BREXIT?

Why we see opportunity in UK smaller companies

Since the European Union (EU) Referendum in 2016, fears surrounding Brexit and its implementation have seen UK equities fall in value. Global investors have withdrawn from our domestic market, fearing the impact of protracted negotiations, extended uncertainty and a 'no-deal scenario' on UK listed companies. Businesses with significant domestic exposure have, correspondingly, been most notably affected.

Smaller companies overall are more impacted by changes in our economy than their larger brethren, because they tend to be more domestically focussed. Smaller companies that import materials to sell at home are more affected by sterling weakness than large multi-nationals, who make the majority of their sales internationally. It is unsurprising therefore, that sentiment towards smaller companies has been more negative than larger UK equities since the vote.

With a deal negotiated between Theresa May's Government and the European Union, we are, at the time of writing, closer than ever to securing an orderly exit from the EU. However, there is no guarantee that the agreed deal will be ratified by the UK Government.

Deal or 'soft Brexit'

The FTSE All-Share index is currently trading at a 27% discount to international peers [1]. Should the Brexit deal pass parliament, it is likely that UK smaller companies, which have traded under a 'Brexit-discount' for more than two years, will benefit from increased investor interest. Moreover, a recovery in the value of the pound would offer a boost to those companies who import their products from abroad and to sell their goods and services at home.

No deal or 'hard Brexit'

Should the UK Government fail to pass its negotiated exit deal, it is highly likely that the initial impact will be a further decline in the value of the pound. As we experienced with the outcome of the EU Referendum, there could be a sharp and relatively indiscriminate fall in the value of domestically exposed companies.

Although a no-deal scenario is likely to provide significant challenges to the UK, we believe that the real impact is likely to be much less than perceived. Most of the companies we speak to and invest in have made plans to minimise the impact of leaving the EU on their operations. Company management teams, whilst clear that Brexit would likely bring some additional administrative and cost burdens, do not envisage a scenario where a hard exit would severely impact their businesses. The impact on individual companies will be dependent on their business model. Companies importing perishable goods from the continent are more likely to find their operations impacted by delays at the border than those importing non-perishables for example.

Crucially, businesses have had over two years to prepare. With negative sentiment already priced into the shares of UK companies, we believe that a further fall post 29 March 2019 is likely to prove unsustainable across the market. The active, long-term and patient investor may find opportunities to purchase companies with strong fundamentals at historically depressed share prices. We believe that, in time, markets will adapt and recover.

Investing beyond the fray

In times of market uncertainty, it is our view that the interests of investors are best served by maintaining a longstanding and rigorous investment process. We seek to find companies capable of delivering growth without relying on the economic environment. Within the portfolio, investments are made in companies that we believe have significant self-help potential, a scalable model, or operate within a growing niche – characteristics we believe allow companies to flourish, even against a challenging economic backdrop.

One example is 4imprint, a UK listed business that supplies promotional materials. The majority of its trading occurs in the US. Operating within a highly fragmented market, the company benefits from a large customer database, strong market position and supplier network. We believe these are sustainable competitive advantages, which can help to support the growth of the business against a changing backdrop. 4imprint is also benefitting from the recovery in the US economy at a time where many UK listed smaller companies are dependent on the outlook for the UK.

Brexit-related negativity is likely to continue to dominate markets in the medium term. However, we believe that focussing on companies with strong fundamentals and investment cases that are less dependent on the economy will position our portfolio to weather the potential storm.

Concluding thoughts

The Brexit vote and extended negotiating period has caused great uncertainty for UK listed businesses. It seems inevitable that the negative sentiment towards these companies will persist until we have greater clarity.

The value of active fund management, we would argue, rests in the ability to navigate the challenges posed by events such as these. We shall continue to search the UK small-cap universe for investment opportunities that we believe will enable us to meet our client objectives in the future. We believe that for the patient, long-term investor, developments in the UK's relationship with the EU has the potential to provide investment opportunities for smaller company investors. ■

All comments as at 26 November 2018.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Invesco Perpetual UK Smaller Companies Investment Trust plc: *As this is a smaller companies product, investors should be prepared to accept a higher degree of risk than for a product with a broader investment mandate.*

The product uses derivatives for efficient portfolio management which may result in increased volatility in the NAV.

The use of borrowings may increase the volatility of the NAV and may reduce returns when asset values fall.

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When making an investment in an investment trust you are buying shares in a company that is listed on a stock exchange. The price of the shares will be determined by supply and demand. Consequently, the share price of an investment trust may be higher or lower than the underlying net asset value of the investments in its portfolio and there can be no certainty that there will be liquidity in the shares.

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For more information on our products, please refer to the relevant Key Information Document (KID), Alternative Investment Fund Managers Directive document (AIFMD), and the latest Annual or Half-Yearly Financial Reports. This information is available using the contact details shown.

[1] Source: Barclays as at 31 October 2018. Data reflects the price to book valuation of the FTSE All-Share Index versus the MSCI All Country World Index.

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