

TRANSCRIPT: EPISODE 407

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. UK smaller companies have spent years out of favour, but valuations remain exceptionally low and corporate activity is rising — could sentiment finally be turning?

Chris Salih (CS): I'm Chris Salih and today we're joined by Katen Patel, co-manager of the Elite Rated JPMorgan UK Small Cap Growth and Income Trust. Katen, thank you very much for joining us today.

Katen Patel (KP): Hi Chris, thank you very much for having me.

[INTERVIEW]

CS: It's no problem at all. I'll start with the obvious, only one place to start. The last 10 years, UK small cap, unloved for a variety of reasons since Brexit, COVID, 2022 liquidity, all those challenges. You've got the optimist on one side who say valuations are incredibly attractive once in a generation, once in a lifetime. And then you've got those on the other side, the pessimists who say, "Yeah, but you've been saying that for the last however many years." Are we reaching a point where something has to give in the market? Is there an inflection point that you're thinking is gonna come at some point, be it political, economic, you know, consumer related? How do you perceive that market at the moment?

KP: Yes. Thank you for the question. Very good question. It's one we've been asking ourselves for a couple of years now. I think we've gone through, I see many challenges over the last decade or so post the referendum that we've had COVID, various Brexit negotiations and whatnot, Russia-Ukraine, Iran situation this year. And throughout that period, actually the small cap index has continued to push on over the last decade or so, which is encouraging.

TRANSCRIPT: EPISODE 407

That said, you've talked about valuation briefly and that it is still incredibly attractively valued. In terms of catalysts, that's one thing we do get asked from a lot of clients. And I don't think there's one particular catalyst. I think it'd be a combination of things. I think in the last decade, probably two decades actually, we've seen huge outflows of money out of the UK stock market, both in small cap and in large cap and pension funds, insurance companies, et cetera, reducing their holdings.

And I think we have reached a bit of a flaw there. Allocations have come down to about 5% of portfolios from the 20%, 20 years or so ago. So the outflows stopping, I think is one of the key things. The other thing is obviously the economic side and to be fair to UK GDP has probably been slightly better than expectations this year. And in the small cap space, we haven't really seen huge earnings downgrades, but when this area of the market tends to perform well is when we have stabilisation in the earnings trends and small upgrades coming through. And that can come from just the fact the market is being overly pessimistic about the outlook and things are starting to look up. And again, that could be catalysed by perhaps interest rates starting to come down and growth starting to pick up.

So all of those sorts of things coming together is important. Clearly the political side is also vital and perhaps also just some stability in this part of the market, which again, we haven't had for a long time. Would be important. Perhaps regulatory drivers, helping the situation, encouraging more investment in UK domestic assets. All of those sorts of things coming together could help the UK small cap space start to rewrite and perform as it has done in the past.

CS: I mean, I spoke to your fellow co-manager, Georgina earlier this year, and one of the things she describes, not only is it just sort of so compelling, but it's been like that for so long, but also it's just so widespread as well. I mean, it doesn't matter what type of company you are, you're sort of affected by that sentiment. Is it just a case of, is it all tied to sentiment and just waiting for that re-rating for something to come through as a catalyst? It's not the earnings anymore, it's just purely that sentiment side of things.

KP: Yes, partly. And it's definitely been the case, yeah, across various sectors. You look at the valuations in the UK versus other markets, and particularly the US, where you've got companies perhaps with similar exposure, similar growth rates, and they're just trading at huge discounts in terms of valuation. And we've seen it across, say, financials, industrials, retail, et cetera, and some high quality companies that have been around for a long time.

So I'm looking at one of our large holdings in the portfolio is a company called Four Imprint, which produces goods for corporates, so branded goods, so be it umbrellas, cups et cetera, that are given out at trade shows or to clients. And 90% of their business is in the US. It's a company that over the last 15 years has grown top line north of 10% a year. The sales line has grown up north of 10%. Earnings have grown at 15% per year over a very long period of time. It's huge exposure to US market, very strong balance sheet, returns lots of cash to shareholders, and it's trading at probably two thirds of the valuation it did 10 or so years ago. And that is just purely, I think, sentiment, some of the outflows that we've seen out of the UK market.

And say the catalyst, we don't know what that's gonna be. That will, you know, hopefully just the delivery of earnings consistently and seeing these expectations in the market being surpassed will hope, to hopefully rerate those companies back to where they were.

CS: One thing I did wanna mention on the income side is that one thing that has cropped up recently is that the FTSE small cap now has a yield that's actually higher than the FTSE 100. Could you maybe just explain the relevance of that and how unusual that is as well, please?

TRANSCRIPT: EPISODE 407

KP: Yeah, so you've got some. I guess in the FTSE 100, we've got a number of say more mature companies that have gone through their growth cycle, have matured and are returning, then returning lots of cash to shareholders as they have less investment opportunities. And that's obviously been the opposite in small cap where you're looking for companies that have opportunity to reinvest and grow their businesses. But such is the case that because of, I think the strength of balance sheets and the valuations that we see, they're generating so much cash that actually they're returning lots of cash to shareholders, whilst actually still being able to reinvest.

CS: And the problem, I guess, is why I assume something's got to give eventually is because you guys aren't any ones who are noticing this. You've got the M&A and the private equity guys sort of hunting it down. Has it continued to grow a pace? And for you guys, is it always welcome? I know, again, speaking to Georgina, it's not always been welcome, but maybe just tell me, is it getting better, that environment for finding companies or are you sort of pushing them away more often than not?

KP: Yeah, so M&A in this part of the market has always been a feature and I think historically it's been about 5% of the small cap spaces acquired per annum. It's really interesting, when I came back from my summer holidays, I was going through all of the news flow from the last few weeks that have been away and the overriding theme was just the amount of M&A taking place and it's bids from both corporates and private equity. It's domestic buyers and international buyers looking at the small cap space and it definitely feels like it's taken a step up this year.

And the valuations, to be fair, have been reasonably generous in terms of the premiums we're getting. So I think last year we were probably getting a 30 to 35% premium, and this year it's moved to probably a 40 to 45% premium in terms of where the bids are coming.

And it's really on a case by case basis. Sometimes it can be incredibly frustrating where you think you're investing in a company that's got a very long track record of growth with potential to perhaps return lots of cash to shareholders over time and you think the share price could be double, triple where it is now and then you have a bid at 30, 35%, doesn't really cut it. And we'll always have those conversations with the board. But sometimes there are large shareholders that are willing to accept. There might be a large founder shareholder who's willing to accept has had enough of the valuations that they've seen over the last decade. So it's really on a case by case basis. We'll always try and fight our corner in terms of trying to get the best price we can. But I think it's something that's going to continue as long as the valuations are here.

CS: Is it a frustration because it can put a lid on growth because you find something relatively small that could grow exponentially and that gets, that growth gets limited to a degree. And I guess longer term, which I would be quite interested to get your thought is this fear that the hopper of these IPOs filling up to replace that is not coming through at the same speed that perhaps you'd like it to.

KP: Yes. I think that's the key frustration. So I say M&A's always been a feature, but it's the fact it's not being replaced on the other side is the difficulty. So say that we've got, there are a thousand companies in the index, but it's always nice to have fresh blood coming into the index. And some of our most successful holdings in the last couple of years are actually being companies we invested in at IPO in the last couple of years because I think when the IPOs do come, I think the investment banks realise they need to be a high quality IPO to get them away because of sentiments in the market. But there's the hopper is not being refilled at the moment. There's been various macro situations, I guess stopping that. But there are plenty of private companies out there which will hopefully come to list in the UK market in June course.

TRANSCRIPT: EPISODE 407

CS: Okay. And share buybacks in general, again, Georgina, I know you guys have sort of traditionally not been fans of them, but that has turned around now. Is that a limited window in terms of your views on companies doing that? It's almost to protect themselves to a degree. How do you perceive that now?

KP: Yes, it's definitely been, when we're having our meetings with management of these companies, it's always speaking to them about how they're allocating capital. And we generally encourage them to invest back into their businesses as long as there's a proper hurdle rate on that investment and as long as obviously the balance sheet's in good shape. But I think what we've seen in the last few years is actually balance sheets have got stronger and stronger, because of the geopolitical situation and volatility. But valuations have become so low that in many cases, the best investment company can do is by buying its own share. The returns they're getting on that is just as comparable as to going to spend it on a new factory or whatever it may be.

So we've absolutely changed our tune, I think, in the last year or two on that and been happy with companies to buy back their shares, but also, you know, hopefully balance that with reinvestment and obviously keep their balance sheets in good shape. But it's very unusual in the small cap space to see the level of buybacks we're seeing. But I'd say that is very much because of balance sheets and where valuations have got to.

CS: And I guess the thing you're sort of looking at, because again, the idea is as a long-term holding is that small caps tend to do a lot better in recoveries, but also that long-term growth is much stronger than in sort of large caps historically. So it's kind of a case of holding your nerve to a degree in challenging periods. And it does feel like there is gonna be some sort of point where something has to give one way or another. And I assume for you, it's kind of you're kind of getting paid quite well to wait with these M&A cards coming in as well.

KP: Yes, I think so. And then again, it's, I think a case of having those conversations with the management teams and saying, look, we are long-term investors here. We are investing in you for five, 10, 15 year opportunities. So if there are investment opportunities where, that are attractive to you to grow your product sets or expand into new territories, then please do that. But I think companies just because of the environment being slightly more cautious. So keeping their powder dry and, you know, buybacks can be turned on and off relatively easily. It's much easier to do that than having a high dividend yield and then cutting that. The market tends not to like that. So it's a flexible way of keeping your powder dry, but also returning some cash to shareholders.

CS: Okay. Obviously it's got small cap in name, but you do have mid-caps in the portfolio. Is the story for UK mid-cap almost identical? Are there slight nuances? Maybe give us an example of an opportunity in that space that stands out.

KP: Yes, it is, to be honest. So the index we are benchmarked against is Numis smaller companies plus AIM, and that goes up about halfway into the FTSE 250. So FTSE 250 is generally considered your mid-cap index. And it's been very much the same. So valuations have been incredibly attractive there. M&A has been taking place in that space as well. There are opportunities throughout the entire small and mid-cap space, I would say. So we've had companies that have gone out of our benchmark. We can continue to hold them. But a company like Softcat, for example, this is a value added reseller. So this essentially helps corporate clients or government clients to source their IT needs, help them with cybersecurity, et cetera. And it's actually been benefiting from all of the AI trends that we know a lot about and hearing about constantly.

TRANSCRIPT: EPISODE 407

And it's a company that we actually have held since IPO. Sold out at one point because of valuation had gone out of our index, but have reentered a position because the growth has been astonishingly strong. It's delivered most 10% top line growth consistently, very high margin, high return on capital business and pays out dividends and special dividends to shareholders, has been a phenomenal story. I think the shares are probably up over 10 times since their IPO. But that's a company that is firmly in the mid-cap space. It wouldn't surprise me if eventually it became a large cap company.

CS: Or gets bought out.

KP: Or gets bought out.

CS: One thing we should talk about is also the sort of structure of it. This is an investment trust. It can do things that an open-ended portfolio cannot do. In your case, you can invest a little further down, sort of hundred to 300 million. The word that sort of skins sort of chills down the spines of yourselves and all of the UK small caps in, is the word liquidity. What does that opportunity allow you to do? Is that pond of 100 to 300 million full of attractive options? Maybe give us an example or two that jump out there as well.

KP: Yes, it really is. And I think we're fortunate that we can. We start to invest in companies about 100 million market cap, but we'll start monitoring them before that and meet the company, do some analysis. And there's a real suite, but I think between 100 and 300 million where there are some fantastic companies who are doing well, but very attractively valued. So, a recent one that we've been investing in is a company called Cortex, and we've had this for a little while now in the portfolio. So they provide subscription-based vehicle telematics, tracking software, driver analytics, and they're often selling to small businesses in the UK and also overseas. So a small team of plumbers or electricians who are operating in their local community and the owner of that business can track those vehicles, make sure they're on the most sensible route, see how long they're spending at each job, et cetera, and optimise for that.

But this is a company that has delivered, again, very strong growth. I think we entered around 100 million market cap. It's now around 200 million market cap. It's got opportunities to expand into the North American market, which is doing well. It's expanding into Europe as well. Again, a very strong balance sheet. But these sorts of companies which have hopefully a 10, 15, 20-year growth pathway ahead of them, we've picked up on early and obviously have to be mindful of our position sizing because of liquidity, but the closed end structure does allow us to invest in these sorts of companies.

CS: One point I just wanted to pick up on which perhaps gets overlooked is often people just assume FTSE 100, UK large cap, international, mid and small, domestic. That's not always the case. There are plenty of companies that you invest in that can be either are or will be international in nature, and that perhaps gets overlooked in that sentiment argument, which is at the hub of all the challenges that are sort of facing the UK small cap market.

KP: Yes, that's a really good point actually. So FTSE 100 is probably 80% international revenue, 20% domestic. And as you say, a lot of people assume small and mid-caps are probably 80 or 90% domestic, but actually it's about 50/50. So you have broad exposure to international markets as well, which again is at odds with the valuation that we see because as okay, an example earlier of four imprint, which is 90% in the US, and benefiting from whatever economic drivers are going on there. So really, there are opportunities to invest in both companies benefiting in the domestic space, but also international. I think the beauty with small caps as well is they're less impacted by the general macro environment. They're often in such a niche that there are their own drivers going on.

TRANSCRIPT: EPISODE 407

So for example, there's a company called Volution, which we're invested in, which produces ventilation systems for commercial and residential properties. And a couple of years ago, we're hearing lots of horror stories about mould buildup in tenanted properties, et cetera, and air quality. And so there have been this regulation that's come out to change that. And Volution is a great example of a company that's operating in a pretty challenged domestic construction market, but actually because of the regulatory drivers, they've continued to see very strong organic growth drive their margins higher. So I think that is one of the beauties of small caps, is you've got both domestic international exposure, but often in their own niches and have their own growth drivers.

CS: And I guess one thing that's a big benefit to you guys, which we should quickly make a point of is that as flows, as sort of focus has shifted away from your area of the market, small caps, particularly those hundreds of 300 million, the analyst coverage has gone down as well, which means there's even bigger opportunities because less people are looking at these companies in depth.

KP: Yes. Yeah, absolutely. And we're very fortunate here. We've got a big team, 10 UK investors, many of those focused on small, mid-cap mandates and we have access to lots of data, we have access to all the company management teams we need to. So being able to go through 10 years of company's house data to look at how a small cap company that's only covered by one land analyst is performed, we have the ability to do that. And I think that has helped us find some of these diamonds in the rough, I guess, that are just not known to the wider market. And we'll continue to do that and hopefully have those companies in the portfolio over the longer term and hopefully ride them up all the way to the 1400.

CS: And I guess just to round off, the name of the fund, of the trust does have the word income in it. We need to be clear that while it's in the name, it doesn't, you don't sort of deliberately let dividend yield drive that decision making. Maybe just explain how you get from A to B in terms of that process leading you to those names that actually offer those income elements to investors.

KP: Yes, very good point. So the trust pays a dividend of 4% of NAV, which is determined to the NAV, the net asset value of the trust at the end of our financial year, so end of July. So 4% of that is then paid out in quarterly instalments. But for Georgina and I, focus is very much on capital growth, finding companies where the share price is going up year after year. But our underlying investment process focuses on the number of things, be it high returns on capital they're investing, looking for companies that are getting earnings upgrades where expectations are too low. And then free cashflow yield, strong balance sheet. So company, we like companies that don't have much debt, companies that are throwing off lots of cash, which gives them optionality. So the underlying dividend yield of the portfolio is already 3%. So then the other 1% difference is made up by choosing the, the NAV.

So for us, we can continue to focus on finding those companies that are generating capital growth, share prices going up and rather than having to focus on the yield. But it's an. As part of our underlying investment process that comes through significantly. I think if I give you one figure, which again, just speaks to the valuation. If you look at the, what we call the free cashflow yield of the portfolio, so this would be for a single company, if it was making 10 million of cash on 100 million market cap, it would be generating 10% free cash free yield. For our portfolio at the moment, it's around 8.5% free cash yield. And the index itself is at 6%, which is just astonishing. And all the time I've been working alongside Georgina for, coming up to 15 years, and have never seen it as high as that just gives you a sense of how much cash is being generated and how attractively valued these companies are.

TRANSCRIPT: EPISODE 407

CS: It's why we hope at some point that sentiment will change. Katen, thank you very much for your time today. Hopefully the next time we speak, the sentiment will have changed and you'll be even happier than you already are with the thing, with what's going on in the fund.

KP: Thank you very much for having me.

SW: JPMorgan UK Small Cap Growth & Income aims to provide investors with capital growth and an enhanced dividend from UK-listed companies further down the market-cap scale. It invests in high-quality, fast-growing, and innovative smaller companies that drive the UK economy, using a bottom-up approach to identify attractive stocks. To learn more about the JPMorgan UK Small Cap Growth and Income Trust please visit fundcalibre.com