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Premier Miton INVESTORS

Miton UK MicroCap Trust plc
Trust insight

Fund managers, Gervais Williams and Martin Turner, discuss why they have recently bought stock market 'insurance' in the Miton UK MicroCap Trust's portfolio.

Why is it currently worth buying stock market 'insurance'

The last three decades have been a very stock market friendly environment, with share prices rising either due to economic growth or due to additional stimulus through crises, that have driven up share prices even further. Stock market returns have been so good, for so long, that global stock markets are now standing on very forward-looking valuations. The big question now is how much upside is left, and how much potential downside risk are investors carrying at present?

In the past, the pace of economic recoveries has normally been related to the trajectory of demand. Yet the key constraint to the current recovery is different. It appears to be related to the ability to supply. Whilst policies such as the UK furlough scheme have sought to keep our industrial capacity in place during the pandemic, a wide range of industry bottlenecks have become evident.

Central banks use economic stimulus to boost demand. Hence, whenever the recovery faltered in the past, central banks stepped in with additional stimulus. Politicians stepped up state spending. It kept up the momentum. But the current economic recovery is paced by the ability to supply. In effect, there is already excess demand and it is spilling over into inflation. So, the appropriate response from central banks and politicians at this early stage of economic recovery is the withdrawal of stimulus.

This is a big challenge. In effect, the authorities should be bearing down on demand, via increases in interest rates and taxes. This would cap inflation and keep it under control.

But raising interest rates and taxes isn't popular, because they can make stock markets and house prices peak. Politicians would much rather scale up demand as they did in the past. Just as President Biden is doing, via $500 billion of extra spend on infrastructure. The US may need the infrastructure spend. The point is that it is bad timing.

In the short term, the extra demand can boost company profits. After the giant government spend following the pandemic, you may have noted the recent huge improvements in company profits. But the additional spend comes at the risk of higher inflation. And in time, extra inflation is reflected in lower stock markets valuations.

In effect, we have a dilemma. Either the authorities start withdrawing stimulus and actively slow demand, or there's renewed inflation. Both outcomes are stock market unfriendly, because both policies are a challenge for corporates.

One of the advantages of investing in quoted micro-caps, is that many of these are relatively young businesses. Often, they operate in immature industries. Even during global recessions, some can continue to thrive, given their juvenile status. Furthermore, being relatively minor, they can sometimes eke out incremental market share gains, and hence offset an adverse trend. Importantly, in our view, the nature of quoted micro-caps, is that they have a better chance of sustaining growth, compared to the majors.

If business trading conditions become more difficult, due to interest rate and tax rises, or due to renewed inflation, then we believe that quoted micro-caps, in particular, have the advantage. It doesn't necessarily mean that micro-cap share prices are immune to a market setback. Last year, when global markets suffered a setback on the pandemic, the share prices of quoted micro-caps fell like all the others. But thereafter, their advantages led to their share price recovery being so much better than the mainstream stocks.

With all this in mind, we believe that it is a good time to buy stock market 'insurance'. The principle is a bit like your car insurance. You buy it to cover a known period and at the end of the term it is worthless. In the case of stock market 'insurance' it can 'pay out' if stock market prices fall to a specified level. Effectively, if there isn't a claim, it ends up detracting from investment returns. Last year, during the uncertainty of the pandemic stock market insurance was really expensive. Furthermore, stock market valuations were already depressed, so the downside risk wasn't as high.

But at present, with all the good corporate results and the forward-looking valuation of the stock market, the position is different. Hence, the Trust has recently bought stock market 'insurance' in the form of FTSE Put Options covering the risk of a major downturn in stock markets over 2022. Currently, this covers around 38% of the Trust, but if the 'premium' gets even cheaper, the Trust might buy some more.

The Trust did have some stock market insurance last year, covering in that case approximately 28% of the portfolio. When the stock markets did collapse on the global pandemic, the share prices of the stocks in the portfolio did fall back abruptly. The insurance softened the setback to some degree. But importantly in our view, we were able to take profits on the insurance in March 2020 and use the extra cash to buy more quoted micro-caps when their share prices were most depressed. Thereafter, the Trust didn't just recover, it recovered in greater magnitude, with the extra shares bought at the bottom. We'll have to see how it turns out this time.

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Gervais Williams and Martin Turner
4th August 2021

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A free, English language copy of the trust's full Prospectus, the Key Information Document and Pre-investment Disclosure Document are available on the trust's website, or you can request copies by calling us on 01483 306090.

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