK smaller companies. Yet, we suspect that, unlike the phoenix, it won't take 500 years for smaller companies to rise from the ashes. Taken together with an attractive, if modest, yield, relatively low, competitive charges and the potential for considerable alpha generation, should the stars align at the same time, RIII could see a period of supercharged returns.

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