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Investing in UK micro-caps with investment trusts

How investment trusts can provide investors with access to the high-growth UK micro-cap sector...

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ROCKWOOD STRATEGIC

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The saying 'mighty oaks from little acorns grow' sums up investing in micro-caps as well as any. The so-called 'magnificent seven' may boast $1 trillion plus companies among their ranks but Apple, Microsoft, NVIDIA and Amazon began their public journey as much smaller companies and Netflix qualified as a micro-cap (by US standards) on IPO.

Not only does the micro-cap sector provide the opportunity for investors to unearth the 'mighty oaks' of the future ahead of the crowd but UK micro-caps have consistently outperformed their larger-cap counterparts over the long term.

The micro-cap sector is also a fertile hunting ground for active managers looking to exploit the pricing inefficiencies from a lack of research coverage. Howard Marks, co-founder of Oaktree Capital, observed in his book: "Inefficiency is a necessary condition for superior investing. I should limit my efforts to relatively inefficient markets where hard work and skill would pay off best."

What is a micro-cap?

Starting with the basics, micro-caps sit at the lowest end of the market-cap spectrum. The distinction between small and micro-cap can vary but the average market cap of the companies in the MSCI UK Micro Cap Index is around £100m, compared to £1.3b for the MSCI UK Small Cap Index (with the largest constituents being over £400m and £6b respectively).

Investment trusts focusing on the micro-cap sector tend to invest in companies with market caps from £20m up to £250m, although holdings may subsequently grow in value beyond this. There has been a tendency for small-cap investment trusts to gravitate towards the upper end of the small-cap sphere in recent years, meaning that micro-cap trusts can offer a highly-differentiated alternative.

Why invest in UK micro-caps?

The UK micro-cap sector has historically proved attractive to investors looking for growth opportunities, as we explore in more detail.

Fired up for growth

Put simply, smaller companies tend to offer superior growth potential to their larger peers. Beyond the obvious arithmetic advantage of a smaller base number, higher revenue and earnings growth are often a feature of companies in the earlier phases of their life cycle.

Smaller companies may also be nimbler in reacting to changing market conditions with flat management structures promoting quick decision-making.

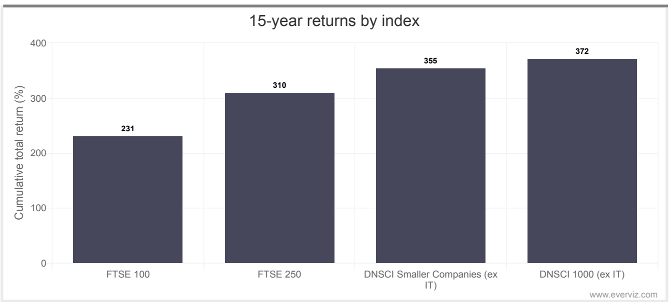
It's worth challenging a few of the misconceptions about micro-caps. The first is that micro-caps are more dependent on the domestic economy but, in reality, the sector has its fair share of companies with substantial overseas revenue. Micro-caps may also be perceived as having high levels of debt, however, there are a number of companies in net cash positions and, as a result, with low sensitivity to interest rates.

Leading the pack

History shows that UK micro-caps have outperformed their larger-cap peers over the long term, due to this superior growth potential.

As shown in the chart below, the highest-returning index was the Deutsche Numis 1000 (ex-investment trusts) which covers the bottom 2% of the UK-listed market by value, with a 15-year cumulative total return of more than 370%.

Fig.1: 15-Year Returns



Source: FE Analytics (as at 28/05/2024)

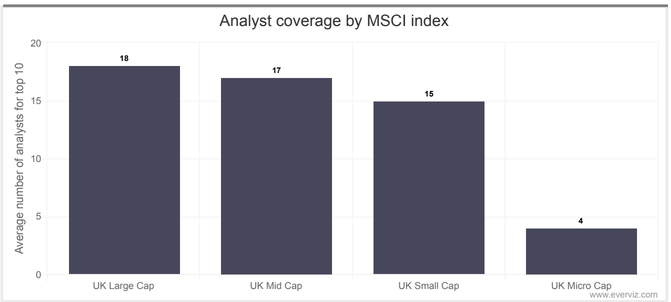
Past performance is not a reliable indicator of future results

This is followed by the Deutsche Numis Smaller Companies (ex-investment trusts) Index which comprises the bottom 10% of the UK market by value. Both of these smaller-cap indices have delivered considerably higher returns than the large-cap FTSE 100 Index.

Attractive valuations

The UK micro-cap sector is significantly under-researched relative to larger-cap sectors. The chart below shows that analyst coverage drops off steeply between the MSCI UK Small Cap and Micro Cap indices: on average, the top ten companies in the MSCI Micro Cap Index are followed by four analysts, compared to 15 plus for the larger indices.

Fig.2: Analyst Coverage



Source: MSCI factsheets, Financial Times

As a result, many UK micro-caps have no analyst coverage at all, which allows active fund managers to deploy their stock-picking skills to exploit pricing inefficiencies at the lower end of the market-cap spectrum.

In addition, valuations of UK micro-caps remain below their long-term averages and global peers. These subdued valuations have prompted an increase in M&A activity with Peel Hunt reporting that 10% of the FTSE Small Cap Index was acquired in 2023 (by number) including micro-caps. The average premium was 50% in 2023, which demonstrates the potential upside in current valuations.

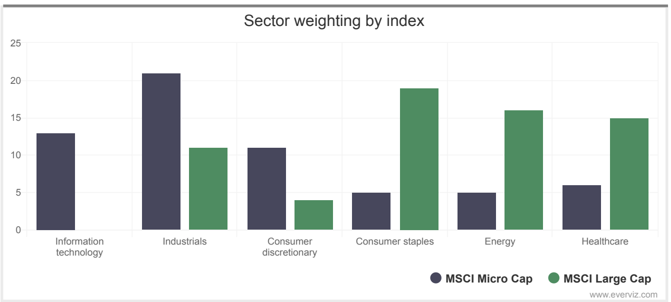
A broad universe

The universe of micro-caps is sizeable, with around 600 sub-£150m companies across the main market and AIM and has been regularly refreshed through IPOs during positive market phases. IPO activity has been low of late but will normally pick up through the cycle.

The sector also offers a more balanced spread of companies than larger-cap sectors, with the top ten constituents accounting for less than 10% of the MSCI Micro Cap Index, compared to 35% and 60% for the MSCI Mid- and Large-Cap indices respectively (as at 30/04/2024).

Turning to industry sectors, the micro-cap sector encompasses a broader range than the large-cap sector which is heavily dominated by a small number of sectors, including consumer staples, energy and healthcare, as shown in the chart below.

Fig.3: Sector Weighting



Source: MSCI factsheets (as at 30/04/2024)

The chart also shows the higher exposure of the micro-cap sector to higher-growth sectors such as information technology, industrials and consumer discretionary, which have been among the highest-returning MSCI sectors over the last five years.

Actively managed funds dominate the micro-cap sector as there are no 'tracker' or passive funds due to spreads, liquidity and thus the practical cost of index copying. This expansive universe of investable micro-cap stocks therefore presents a prime opportunity for active managers to identify the future success stories. However, it's also important to identify the companies with the requisite financial resources, management expertise and competitive position to prosper.

A balancing act

Finally, the UK micro-cap sector provides the opportunity to diversify a portfolio by market cap and geography. While there is some correlation between small- and large-cap equities, the latter tend to be driven more by broader macroeconomic conditions than company-specific factors.

Research by Cheol S Eun, Wei Huang and Sandy Lai revealed that stock-specific factors accounted for "more than 50% of small-cap fund variance but less than 5% of large cap fund variance". As a result, micro-caps could help to insulate a portfolio from macroeconomic headwinds, as well as offering a potential source of alpha generation.

How difficult is it to invest in UK micro-caps?

Investing in individual micro-cap companies can be difficult for private investors due to the lack of research coverage, as mentioned earlier, and the more speculative nature of some companies in this sphere.

Given that micro-caps have more limited access to external financing than their larger peers, investors need to evaluate their financial and competitive positions, the quality of management teams and operational strengths and weaknesses. However, this assessment can be challenging to conduct via desk-top research alone.

As a result, active fund managers often take a private equity style approach to investing, based on specialist due diligence and direct engagement with company boards. Post investment, they may work closely with management teams to help shape future strategy and unlock shareholder value.

Another challenge in the micro-cap sector is illiquidity, which often results in a wide buy–sell spread or even the inability to buy or sell shares through standard retail channels, and can present a hurdle for retail investors looking to buy individual company shares.

It's also worth noting that the micro-cap sector tends to experience higher volatility than larger-cap sectors due to the smaller trading volumes and greater sensitivity to investor sentiment. As such, it is more suited to a longer-term investment horizon.

Why invest in UK micro-caps with investment trusts?

Investment trusts are a type of fund that enable investors to gain broad exposure to the UK micro-cap sector, while managing some of the risks mentioned above. By buying shares in the investment trust, investors have exposure to a diversified portfolio of assets held by the trust, rather than investing in individual companies.

There are currently 25 trusts in the AIC UK Smaller Companies category, although only a handful focus on the micro-cap sector. The scope varies by trust, with some trusts investing in a more concentrated portfolio of companies while others take a broader approach. Some trusts also take stakes in private companies that are not accessible to individual investors.

Many of these managers have extensive expertise and experience of investing in micro-caps. By way of example, the manager of Rockwood Strategic (RKW) has over 20 years of experience in UK small-cap equities and takes an active private equity style approach to investing in micro-caps.

Rockwood carries out extensive due diligence and engagement with key stakeholders prior to investment. Its concentrated portfolio of around 20 companies allows active engagement on an ongoing basis, and the manager works closely with management teams to identify the key catalysts to unlock shareholder value.

Investment trusts vs open-ended funds

It's fair to say that some of the benefits mentioned above, whether a diversified portfolio or manager expertise, also apply to open-ended funds. However, investment trusts have some unique attributes which may help them deliver superior returns compared to their open-ended peers.

Firstly, open-ended funds are not publicly traded (unlike investment trusts), meaning that the size of the investable fund will rise and shrink with the purchase and sale of units in the fund. This means that open-ended funds typically have to be very mindful as to how they will meet short-term redemption requests from investors: this limits their ability to invest in less liquid stocks such as micro-caps which may not be able to provide liquidity when cash-calls arise. Open-ended fund managers are thus nudged into very diversified portfolios in order to improve the chances of accessing liquidity when required.

Investment trusts do not have this problem as publicly traded companies. The buying and selling of shares in the investment trust does not impact the size of the investable fund and, as trusts are not required to keep cash for redemptions, this allows a longer-term investment horizon in smaller companies. Indeed, the manager can construct the portfolio for return and risk, with lower liquidity considerations.

Another factor is gearing, whereby the trust can borrow money with the goal of enhancing returns (although it can also increase losses). Trusts are typically able to borrow up to a certain percentage, for example 20% of the assets under management, whereas open-ended funds are not able to deploy gearing.

Lastly, investment trusts can use capital reserves to pay dividends (if required). This can provide income for investors in a sector which is more growth- than income-focused.

Case Study

Rockwood Strategic

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Launched: 2015

Manager: Harwood Capital

Ongoing charges: 1.87%

Investment policy: The trust aims to invest in securities under £250m that the manager believes can generate a 15% IRR (internal rate of return) over the medium to long term.

Comparative Index: FTSE Small Cap (ex-Investment Trusts) Index, FTSE AIM All-Share Index

Rockwood Strategic (RKW) aims to deliver long-term growth for shareholders by investing in a concentrated portfolio of UK smaller companies.

Manager Richard Staveley is a bottom-up stock picker with a value-oriented approach. He looks to capitalise on pricing inefficiencies from a lack of research, with a particular focus on companies with a sub-£150 market cap, but can invest up to £250m.

Rockwood has a highly concentrated portfolio of around 20 companies, split between 'core' and 'springboard' positions, which is a key differentiating feature of the trust. Core investments generally comprise a position of 5-15%, with a smaller holding of 2-4% for springboard positions, which in the future may become 'core'.

Richard takes a private equity style approach to managing portfolio companies, with a typical holding period of three to five years. Portfolio companies are typically turnaround or recovery situations where operational, strategic and/or management changes can improve profitability and shareholder value.

Turning to the exit thesis, Richard believes that 80% of the portfolio will ultimately be acquired by a trade or private equity buyer, if the stock market fails to re-rate the shares on delivery. Rockwood has received a number of offers for portfolio companies in the last two years, and acquisition premiums have been a boost for returns due to the concentrated portfolio.

In the ten-year period to 27/05/2024, RKW has delivered a net asset value total return of 91%, the highest in the AIC UK Smaller Companies sector and well ahead of its AIC peer group average of 31%.

1) What is the investment trust's goal?

Rockwood's goal is to deliver long-term capital growth for shareholders by investing in listed UK small-caps capable of delivering a 15% IRR over a three-to-five-year time period.

2) What kind of stocks does the manager like?

The manager is predominantly a bottom-up stock picker with a universe of around 500 companies across the FTSE Small Cap and AIM indices, excluding biotechnology, early-stage resources and unproven technology businesses. The manager can invest up to 15% in unlisted companies although this is currently less than 2% and not a primary focus for the manager.

The manager focuses on companies with a sub-£250m market cap which are often overlooked by investors due to their size. He looks for companies with strong free cash flow, a proven business model and identifiable assets at attractive valuations.

3) Are investment decisions driven by a particular investment style?

The manager has a value-oriented investment style, which differentiates the trust from its quality growth-oriented peers. The manager looks for attractively valued companies with material scope for earnings growth, often through turnaround or recovery opportunities.

The manager will identify the catalysts for an improvement in profitability and shareholder returns, and actively engage with management teams to execute the necessary operational, strategic and management changes.

The manager develops an exit thesis prior to investment, which seeks to mitigate the illiquidity issues of smaller-cap companies. The trust will typically hold investments for three to five years to allow time for strategic or operational changes to be executed and a corresponding re-rating in valuation.

4) How many stocks does the investment trust typically hold?

The trust holds a concentrated portfolio of around 20 stocks, split between 'core' holdings (5-15% stake) and 'springboard' holdings (2-4%). It is expected that there will be 5-10 core holdings and then 10-20 springboard holdings. The number of holdings is at the low end due to takeovers.

5) What is the investment trust's dividend policy?

RKW pays out at least 85% of net income received after expenses.

6) What are the investment trust's ongoing charges?

The investment trust's ongoing charges are 1.87%.

7) Does the investment trust have performance fees?

The management fee is 1% of net asset value. There is also a performance fee of 10% based on net asset value returns over a 6% annual absolute hurdle rate, with a high watermark. Total fees are capped at 3% when net assets exceed £100m.

8) How much attention does the manager pay to the index, and to what extent are absolute returns important?

The manager takes a highly active, benchmark-agnostic approach. The stated goal is to invest in companies with the potential to achieve a 15% IRR over three to five years and this goal is the sole focus.

9) Does the investment trust use gearing and, if so, is it structural or opportunity led?

The manager can use gearing up to 25% of net asset value although there are currently no plans to utilise this in the foreseeable future.

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