



JMI

Small-cap outlook: Time to pick up small-cap bargains

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It's been a turbulent first half of the year for UK smaller companies, with the FTSE Small Cap Index down sharply year to date. JMI has a strong long-term track record but has struggled so far in 2022 against a backdrop of indiscriminate selling of both UK-focused and more internationally-diversified stocks.

While concerns over the outlook for the UK and global economy are growing, the small-cap outlook remains supported by strong balance sheets and historically low valuations. With a -9.58% discount to net asset value (as of 12 August 2022), JMI provides discounted exposure to the compelling long-term growth potential of this exciting segment of the market.

Discounted exposure to a cheap market

JMI has a structural growth bias in its portfolio. We believe that growth is one of the central tenets of smaller company investing—we want to identify companies that are able to grow to become the mid-cap and large-cap stocks of tomorrow. Nevertheless, in the current environment, with growth stocks tending to suffer more than value – and in line with our process – we maintain a positive exposure to value. JMI is currently cheaper than the index on a price-to-earnings (P/E) ratio basis, and crucially also provides a much higher free cashflow yield.

Not only is the portfolio offering value, but the market itself looks cheap at the moment. While the small-cap outlook remains clouded by economic uncertainty, the long-term opportunity is attractive, with the small-cap index currently trading on about the same P/E rating as the FTSE 100, which itself is cheap in historical terms. At the same time, balance sheets are generally strong, and companies are generating plenty of cash—the number of special dividends and share buyback announcements this year has been unprecedented.

Superior growth prospects for small-cap stocks

The attractiveness of valuations is also reflected in the increased merger activity in the small-cap market at the moment. There have been four bids for companies held by JMI this year, many at a valuation premium of more than 40% or 50%. These bids confirm our view that the UK smaller company sector is currently undervalued.

Such a low valuation for small caps is unusual, particularly relative to the large cap market. Past experience suggests small-cap stocks will offer superior growth prospects than their larger peers, even through periods of economic upheaval. During the Covid crisis, for example, and even more markedly during the Global Financial Crisis, it was noticeable how many stocks operating in small niche markets were able to continue to grow despite the volatile market backdrop and rising commodity prices. It's in these more challenging times that investors can often find the most attractive opportunities for long-term growth.

Investment opportunity from adversity

One area of potential opportunity in small caps is the long-term growth opportunities being created by global supply chain disruption. This theme is only just beginning, but we believe there is significant potential over the next several years for a range of UK-listed companies to benefit as firms look to decrease their reliance on overseas suppliers. We have also looked to gain exposure to companies that can benefit from current higher commodity price trends, having identified the drop in investment spending across the oil and gas sector more than 18 months ago.

Another area of interest is the retail sector, which has been hit hard in recent months by concern over the impact of the cost-of-living crisis on consumer spending. Retail stock valuations are lower in some cases than during the Global Financial Crisis.

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While we share some of the concerns over the strength of the consumer, we feel that many retailers will continue to be supported by the large pool of excess savings that was built up over the course of the Covid lockdowns (as much as £200 billion in the UK alone) – much of which is held by the top 30% of earners, who account for 50% of discretionary spending. The retail sector looks to be heavily oversold and we are looking at selected opportunities in selected small-cap retail franchises.

Discriminate in the IPO market

JMI also continues to participate selectively in the primary market. 2021 was an extraordinary year for initial public offerings (IPOs), but finding quality in such a frothy market was a challenge. Activity has dropped dramatically this year, but we think exciting opportunities can often be found when the market's attention is elsewhere. With a number of companies exiting the market, we're keen for new companies to come to the market. The important thing is to be patient and discriminate to find the hidden gems.

All data unless otherwise stated is sourced J.P. Morgan Asset Management as at 30 June 2022

The £300 million JPMorgan UK Smaller Companies Investment Trust is dedicated to finding the most attractive high quality UK-listed small-cap stocks. [Find out more >](#)

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