Miton UK MicroCap

Specialising in the very smallest UK listed companies, MINI can provide a differentiated source of growth...

Update
30 December 2021

Summary

Miton UK MicroCap (MINI) was launched in 2015 to invest in the UK's smallest listed companies, typically AIM-listed stocks with market capitalisations of less than £150m. The strategy focusses on generating capital growth, the managers Gervais Williams and Martin Turner looking for companies that are positioned to generate substantial surplus cash in excess of market expectations in the near term.

As discussed in **Portfolio**, the trust itself was launched to take advantage of major global economic and financial trends that Gervais and Martin believe will reverse the trend in highly rated, large growth stocks outperforming and favour smaller, cash generative, attractively valued stocks. The managers believe that the UK AIM market offers a wide opportunity set of genuinely small companies with the capacity to grow substantially.

Although the macro trends forming the raison d'être of the strategy have yet to play out, global returns still being dominated by highly rated large-cap growth stocks, MINI has performed well, beating the FTSE AIM All-Share Index and matching the returns of its peers in the UK Smaller Companies sector over a period that did not favour its value-orientated style. As reviewed in **Performance**, some outsized returns in 2020 and 2021 versus peers and benchmarks have hinted at the potential gains MINI offers if the underlying thesis of Gervais and Martin plays out.

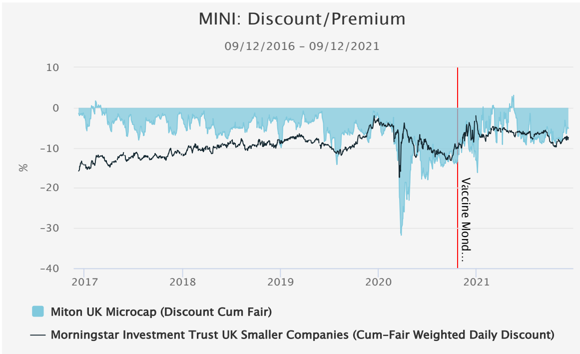
MINI currently trades on a discount of c. 7.4%. The trust offers an annual redemption scheme that limits the potential impact of the **Discount** on trust shares for investors that wish to redeem and are willing and able to wait for the redemption date as set by the board each year.

Analysts:

John Dowie

Key Information:

Price (p)	88
Discount (%)	-7.4
OCF (%)	1.54
Gearing (%)	-4.9
Yield (%)	0.0
Ticker	MINI
Market cap (£)	96,143,133



Kepler View

MINI is a strategy predicated on the contrarian worldview of the managers, Gervais and Martin, who predict that the reversal of decades-long trends in globalisation, declining interest rates and the expansion of cheap credit will flip the dynamics of equity markets, seeing small value stocks outperform the highly rated mega-cap stocks that have dominated markets for many years. Gervais and Martin argue their case persuasively and passionately. However, even if an investor does not entirely agree with the managers' weltanschauung, the UK microcap sector offers a set of highly differentiated opportunities and could act as a diversifying source of returns for an investor. The ability of microcap companies to grow in a stagnant economic climate could prove useful.

MINI does have some potential drawbacks for investors, it is focussed on generating capital gains, so does not provide much income, and microcaps are an inherently volatile asset class that are particularly sensitive to liquidity conditions in markets. However, for a risk-tolerant investor without an income requirement, the potential for growth from MINI is attractive, and the focus of Gervais and Martin on cash generation, the general avoidance of **Gearing** and highly speculative stocks and the use of portfolio protection do mitigate some of the risks of the asset class. The annual redemption facility also provides some comfort that an investor's capital will not be trapped behind a deep and persistent **Discount** if sentiment towards the trust turns negative.

BULL
Microcaps provide returns less dependent on global growth
Annual redemption facility provides backstop for investors being impacted by discount
Use of portfolio insurance can assist recovery from market drawdowns

BEAR
Microcap stocks are substantially more volatile than larger cap peers
Charges are above average for sector
Costs of portfolio insurance will be a drag on performance in bull markets

Portfolio

Launched in 2015, Miton UK MicroCap (MINI) invests in the UK's smallest listed companies, typically AIM-listed stocks with market capitalisations of less than £150m. The strategy focusses on generating capital growth, the managers Gervais Williams and Martin Turner seeking companies that are positioned to generate substantial surplus cash in excess of market expectations in the near term. Once improvements in cash flow cause a re-rating in the stock, Gervais and Martin will typically sell and recycle the capital into their next idea. As stocks are sold before becoming stable dividend payers, the portfolio of MINI has a generally low yield, hence the trust generates a limited income.

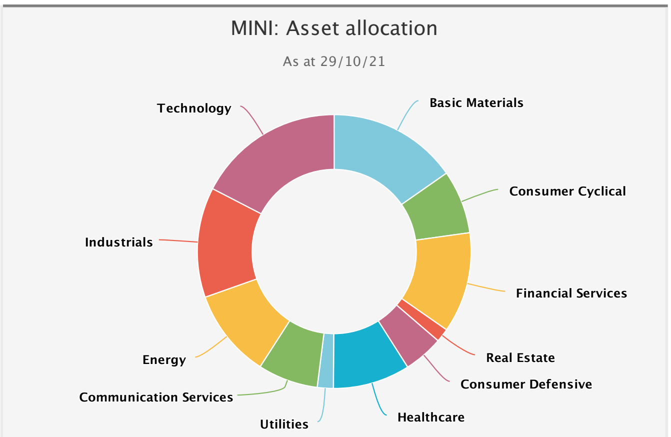
Although the process of MINI is largely bottom-up, the trust itself was launched to take advantage of major global economic and financial trends that Gervais and Martin believe will result in the next few decades in markets being radically different than the conditions that have broadly prevailed since the early 1980s. Gervais has published several books on his worldview and shares several ideas and themes with other contrarian thinkers such as Jonathan Ruffer. The first key observation is that interest rates have fallen progressively since the early 1980s, fuelling global credit expansion and a long-term equity bull market that favoured long-duration assets (growth stocks with cash flows weighted more to the future). The second observation is that globalisation has both opened new markets to large companies and integrated hundreds of millions of workers into the global systems of production and trade, allowing corporations to both grow revenues and capture a greater share of output at the expense of labour. Globalisation has also been disinflationary, the supply of cheap goods keeping consumer prices low, allowing interest rates to fall and assuaging the wage demands from workers. The combination of access to cheap financing, the ability to lower costs via offshoring and access to new, fast-growing emerging markets all favoured large companies.

However, Gervais and Martin believe the interconnected trends of the credit boom and globalisation are near or have passed their high-water mark. Since the global financial crisis, the law of diminishing returns has struck both globalisation and debt, and worldwide both growth and productivity have stagnated. This has led to languishing wages which in turn has fuelled the rise of nationalist politics that manifested with Brexit and Donald Trump. Rising costs in offshore production, the breakdown in relations between the US and China and the rise of nationalist politics all led the managers to believe global supply chains will localise. This prediction was made before the major disruptions to global supply chains brought on by the coronavirus pandemic. The fragmentation of global markets, the reshoring of supply chains and the end of the ability of companies to refinance their debt ever more cheaply will shift the competitive advantage to smaller companies.

There are several reasons why smaller companies may potentially outperform in this new regime. Smaller companies are far less dependent on broad economic growth to drive their own growth, a new company taking market share or launching a new product or service can grow exponentially in a low growth economy. Reshoring will benefit small, domestic companies that will form part of these new, localised supply chains. Somewhat counter-intuitively, rising wages will give smaller companies an edge over larger companies as smaller companies are more productive per worker than their larger counterparts due to easier internal coordination and less bureaucratic inefficiency (this factor has substantial academic research behind it). As interest rates bottom out and refinancing existing debt no longer constitutes a means of increasing profit margins the debt-laden balance sheets of large companies will become a hindrance rather than a benefit, the sounder balance sheets of small businesses will be more robust to unstable financial and economic conditions. The view of Gervais and Martin is that large, growth companies are currently priced for perfection, the valuations assuming the future will resemble the immediate past with substantial long term future growth priced in. A shift in growth expectations, inflation or interest rates that adversely affects long-duration assets could result in disappointing returns for large, growth stocks. The underlying philosophy is that the world is changing, and that small will be beautiful once again.

With this worldview in mind, MINI was launched in 2015 to provide access to investors to a unique market of smaller companies, the UK AIM market. Few other stock markets globally have such a deep and broad opportunity set of truly small companies: as of the end of March 2021, the AIM market had 822 companies with a median market capitalisation of c. £45m (Source: Allenby Capital). To put that in perspective, the median market cap of the FTSE 250 Index is c. £1.3bn (as at 30/11/2021, Source: FTSE Russell). Gervais and Martin build a diversified portfolio with typically around 120 holdings such that any issue with any one stock will not overly harm the portfolio, microcap stocks being inherently more volatile than larger companies. The number of stock holdings has ranged from circa 90 to over 130, currently, the portfolio is at the upper end of this range due to the managers seeing opportunity in the plethora of attractively valued primary and secondary issues at the end of 202. The portfolio will also have a spread of sectors and companies at various stages of their life cycle. The diversified portfolio also helps manage the liquidity risks that can arise when trading microcap stocks.

Fig.1: Sector Allocation



Source: Premier Miton

The investment process is built to identify attractively valued companies that are positioned to generate surplus cash in the near term that the market has not priced in. In the manager's view, the undervaluation of these types of stocks usually comes about due to inertia in the market's understanding of a business, typically underappreciating the impact of CapEx, acquisitions or management changes. This is unsurprising given the relatively scant analyst coverage of microcap stocks versus larger companies. It also means that Gervais and Martin do not need to build elaborate long-term forecasts for a company, a particularly difficult task for microcaps whose situations are often fluid and dynamic. Rather, Gervais and Martin spent time meeting company management with a focus on understanding the catalysts for generating more cash in the near term. This naturally tilts the portfolio towards having lower duration assets, i.e. companies whose value will be more dependent on near term rather than long term cash flows. This ties in with the manager's top-down view that long duration, growth-orientated assets will become vulnerable to a correction. Therefore, Gervais and Martin avoid 'unicorns', companies with high valuations based on business models yet to prove their ability to generate cash or dependent on heroic underlying assumptions. The required clarity on how cash will be earned produces a meaningful sell discipline: in the early stages of the pandemic Gervais and Martin all their stocks whose access to consumers was cut-off by lockdown measures.

Gervais and Martin will conduct hundreds of manager meetings a year looking for company management that can articulate a clear vision of how they are going to deliver surplus cash. Alongside a solid, executable business plan, Gervais and Martin look for managers that create a culture whereby staff are well motivated and engaged. This follows from the idea that skilled staff are the key to creating outstanding customer service, and although this sounds somewhat trivially true, it is routinely overlooked due to a myopic focus on short term financial results. This engagement of staff and resulting excellent customer service levels are major factors in protecting margins in the event of rising cost pressures from wage and price inflation. Gervais and Martin will look for evidence that company management is responsive to feedback from staff and overall are renumerated in such a way to avoid myopic short-termism. As an example, Virgin Wines is one of the UK's largest direct-to-consumer wine retailers that has cultivated a network of winemaking partners and suppliers resulting in the production of highly rated wines. The high-quality product and strong customer service have led to a level of asset turnover double that of most of their nearest competitors. Cash generative and with a management team closely aligned to the needs of their frontline staff, Virgin Wines is the type of business Gervais and Martin seek out.

As discussed in **Gearing**, the managers will tend to hold a reasonable cash balance such that if opportunities arise, no additional risk via borrowing is required to take advantage of it. A further layer of capital protection is the purchasing of portfolio insurance via put options on the FTSE All-Share Index if pricing is attractive (which generally occurs when market volatility is low). This fits with the general top-down view of asset prices being richly valued and vulnerable to sell-offs. The puts also have the added benefit of providing a source of cash during times of market stress, allowing Gervais and Martin to buy good companies at discounted prices, although they cost the trust to hold when markets are stable or rising. As discussed in **Performance**, the gains generated by the sale of these options and the reinvesting of proceeds was a major factor in the outstanding performance of MINI in 2020.

Gearing

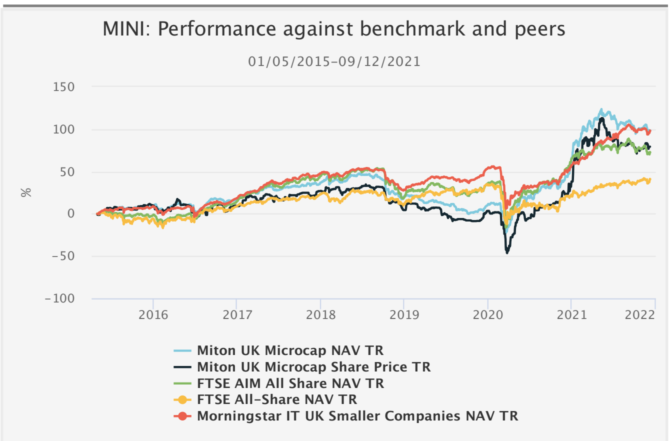
MINI currently has no borrowing and has net cash of c. 4.9% (as at 30/11/2021). This level of net cash is fairly typical for the trust, with the managers preferring to retain a buffer to rapidly access any new investment opportunities that may arise. Cash balances moved sharply higher during March 2020 as put protection was sold for a significant profit, and the cash recycled back into the portfolio at an opportune moment.

The trust's policies permit gearing up to 15% of NAV as at the time of borrowing, and the trust does currently have a bank borrowing facility in place. However, to date, Gervais and Martin have yet to utilise gearing, but they may do so in the future if they believe an exceptional buying opportunity has arisen (such as the market crash of 2008/2009) and they have no other source of ready cash (such as proceeds from put protection). However, without such extreme circumstances, we would not expect to see MINI use gearing in the foreseeable future.

Performance

MINI was launched on 01/05/2015, and since its inception, has returned 98.4% in NAV total return terms, outperforming the FTSE AIM All-Share Index ('AIM Index') and the FTSE All-Share Index, which returned 72.5% and 40.8%, respectively. MINI has matched the performance of the Morningstar Investment Trust UK Smaller Companies sector ('peer group'), which returned 98.0%. All figures are given as at 09/12/2021. Although the trust does not have a formal benchmark, the FTSE AIM All-Share Index and Morningstar sector are used for comparative purposes in MINI's reporting. The reason for the lack of a formal benchmark is that the FTSE AIM All-Share Index includes many larger companies that are outside of MINI's opportunity set (as at the end of Q1 2021, there were 27 companies on AIM with a market capitalisation greater than £1bn, Source: Allenby Capital).

Fig.2: Cumulative Returns From Inception

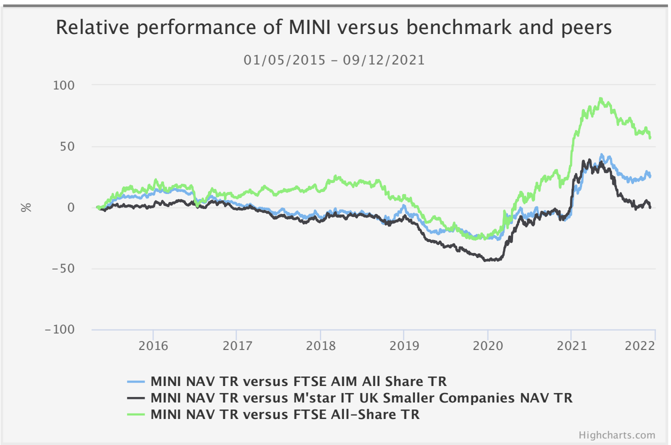


Source: Morningstar

Past performance is not a reliable indicator of future results.

As can be seen in the below chart, the relative return profile of MINI has gone through several phases. Prior to 2019, returns for MINI were broadly in line with the peer group and AIM Index. 2019 was a difficult year, this was the height of the political uncertainty around Brexit, and this impacted the smallest companies disproportionality. Additionally, the Fed had performed an about-face and was cutting interest rates, and this benefitted growth style strategies, a headwind for Gervais and Martin's avowedly lower duration, value-orientated approach. However, recovery soon followed as 2020 was an exceptional year, MINI outperforming the AIM Index by 28.2% and growth-oriented peer group by 47.6%. As an aside, there are 22 trusts with a Morningstar style designation, of which nine are growth tilted, eight are blend and five are value orientated. Year to date, as at 09/12/2021 MINI has returned 18.9% on a NAV basis, versus 4.3% for the AIM Index and 25.3% for peers. We would note that the volatility of MINI has become elevated versus larger companies in this period. On a 36 month, rolling basis the NAV volatility of MINI had been moderately higher than FTSE All-Share Index prior to 2020 (c. 1.2x times) but jumped to c. 1.7x times after Q1 2020 due to a larger fall peak to the trough (max drawdown of c. 41% versus c. 25% for the FTSE All-Share Index). As the market drawdown rolls out of the calculation window and assuming no further market disruptions, we would expect MINI's volatility to begin to converge back closer to the FTSE All-Share Index.

Fig.3: Relative Cumulative Performance From Inception



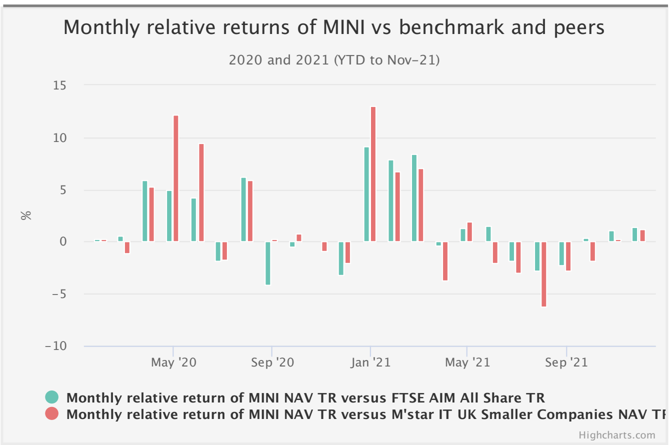
Source: Morningstar

Past performance is not a reliable indicator of future results.

Looking at the performance in 2020 and 2021 in detail per the below chart, we can see the outperformance has been achieved in two clusters of highly performative months. The first cluster of outstanding relative months began in March 2021 when the market crashed with the initial coronavirus outbreak. The put options were sold in early March for £2.7m, generating a profit of £1.8m on an original purchase price of just under £1m. In a trust with a NAV of c. £71m (as at the end of April 2021), this is a material gain. The cash proceeds were then recycled into the market near the bottom, meaning MINI then achieved outsized gains in the recovery that followed Q1. Immediately selling stocks with cash flows heavily disrupted by the lockdown was also likely additive. Buying companies that themselves could engage in additive acquisitions at discount prices was also a boost to returns.

The next phase of outperformance commenced with the announcement of successful vaccine trials in November 2020. This led to a rally in value stocks, the expectation of a broad-based economic recovery being seen to benefit more cyclical stocks which had underperformed growth and especially technology stocks in the initial recovery phase. This so-called reflation trade petered out by the end of Q1 2021, however, Gervais and Martin have managed to hold onto a significant proportion of their gains versus the AIM Index.

Fig.4: Monthly Relative Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

Overall, we note that due to the small size of the market capitalisations of the stocks Martin and Gervais trade, even marginal shifts in the demand for their holdings create outsized returns, MINI posting high single and double-digit outperformances in multiple months over 2020 and 2021. Although the macro trends forming the raison d'être of the strategy has yet to play out, markets are still being dominated by highly rated large-cap growth stocks, MINI has posted respectable gains since inception, and materially outperformed the large-cap dominated FTSE All-Share Index. Gervais and Martin argue that we are still in the foothills of a regime change that will see the smaller, lower duration stocks outperform. Given the return profile of the last two years, the capital gain potential, if this trend does indeed play out, appears significant.

Dividend

MINI's shares currently do not provide a meaningful yield, a nominal dividend of 0.01p per share being paid for the financial year 2021. Gervais and Martin are looking primarily for capital growth opportunities whereby an underappreciated company is re-rated by the market by delivering an unexpected surplus in cash. By the time a company matures into a predictable dividend payer, Gervais and Martin will most likely have sold the position and recycled the capital into the next investment idea. This means the managers are not seeking to generate income from their portfolio and any dividends received are incidental. The dividends that are received are distributed to investors, so the dividend of MINI can fluctuate. To date, from inception, the yield of MINI has not exceeded 0.67% on a twelve-month basis. With minimal revenue reserves and no income objective, we would not expect the board to attempt to smooth distributions.

Management

MINI is managed by Gervais Williams and Martin Turner of Premier Miton. Gervais joined Miton in March 2011 and is Head of Equities of the company. After starting as a portfolio manager in 1985, Gervais has spent the majority of his career as head of UK smaller companies at Gartmore. Gervais has published several books which lay out his thinking on the interplay of investing, financial markets and economics, including 'The Future is Small: Why AIM will be the world's best market beyond the credit boom' (2014) and 'The Retreat of Globalisation: Anticipating radical change in the culture of financial markets' (2016).

Martin Turner also joined Miton in 2011 and has had a long-term working relationship with Gervais. Martin has widespread experience in the investment world as head of small/mid-cap equities at companies including Rothschild, Merrill Lynch and Collins Stewart. Both Gervais and Martin are part of a tight-knit team of six UK-focussed managers at Premier Miton: an asset management firm that has genuinely active management at the core of its business. The company runs multi-asset and equity funds, as well as investment trusts.

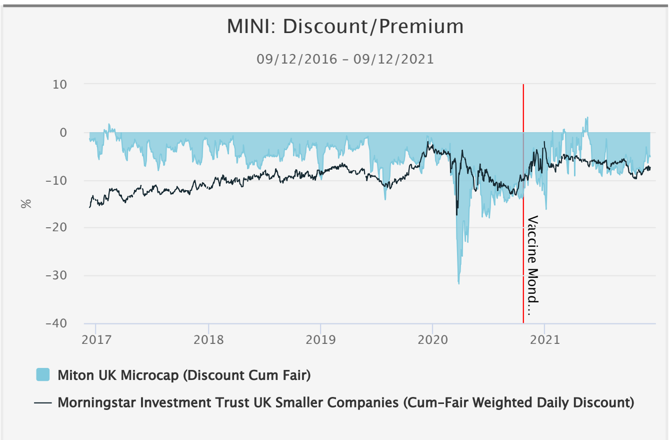
Discount

As at 28/12/2021, MINI was trading on a c. 7.4% discount versus the Morningstar Investment Trust UK Smaller Companies sector's average discount of c. 7.4%. Over the last five years, MINI has been trading on an average discount of c. 6.0% versus the sector's c. 9.2%.

The discount widened rapidly during the earliest part of the pandemic due to poor liquidity and market sentiment, the relatively illiquid microcap space being impacted especially severely. Following the announcement of central bank support in late March 2020, liquidity returned, and the discount began tightening, and by Q3 2020, MINI was trading broadly in line with peers. However, after the announcements of positive COVID-19 vaccine news in November 2020, MINI began trading on a narrower discount than its peers. There are several possible factors that drove this tightening: outstanding NAV performance during this period, improved sentiment towards the UK domestic economy and UK smaller companies, and the action of the redemption facility.

The redemption facility operated by MINI's board offers shareholders the opportunity to request redemption of all or a portion of their holdings at a price close to the underlying NAV. This redemption facility is operated annually at the discretion of the board and is intended to ensure there are no large overhangs of sellers should a large shareholder wish to exit a large position. During the previous redemption point of 30/06/2021 (which was announced on 04/05/2021), c. 2.7 million ordinary shares were requested to be redeemed, which was approximately 2.4% of the company's share capital. The deadline for the redemption facility passed on 02/06/2021. In May 2021, MINI shares traded briefly at a premium. Subsequent to the redemption deadline passing, the discount widened, and MINI has traded broadly in line with peers since.

Fig.5: Discount/Premium



Source: Morningstar

As discussed in **Portfolio**, Gervais has a bullish outlook for UK equities, if underlying UK companies perform well and other investors begin to share his positive outlook towards the UK market, then the discount could narrow, we note that from inception up to the beginning of 2020 MINI had traded at an average discount of 1.9%.

Charges

MINI has an OCF of 1.60%, above the unweighted average of the AIC UK Smaller Companies sector 1.05% as at 30/11/2021 (Source: JPMorgan Cazenove). To provide the capacity to invest in microcap stocks, the trust must limit itself to a relatively small size versus peers that invest in mid and small-cap stocks. Inevitably this means the impact of fixed running costs is greater in MINI than larger UK smaller companies trusts, hence the higher OCF is not surprising and simply reflects a necessary cost of investing in the opportunities offered by microcap stocks.

The OCF is inclusive of a management fee of 0.90% of the market capitalisation of the trust. Premier Miton has agreed that, if necessary, a portion of the management fee will be rebated to cap the OCF at 2%. The management fee is charged 75% to capital and 25% to income.

The KID RIY figure is 2.10%, above the unweighted sector average of 1.93%, though we would caution that calculation methodologies can vary.

ESG

A principal feature of Gervais and Martin's stock selection process has been meeting management and seeking companies with leaders that provide vision and create a culture that engages staff and treats customers well. This has naturally integrated Governance factors into their investment process for many years.

A factor that has become a more important consideration in recent years is Environmental concerns, especially the climate change agenda that will see many if not all companies transitioning from carbon-emitting to zero-carbon entities. This begins with engaging with companies to encourage less-aligned businesses to form and implement a plan to manage their carbon footprint. This is an important risk management consideration, as the managers believe that over time the rising costs of carbon emissions or customer preferences will challenge the viability of carbon-intensive business models. This does not exclude currently high carbon-emitting firms from the portfolio (such as fossil fuel producers) but does mean Gervais and Martin will look for companies ahead of the curve in terms of their business transition.

The awareness of the climate theme has led to several thematic investments into sustainable technology. For example, Tirupati Graphite PLC is a producer of specialist graphite and graphene, graphite being a key input into lithium batteries for which demand is growing hugely with the expanding electrification of vehicles. Not only this, but the company has its own research and development arm that has announced the development of hybrid graphene/aluminium wires that are can be used as a substitute for copper wiring in cars but at half the weight.

Due to the lack of coverage of the microcap stocks by ESG rating agencies, MINI cannot be given a quantitative ESG rating. MINI does not have an explicit sustainable or responsible mandate or apply any exclusionary criteria. Therefore, MINI would not likely be suitable for an investor seeking a particular ESG profile, impact strategy or requiring an explicit set of exclusion criteria, however, for investors that want a manager that is ESG aware and wish to see sustainability considerations reflected in their portfolios, MINI could prove suitable for their needs.

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