BlackRock Smaller Companies

BRSC has a strong track record of consistent outperformance...

Update
09 February 2021

Summary

BlackRock Smaller Companies (BRSC) aims for long-term capital growth through investment in UK small-cap or AIM-listed companies. The manager, Roland Arnold, seeks to identify high-quality companies with strong growth prospects.

As we discuss under **Performance**, BRSC has generated consistently strong returns in recent years, consistently outperforming and generating positive risk-adjusted returns (as measured by the information ratio). Whilst much of 2020 proved relatively challenging, the trust still ended up outperforming over the calendar year and has achieved nearly double the average NAV total returns of the peer group average over the previous five years.

Roland looks to ensure his companies meet five key criteria, as discussed under **Portfolio**. These primarily centre on quality and growth considerations, the two often being symbiotic (Roland believes quality of management, for example, is key in driving business growth). The result is a portfolio of typically c. 120 stocks which Roland believes offer strong growth potential.

The investment strategy is focussed on capital growth, however the trust also has a strong dividend record, with ten-year annualised dividend growth of c. 18.2% p.a. As we note under **Dividend**, this has been reflective of near-equally strong growth in revenue returns achieved. BRSC currently yields c. 1.9%.

BRSC currently trades on a discount to NAV of c. 6.1% (as at 04/02/2021), having rapidly narrowed towards the end of 2020. As we discuss under **Discount**, it was not surprising to us that the discount should narrow rapidly on a more positive market attitude towards UK equities, given BRSC is amongst the largest trusts in the UK small cap sector with liquid shares and a highly diversified shareholder register.

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Analyst's View

BRSC has demonstrated outstanding performance over a number of years. Although 2020 proved more challenging in the most part, a recovery in absolute and relative performance ensued. Past performance is obviously no guarantor of future returns; however, we can observe an internal risk process which seeks to isolate and maximise the contribution to relative returns of stock specific factors. This gives us confidence previous outperformance has been a consequence of stock selection, and not exogenous, variable macro or style factors. A depth in analytical resources and significant experience, in a universe of thinly researched stocks, offers the potential for identifying underappreciated stock opportunities. Rallies in commodities may pose some headwinds relative to the benchmark but this is true for essentially all active UK small-cap strategies, and Roland's management of sector risk, we believe, can reduce any headwinds this may pose.

Allied to a strong growth profile BRSC has a history of strong dividend growth. Whilst drawing down revenue reserves has been necessary to maintain dividends this financial year, we are in some ways oddly reassured by the implications of this. BRSC targets growth opportunities; given the economic environment, we believe there are likely to be better long-term uses of excess cash flow for small companies at this time than returning it to shareholders via dividends, such as capex or M&A. A reduction in dividends received would suggest to us that BRSC's philosophy is very much reflected in the current portfolio.

BULL
Strong, consistent track record of absolute and relative performance, and risk-adjusted returns
Stock picking appears the main driver of relative returns
Board has proven supportive on progressive dividend policy

BEAR
A sharp commodity rally could prove headwind to returns relative to benchmark
Gearing can exacerbate downside, as well as amplify upside
Little to no discount opportunity currently

Portfolio

BlackRock Smaller Companies Trust (BRSC) aims to provide shareholders with long term capital growth through investment in small-cap UK companies. The trust is managed by Roland Arnold, who utilises the resources and ideas of the broader Blackrock Emerging Companies Team to identify companies with attractive growth prospects. Using this analysis, he seeks to build a portfolio of c. 120 UK smaller companies (currently 117, as at 31/12/2020).

Roland notes that smaller companies have sparser broker coverage than their large cap peers, and are more likely to thus offer informational and pricing inefficiencies. With extensive analytical resources within the BlackRock Emerging Companies Team dedicated to understanding the underlying businesses and their industry drivers, he believes this should give him a potential informational edge to help generate positive contribution to returns from stockpicking.

Idea generation and stock selection is primarily driven by bottom-up considerations, with Roland looking to identify companies which meet his qualitative requirements on five key considerations.

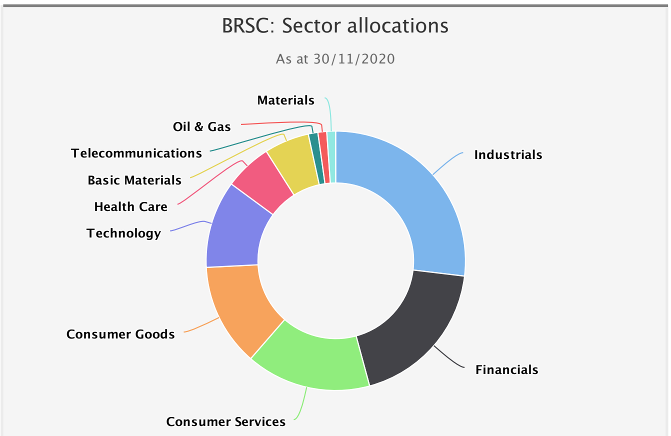
- Management quality, and management's strategy for future growth
- The core product, and an assessment of its strengths and weaknesses relative to competitors
- A track record of consistent growth
- Good conversion of earnings to cash, and,
- Robust balance sheets and a strong financial position

This approach is consistently applied across the funds and trusts run by the Blackrock Emerging Companies Team, including fellow UK small-cap trust **Blackrock Throgmorton Trust (THRG)**. However, BRSC differs from THRG in a number of ways. BRSC will be wholly or nearly wholly invested in UK equities, and will not hold positions in overseas stocks. It will also be wholly 'long' the stock market, is typically invested further down the market-cap range, and will not 'short' individual stocks. BRSC is a long only trust that uses structural gearing (within a range of 0-15%) to increase its market exposure, and is focussed further down the market cap scale than THRG, and would be considered a pure UK small & mid-cap focussed trust.

Whilst the portfolio is constructed from bottom-up stock ideas, Roland is cognisant of benchmark considerations and relative risk incurred from sector positioning is considered within the investment process. This means that BRSC will include, for instance, what the manager regards as high quality names (if such stocks can be identified) from the mining sector when Roland believes it is attractive to do so. In recent months this has seen the manager adding Hochschild Mining to the portfolio, noting the sector tailwinds the mining industry has recently been enjoying. The company (a silver miner with significant activities in Mexico) is a low-cost producer and one of the few mining companies to meet his stringent quality criteria.

Although Roland is aware of relative risk from sector weightings, he does not target a neutral sector weighting or seek to construct the portfolio to make calls on the relative outlook for different sectors. The current sector weightings, as can be seen in the chart below, are an output of stock ideas. However, the internal risk analytics team will regularly update Roland and the team on the current contributions to active risk, with the aim of ensuring most active risk (i.e. reasons why the trust is likely to deviate from the benchmark index) is derived primarily from stock-specific factors.

Fig.1: BRSC: SECTOR ALLOCATION



Source: Blackrock, as at 30/11/2020

In the case of Hochschild, the low all-in cost of production and strong corporate governance he observes reinforce Roland's confidence in the competitive position of the company relative to peers. However, the search for companies with a strong competitive position does not focus solely on relative cost positions and pricing power. There is an emphasis on identifying companies which offer innovative products or services which genuinely differentiate themselves from competitors, or which offer tangibly superior goods or services to industry peers. This should, in the manager's view, help create superior brand loyalty and more reliable cash flows, this greater predictability in turn affording management teams a more stable structure around which to construct strategies for growing the business.

Regular meetings are conducted with management teams to ensure good quality corporate management remains in place to appropriately deploy capital and execute strategies, as well as seeking to understand operational growth strategies. The broader BlackRock team aim to conduct a minimum of 750 company management meetings a year, and note that they typically and consistently exceed this. Whilst this serves to help update them on ongoing progress at existing or prospective holdings, this can also serve to generate new ideas in disruptive competitor companies or related industries (such as disruptor companies within the supply chain).

Although Roland and the team will be wary of overpaying for a company's shares when introducing them to the portfolio, their greater focus is on the growth potential of the company. The ability of companies to grow is considered key, with the manager highlighting the proportionally greater impact that earnings growth has been demonstrated to have when compared to changes in valuation on the enterprise value of a firm over the long term. Research from Goldman Sachs, amongst others, has highlighted that whilst in the short-term share prices can be driven by changes in the valuation multiple, over the longer term a company's earnings growth has consistently proven to be the primary driver of shareholder returns. This informs the team's focus on companies growing their cash flow.

This emphasis, in the stock analysis input, on growth as the ultimate driver of returns has an output result of a portfolio which tilts towards 'growth' and 'quality' factors. However, BlackRock's in-house risk analytics suggests that stock specific factors remain the dominant contributor (c. 53% at present) to active risk (i.e. performance deviation from the benchmark), rather than style factors.

Whilst Roland is focussed on ensuring the companies selected are growing, and is focussed on capital growth, BRSC also has a strong dividend record. As discussed under **Dividend**, this has led to very strong rates of dividend growth, but this has not been to the deterioration of capital, with BRSC itself generating strong earnings growth of c. 17.8% p.a. over the ten years to the end of financial year (FY) 2020. As a result of capital growth, the dividend yield remains relatively low – currently 1.9%. Earnings growth has been reflective of the strong operating performance of the portfolio holdings, which have seen significant growth in free cash flow enabling them to return increasing amounts of capital to shareholders.

The focus on growth as the long-term driver of stock performance means that Roland is unlikely to exit a position wholly on valuation concerns. Instead, sales are likely to occur when he observes a deterioration in the fundamental operational performance of a holding, or if the investment case has otherwise deteriorated in his opinion. Adjustments to position sizes are more commonly made, however, with positions resized on an ongoing basis back to their target weight. BRSC has a general limit on any position size of c. 3% (though sector allocations are free of any restrictions). This is undertaken with the aim of maintaining a diversified portfolio, ensuring stock-specific risk in any one position is reasonably constrained.

BRSC: TOP-TEN LONG HOLDINGS

HOLDING	%
YouGov	2.5
Watches of Switzerland	2.5
Ergomed	2.0
Treatt	2.0
Grafton Group	2.0
Stock Spirits Group	2.0
Impax Asset Management	1.9
IntegraFin Holdings	1.9
IG Design Group	1.9
Calisen	1.9
Total	**20.6**

Source: Blackrock, as at 31/12/2020

Roland is positive on the outlook for UK stocks, noting the trade deal agreed between the UK and the EU finally provides the UK market with some long-awaited clarity. Clarity, in his view, will now have potential to drive flows into UK equities, particularly small caps, as global asset allocators reassess their underweight positions. He also expects that the economic and operational challenges presented to businesses by the ongoing COVID-19 pandemic should potentially benefit industry leaders, which he looks to take exposure to. Roland notes that following such periods of such economic trauma there can typically be expected to come a period of consolidation as over extended, poorly run, and/or obsolete businesses are forced to enter insolvency whilst industry leaders consolidate and extend their competitive advantages and market share. The nature of the current crisis, in his view, will serve to accelerate the advantages enjoyed by capital-light, data-heavy businesses with robust balance sheets, who stand well positioned to expand their market share and more rapidly grow revenues and earnings.

Gearing

BRSC currently has gearing of c. 7% (as of 04/02/2021), based on the most recently reported gearing figures. Gearing is expected to operate within a range of 0-15% of net assets.

This includes structural gearing totalling c. £60m (c. 6% of current net assets). Roland also has access to short term debt through a £35m three-year revolving loan facility and an uncommitted £10m overdraft facility, both of which he can draw down as he deems appropriate. The structural gearing consists of a £15m debenture, £25m senior fixed rate notes maturing in 2037 paying a coupon of c. 2.74%, and a further £20m of senior fixed rate notes paying a coupon of 2.41% and due to mature in 2044. It should be noted that the latter fixed rate notes were issued in

December 2019, and are partially intended to facilitate easy refinancing of the £15m debenture, due to mature in 2022.

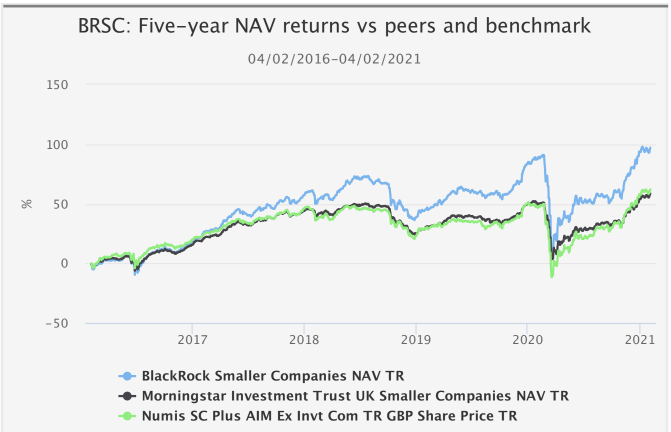
Gearing levels are typically a function of the stock-specific level opportunity set identified by the manager. Over the past five years, this has typically ranged between c. 1% to 11%, with an average level of c. 7% (Source: Morningstar).

Performance

Roland has been portfolio manager of BRSC since May 2018 (co-manager until June 2019). Over this period (to 04/02/2021), BRSC has delivered significant outperformance of the Morningstar UK Smaller Companies sector. BRSC has generated NAV and share price returns of c. 21.9% and c. 23.5% respectively, relative to sector average NAV and share price returns of c. 9.5% and c. 12.2% respectively. Roland has also significantly outperformed the benchmark (Numis SC including AIM excluding investment companies) index, which returned c. 12.4% over this period.

Despite the manager change, the investment approach within BRSC has remained consistent over an extended period and has featured Roland as a senior member of the team for a significantly longer period. In this vein, we note that over the five years to 04/02/2021 BRSC has delivered NAV and share price returns of c. 97.1% and c. 107.9% respectively. This has represented strong outperformance of the Morningstar UK Smaller Companies peer group, which has seen average NAV and share price returns over the same period of c. 58.5% and c. 64.4% respectively. It also represents strong outperformance of the benchmark index, which returned c. 62% over this same period. As such, BRSC has achieved nearly double the average NAV total returns of the peer group average over five years.

Fig.2: BRSC: Five-Year Nav Returns Vs Peers And Benchmark



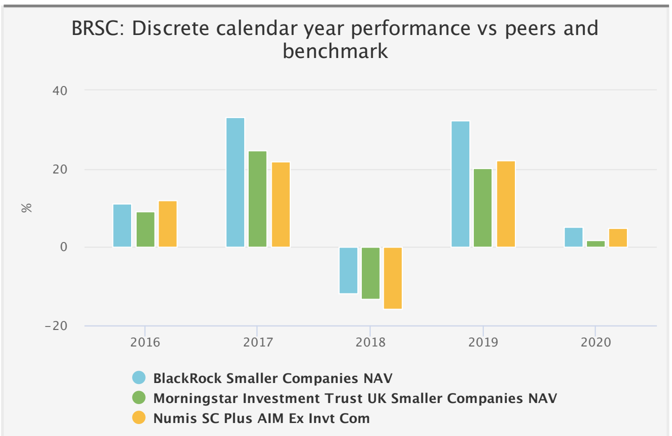
Source: Morningstar

Past performance is not a reliable indicator of future results.

As we can see in the discrete calendar year performance chart below, outperformance has been gratifyingly consistent. We estimate that if investors had bought BRSC at any daily point in the previous five years, they would have subsequent 12-month NAV outperformance to the peer group NAV average and benchmark on c. 92% and c. 95% of occasions, respectively. Unsurprisingly, then, BRSC has outperformed the peer group in all of the previous five calendar years, and outperformed the benchmark in four out of five of these years (the exception being 2016, concurrent with a very significant commodity rally, as we explore further below).

As noted under **Portfolio**, Roland actively aims for the majority of active risk (i.e. risk relative to the benchmark) to be derived from stock specific factors. We understand that this has been consistently the case, and as such much of the outperformance generated by BRSC in recent years can thus, in our view, be attributed to stock selection.

Fig.3: BRSC: Discrete Calendar Year Returns



Source: Morningstar

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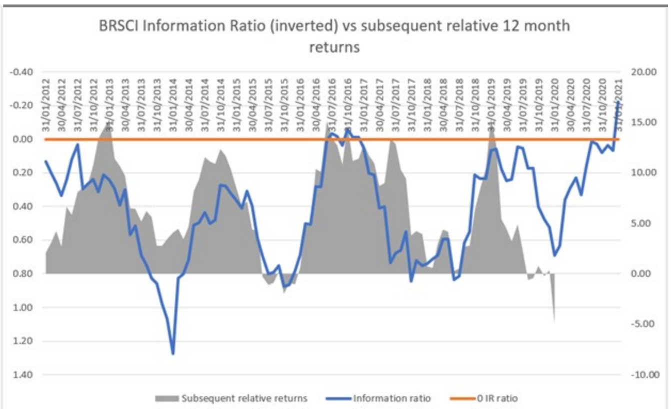
2020 initially proved slightly more challenging for BRSC, before the NAV subsequently rallied towards the end of the year. Despite this, BRSC has underperformed both its peer group and benchmark over the previous 12 months to 04/02/2021 on a NAV basis, with NAV and share price returns of c. 6.9% and 2.1% respectively. This trailed a benchmark return of c. 9.6%, and peer group average NAV and share price returns of 5.7% and 3.8% respectively over the same period. Whilst BRSC's gearing was not particularly extended in Q1 2020, it nonetheless detracted from relative returns to the benchmark in Q1 2020. Positions in 'new economy' stocks and industry leaders with a strong online presence proved beneficial to returns, though an underweight exposure to the materials sector proved a headwind over the year as a whole.

This more challenging 12-month period has seen risk-adjusted returns, as measured by BRSC's information ratio (IR) relative to the benchmark, fall to amongst the lowest levels seen in the previous ten years (as measured by monthly data points). Yet it has remained consistently positive. We regard this as interesting. This suggests that even in a more challenging environment, the investment process and depth of qualitative analysis undertaken can yield stock-specific benefits in the thinly covered small-cap universe.

Furthermore, we note what we regard as an interesting mean reversionary relationship between current risk-adjusted returns (as measured by the IR) and subsequent relative returns. In the chart below, we have inverted the IR of BRSC relative to the benchmark. When the blue line is below the orange, it indicates a positive IR has been achieved over the previous 12 months; the further below the orange line the blue line is, the better the IR achieved has been. In grey, we have the relative returns achieved by BRSC over the subsequent 12 months. The relationship is not deterministic, but there is a clear trend to stronger subsequent relative returns in an absolute sense after a period where the IR has been 'weaker' (despite having been near universally positive).

From this, we would also note the consistently positive IR ratio achieved (the scale is inverted, so whenever the blue line is below the orange, the IR is positive), as well as the consistency of outperformance on a rolling 12-month basis. If this relationship is maintained, it would suggest to us that we could be entering a more supportive environment for BRSC on a relative basis.

Fig.4: BRSC: BRSC Information Ratio Inverted Vssubsequent 12-Month Relative NAV Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

Whilst a mean reversionary effect compared to the UK stock market as a whole could perhaps be attributed to the vagaries of flows and sentiment, this clearly is not applicable when considering BRSC relative to the small cap index benchmark. As we have **recently discussed**, however, we believe there is evidence that active strategies suffer relative headwinds compared to the broader index in periods of strong commodity rallies. We would comment that we regard such an outcome as entirely consistent with the output we would anticipate from the investment process employed within BRSC.

Whilst such a boom may prove something of a headwind to relative returns to the benchmark, Roland is cognisant of developments in this sector (which is highly cyclical) and will look to ameliorate relative sector risk when he deems it appropriate. As noted under **Portfolio**, this has included, for example, buying shares in Hochschild, which he regards as a high-quality mining company with a low-cost base.

Dividend

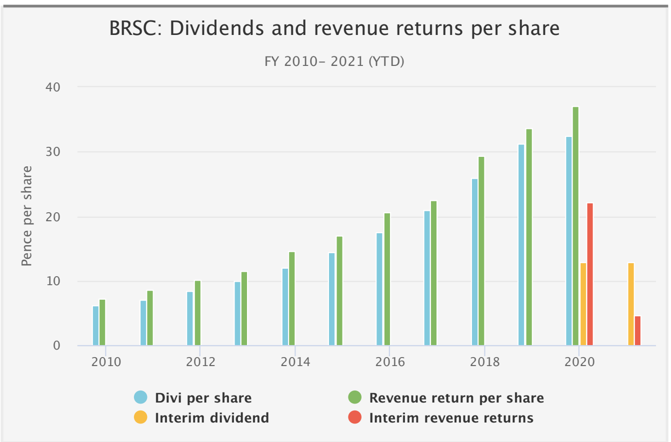
BRSC currently yields c. 1.9% on an historic basis, as at 04/02/2021. Whilst the objective of BRSC is primarily to seek long-term capital growth, the board have consistently acknowledged the importance of dividends to shareholders and have sought to implement a strong dividend record. This has seen ordinary dividends grow in every year since financial year (FY) 2003. Over the previous ten years to the end of financial year (FY) 2020 (February 2020), BRSC generated what we regard as a highly impressive rate of dividend growth equating to c. 18.2% p.a. This has essentially been matched by revenue growth, with the revenue return per share over this same period growing by c. 17.8% p.a.

BRSC has paid an interim dividend in the current financial year (FY 2021) of 12.8p per share, in line with the interim dividend paid in FY 2020. Given the challenging operational environment companies faced over most of 2020, revenue returns over this same period unsurprisingly fell. At the interim reporting period (ending 31/08/2020), BRSC reported revenue returns per share of 4.57p, compared to 22.20p per share in the same period in FY 2020 (a decline of c. 79%).

With revenue returns not covering the distribution, the board has utilised BRSC's revenue reserves to maintain this dividend. BRSC had revenue reserves equating to c. £17.5m as at 31/08/2020, prior to the payment of the interim dividend. This equated to revenue reserve cover of c. 1.1x the FY 2020 dividend. Based on the subsequent dividend, and estimating income received (based upon the difference in ex-income and cum-income reported NAVs as at 04/02/2021), we estimate that BRSC retains revenue reserve (£12.3m) cover of c. 0.82x the full FY 2020 dividend and c. 1.36x the final dividend paid in FY 2020, leaving the board in a strong position to at the very least maintain dividend levels for FY 2021.

In addition to these substantial revenue reserves, the board has also proposed removing restrictions which prevented them distributing BRSC's very substantial capital reserves as dividends. The board noted that it was not pursuing this with the expectation of doing so, but merely to afford maximum flexibility going forward.

Fig.5: BRSC: Dividend And Revenue Return Per Share



Source: BlackRock

Past performance is not a reliable indicator of future results.

Management

Following the trust's AGM in June 2019, long-term manager Mike Prentis retired and Roland Arnold took over as sole manager, having been co-manager since April 2018.

Roland has worked at BlackRock for almost 20 years, and managed UK equity funds since 2010, with a focus on small and mid-cap stocks. Alongside BRSC, Roland continues to run the open-ended BlackRock UK Smaller Companies Fund, which he took over in March 2015, as well as being the sole manager of the BlackRock UK Special Situations Fund.

Roland works within the BlackRock Emerging Companies team, consisting of five investment professionals, who oversee nine open-ended, closed-ended and hedge fund products. Within this team Roland is tasked with co-ordinating research of small and mid-cap UK equities, as well as the industrials sector.

Discount

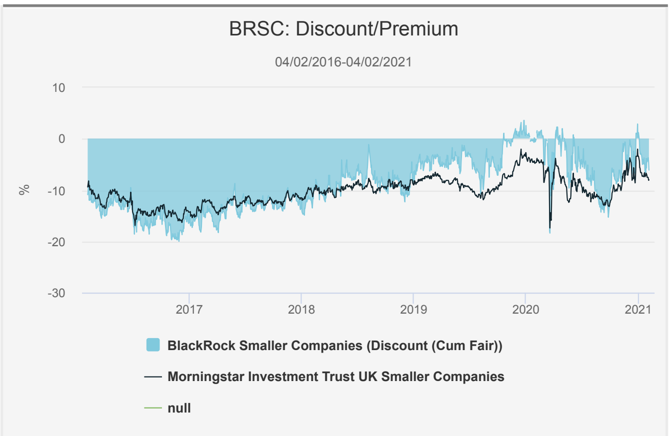
BRSC trades on a discount to NAV of 6.1% as at 04/02/2020, slightly narrower than it has typically traded over much of the previous five years (an average discount of c. 9%). As a more 'risk-on' attitude prevailed over much of Q4 2020, this helped spur a recovery in NAV and an even greater recovery in share price. The latter was further boosted by the agreement of a Brexit deal in late December 2020, with a sharp narrowing in the discount and a move to a narrow premium seemingly anticipating this announcement and consolidating thereafter.

Whilst the board has the ability to repurchase or issue shares, it has not exercised this ability thus far in the current financial year (commencing 29/02/2020). In the previous financial year the board issued 950,000 shares in total at a premium to NAV: these were issued from existing shares in treasury.

As one of the largest trusts in the sector, with a large free float and relatively small notifiable shareholder interests (we estimate c. 31% of outstanding shares), we would suggest that BRSC has proven a primary beneficiary within the sector of return of 'animal spirits' to the UK market following the conclusion of a Brexit deal. We would comment that if the implications of the discount narrowing seen in December 2020 are to presage greater allocations to UK small and mid-caps from both domestic and overseas investors, then this could prove a tailwind to longer-term NAV returns.

The relatively greater liquidity in BRSC's shares could potentially make it an attractive option for institutional investors running larger pools of capital and wishing to tactically increase their allocation to UK small caps, in our opinion. Yet we also note that BRSC has in recent years increasingly been attracting interest from retail shareholders and wealth managers, as has been highlighted by the board in recent annual reports. We would expect this to typically result in higher stock turnover, but also make the discount less vulnerable to an exit by a single major holder.

Fig.6: BRSC: Discount/Premium



Source: Morningstar

Charges

Currently BRSC has an OCF of 0.70%; this is amongst the cheapest in a sector where the unweighted average OCF is 1.07% (Source: JPMorgan Cazenove). This includes a tiered management fee, charging 0.6% p.a. on the first £750m of assets and 0.5% p.a. thereafter. Based on the level of assets at the time of writing (c. £850m) we estimate the management fee to currently be c. 0.59% p.a. Management fees are charged 75% to capital and 25% to income.

The KID RIY for the trust is 0.83%, in comparison to the unweighted sector average of 1.98%, although we would caution that different managers use differing methodologies to calculate this figure.

ESG

BRSC utilises an investment process with a strong focus on ensuring strong governance and good management within the underlying companies, seeking to identify companies with long-term growth prospects and with the ability to protect positions of market leadership considered crucial. Roland sees Environmental, Social and Governance (ESG) analysis as a natural extension of the investment process, feeding into and accentuating analysis around these considerations.

The trust currently has an 'average' score on Morningstar sustainalytics. Quantitative ESG scores such as this are likely to be a by-product of the investment process, as opposed to a conscious target for the managers. An alignment of ESG factors with the stock process suggests to us that the trust is likely to typically meet the criteria of most ESG investors on an ongoing basis, but this is an output of the focus on long-term drivers of returns.

Roland will typically be particularly concerned with sustainability of a business's growth, and he works alongside the BlackRock Investment Stewardship (BIS) team to assess this. Issues such as financial-statement integrity are a key focus, with the BIS team conducting deep-dive research to assess companies' accounting ratios when assessing balance-sheet and earnings-quality risks. ESG is used both as something of a risk determinant, highlighting potential governance issues or other risks to operational developments (for example), and as a tool for measuring the progress made by competitor companies in potentially systematically important issues. Third-party data from MSCI is also used to highlight potential environmental and social factors, giving Roland and the team further insight into potential risks from ESG factors.

Under the auspices of BlackRock as well as the sizeable suite of products they themselves manage, one of the world's largest asset managers, Roland and the rest of the BRSC team enjoy significant access to company managements. This enables them to engage with corporate management teams on ensuring good governance, as they deem it, remains in practice.

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