This is a non-independent marketing communication commissioned by BlackRock. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

Going, going, gone

Why the UK small-cap sector offers some eye-catching opportunities for bargain-hunters...

Update
08 January 2025

Type "should I buy UK small-caps?" into any internet search engine and the phrase "once-in-a-decade opportunity" seems to feature on a regular basis. A primary selling point is undoubtedly current valuations, which continue to look appealing relative to both long-term averages and developed market peers, together with the historic outperformance of UK small-caps relative to their large-cap peers over the long-term.

Despite a promising start to 2024, UK small-cap indices have struggled to gain momentum in recent months due to continued political and economic uncertainty. While investors may be hanging fire until the catalysts needed to turn the green shoots into a sustained recovery become clearer, history suggests such signals are often apparent only in hindsight.

However, the clouds may start to clear for UK equities. Despite a rather mixed reception, the Autumn Budget has provided much-needed clarity on the future direction of government policy. The macroeconomic fundamentals are also looking more supportive: real wages in the UK have risen, and while the Lloyds' business confidence index has dipped, it remains comfortably above its long-term average.

After a period of significant outflows from all-cap equity funds on the back of rising inflation and interest rates, the final piece of the jigsaw could be a reversal in fund flows for UK small-caps. Given current valuations and the long-term track record of strong performance, the sector could attract renewed interest from investors seeking to diversify beyond U.S. equities.

The cream of the crop

The UK small-cap sector lends itself particularly well to active management, not least due to the size of the investment universe and relative inefficiencies in this end of the market.

Valuation opportunities

There are around 1,000 small and mid-cap companies listed on the London Stock Exchange, which provides a fertile hunting-ground for stock-pickers.

Analysts:
Jo Groves
jo@keplerpartners.com

Kepler Partners is not authorised to make recommendations to Retail Clients. This report is based on factual information only.

The material contained on this site is factual and provided for general informational purposes only. It is not an invitation or inducement to buy, sell or subscribe to any product described, nor is it a statement as to the suitability or otherwise of any investments for any person. The material on this site does not constitute a financial promotion within the meaning of the FCA rules or the financial promotions order. Persons wishing to invest in any of the securities discussed in the website should take their own independent advice with regard to the suitability of such investments and the tax consequences of such investment.

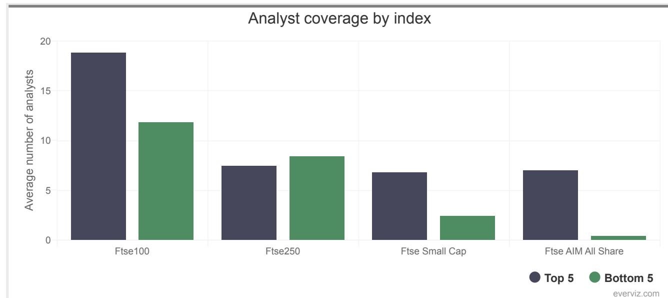
BlackRock Smaller Companies (BRSC) has an investable universe from around £100m up to £2bn in market capitalisation, including AIM. This allows manager Roland Arnold to target the most under-researched area of the market in his quest to identify undervalued companies with the potential for long-term alpha generation.

Starting off with valuation, this remains well below historic averages in the smaller-cap end of the market, with the FTSE 250 and Small Cap (both ex-investment trusts) indices trading on respective discounts of more than 24% and 17% below their 10-year average forward price-earnings ratios.

Limited research coverage of UK small-caps also allows active managers to capitalise on pricing inefficiencies. The chart below shows the analyst coverage of the top and bottom ten companies (by market capitalisation) in each index.

This is a non-independent marketing communication commissioned by BlackRock. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

Fig.1: Small-Caps Have Limited Analyst Coverage



Source: Bloomberg & FT

The small and mid-cap indices have less than half the analyst coverage of the FTSE 100 index and this drops off considerably towards the lower end of the index, with less than two analysts following the smallest companies in the FTSE Small Cap and FTSE AIM All Share indices.

BlackRock leverages its extensive on-the-ground resources to identify these mispricing opportunities, and the team undertakes around 700 company meetings each year. Its strategy focuses on quality companies with the potential for significant growth, while a strict sell discipline on FTSE 100 promotion enables reinvestment in emerging stars.

To manage risk, BRSC maintains a diversified portfolio of 100–120 holdings, split between core and incubation positions with individual holdings capped at 3%. Despite a subdued IPO market in recent years, London remains an attractive destination for public listings and IPO investments have also significantly contributed to BRSC's performance.

Rich pickings

The FTSE 100 is highly concentrated, with the top 10 companies accounting for 45% of the index by value, compared to around 15% for the FTSE 250 and FTSE Small Cap (both ex-ITs) indices. This provides a rich and diverse universe with a broader range of innovative, high growth sectors relative to the heavy weighting in pharmaceuticals, commodities and financial services in the FTSE 100.

Smaller companies can also be nimbler and more entrepreneurial in targeting niche growth opportunities, with market leaders including food-to-go retailer Greggs, online trading platform IG and estate agency Savills.

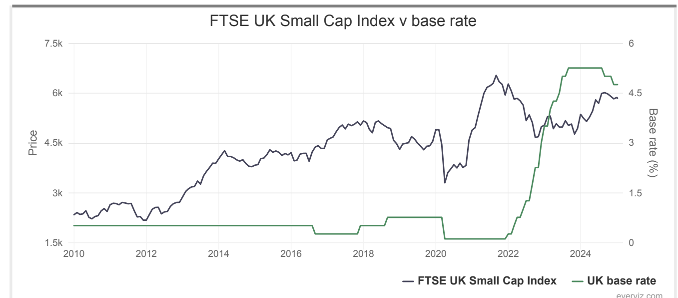
As a result, BRSC's focus on bottom-up stock-picking can lead to active allocations relative to its benchmark, the Deutsche Numis Smaller Companies plus AIM (ex-ITs) Index. The trust currently has a significant overweight to industrials due to the strong secular tailwinds from near-shoring. It is also overweight financial and consumer discretionary to capitalise on attractive valuations as Roland perceived the recessionary fears had been overstated (and were subsequently allayed).

The power of positioning

Another benefit of active management is the ability to position the portfolio according to the macroeconomic and political backdrop.

Small-caps have historically performed better in low or falling interest rate environments, as shown in the chart below. The FTSE UK Small Cap Index performed particularly well in the low-interest rate period from 2010, fell in 2022 when interest rates rose steeply and has risen in recent months ahead of expected rate cuts.

Fig.2: Small-Caps Have Historically Outperformed When Interest Rates Fall



Source: Bloomberg (as at 07/01/2025)

Active managers can also position the portfolio according to 'risk on/off' sentiment from geopolitical events such as the conflict in Ukraine and the Middle East. On the domestic front, Roland sees a positive backdrop for the housebuilding and building product sectors, after the Labour government announced a policy to build 1.5m houses over the next five years.

While this figure may prove optimistic, lower interest rates should support mortgage pricing and boost demand, with BRSC adding to its positions in housebuilder MJ Gleeson, brick manufacturer Ibstock and paving supplier Marshalls. In addition, Roland reduced the trust's weighting in AIM shares ahead of the Autumn Budget due to a possible change in tax rules.

Self help

While the UK small-cap sector can be cyclical, Roland looks to mitigate this risk by avoiding low quality, unprofitable

This is a non-independent marketing communication commissioned by BlackRock. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

businesses in favour of companies that can shape their own success irrespective of the wider economic picture. The trust also maintains geographic diversification, with around half of revenues currently generated outside the UK, reducing reliance on the fortunes of the UK economy.

Key investment criteria include high quality management, strong market positioning, track record of growth, sustainable cash generation and well-capitalised balance sheets. Capital-light, cash-generative business models with high levels of recurring revenue should allow companies to adapt quickly to changing market conditions and provide a sustainable foundation for long-term growth.

Looking ahead, uncertainty remains on the menu as investors digest the impact of government policy on both sides of the Atlantic. However, given the long-term outperformance of UK small-caps against their large-cap counterparts, current valuations may look like somewhat of a bargain if the long-awaited recovery comes to fruition.

All data as at 07/01/2025 unless otherwise stated.

View the latest research note here

Click here to add BRSC to your watchlist

Click here to read related research

Disclaimer

This report has been issued by Kepler Partners LLP. **The analyst who has prepared this report is aware that Kepler Partners LLP has a relationship with the company covered in this report and/or a conflict of interest which may impair the objectivity of the research.**

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 70 Conduit Street, London W1S 2GF with registered number OC334771.