FUNDS & INVESTMENT TRUSTS

Small-cap funds for adventurous investors

If you have the patience and mindset for it, you could look at European, Japanese or Asian smaller companies

Published on May 30, 2025

by **Val Cipriani**

Small-cap companies outperform large caps in the long term – or so the traditional thinking goes.

Their size means they have high growth potential, and they are often misunderstood or ignored by other investors, meaning they can be mispriced. Holding the right selection of smaller companies should give your investment portfolio a serious boost, assuming you have the patience to sit tight through the inevitable ups and downs.

This theory, which was consistently proven right through history, has faltered in more recent years. Small caps underperformed due to a combination of factors, including the rise of passive strategies and the fact that companies tend to stay private for longer. “Even optimists like me are thinking: ‘is this a forever change?’,” admits John Moore, wealth manager at RBC Brewin Dolphin.

However, it could also be that we are approaching the bottom of small-cap underperformance. Long-term investors might see an opportunity in the low valuations available in certain pockets of the sector.

The reason you might still want to bother with small caps, says Moore, is to acquire exposure to a recovery with “a different return potential”. This requires patience and awareness of the risks. Small caps could well outperform again, but you need to go about them with an almost “entrepreneurial” mindset, which is “adventurous by its very nature”, says Moore.

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You could use a global small-cap fund, taking exposure to the best ideas from across the world via the likes of **Global Smaller Companies Trust (GSCT)**. This approach will suit investors who want to keep things relatively simple.

However, there is also a case for a more targeted approach – especially if you think about it in said “entrepreneurial” way. Managers with a lot of expertise in a specific region or country have an edge. Smaller companies tend to be more exposed not only to domestic economic factors, but also to social and cultural ones. To invest successfully, you have to “think like the locals”, says Moore.

On top of that, with a global fund you tend to get a considerable exposure to the US market, at 42.7 per cent for GSCT, for example. But the picture for US small caps is mixed.

Large-cap outperformance has been especially prominent in the US market, which is an exceptionally hard one to navigate for active managers. Plus, many investors will already have a lot of US exposure in their portfolios because the country makes up such a big portion of global indices.

Then of course, there is Donald Trump. Small US companies might be less exposed to tariffs than some of their bigger, more global-facing counterparts, as my colleague Dave Baxter has previously argued.

But some think the domestic situation is not too rosy either. “The danger that Trump’s policies trash the economy means that it is probably best to avoid the subsector altogether,” argues James Carthew, head of investment companies at QuotedData.

Japan, Europe, Asia

The table below shows the performance of a range of region-specific investment trusts compared to the relevant index. Investment trusts are a good option to invest in a sector that can be less liquid than its large-cap equivalent.

It is easy to understand why UK investors might want to look at domestic small caps – they are undervalued, and operating in an economy and sectors that are familiar. Some UK small-cap fund ideas are here.

Here we look instead at small caps in other regions, which is a more niche exposure where picking your own stocks is usually unadvisable or impossible.

How regional small-cap trusts are performing

Trust/index	1-year	3-year	5-year	10-year	Discount to NAV as of 22 May
European Smaller Companies	6.3	38.8	132.3	191.6	-5.4

Performance data: sterling share price total return to 23 May. Sources: FE, AIC

Trust/index	1-year	3-year	5-year	10-year	Discount to NAV as of 22 May
European Assets	1.5	5.6	31.2	45.6	-11.5
US: Russell 2000 index	**-5.3**	**9.4**	**42.5**	**106.3**	--
JPMorgan US Smaller Companies	-2.5	7.8	43.8	130.9	-5.6
Brown Advisory US Smaller Companies	-7.6	6.1	42.5	85.8	-9.4
Japan: MSCI Japan Small Cap	**10.4**	**24.4**	**25.6**	**98.9**	--
Baillie Gifford Shin Nippon	5	-21.8	-33.5	52.4	-12.8
Nippon Active Value	14.1	75.3	106.7	--	-2.1
AVI Japan Opportunity	25.7	47.2	64	--	-2.4
Asia: MSCI AC Asia ex Japan Small Cap index	**-2.7**	**16**	**72.5**	**72.2**	--
Fidelity Asian Values	-1.4	26.7	95.7	132.1	-9.2
abrdn Asia Focus	8.7	23.7	97.1	112.8	-12.2
Scottish Oriental Smaller Companies	5.6	37.6	99.7	85	-12.4

Performance data: sterling share price total return to 23 May. Sources: FE, AIC

But Mick Gilligan, head of managed portfolios at Killik & Co, argues that Japan is "the stand-out small-cap market" due to cheap valuations and solid growth prospects.

"The MSCI Japan Small Cap Index trades on 8.8 times next year's earnings, falling to 6.4 times the following year," he says.

"You'd be forgiven for thinking that the low PEs are due to low growth prospects. But you'd be wrong. Profit growth estimates are very high, at 53 per cent next year and 37 per cent the year after." And the government is pushing for higher returns on equity and more shareholder-friendly governance.

The main options there are high-growth **Baillie Gifford Shin Nippon (BGS)**, value-oriented activist trust **Nippon Active Value (NAVF)** and **AVI Japan Opportunity (AJOT)**, which also has an activist approach but only considers businesses with healthy margins and growing profits.

The first stands out for its discount to net asset value (12.8 per cent as of 22 May, while the other two are trading much nearer to their asset value).

Carthew likes AVI Japan Opportunity. “It has had a run of success, but the managers are doing a good job of recycling the portfolio from past winners into new opportunities. We believe that there is much more to go for the strategy,” he says.

European and Asian small caps also have their merits.

Investing in European small caps is about getting exposure to more nimble businesses that operate in more exciting sectors compared to the large-cap European market, which has a lot of globally-oriented companies.

This comes with its own macroeconomic and geopolitical risk at the moment. But then, could Trump also help make Europe great again?

“Europe is going to have to get some mojo to fight back,” Moore says. “It should be a case of: ‘Right, we’ve built this magnificent social state, but actually, we need to roll our sleeves up and make money to protect and grow that’.”

Montanaro European Smaller Companies (MTE) is an option, with an incredibly strong 10-year record. Interestingly, 27 per cent of its portfolio is invested in the tech sector, against its benchmark’s 8 per cent. Carthew says: “Montanaro can boast one of the biggest teams, or maybe the biggest team, focused on this area. Its focus on quality growth should shine through again.”

For an open-ended option, Darius McDermott, managing director at FundCalibre, suggests **Janus Henderson European Smaller Companies (GB0007476426),** which “stands out from its peers”.

“Although it invests in growth companies, it also has a valuation tilt, something which is uncommon in the small-cap space,” he says. “The fund also targets companies at various points in the investment cycle, allowing the managers to diversify their revenue streams accordingly.”

Asian small caps can be tricky. There can be governance risks, it’s a huge and complex continent, and we don’t know what the effect of Trump’s tariffs will be, particularly in China.

On the other hand, these economies are more dynamic, and tailwinds at play include growing middle classes, urbanisation and younger populations. Smaller companies are a way to tap into those trends more directly.

Among the relevant investment trusts, **Fidelity Asian Values (FAS)** has a strong long-term track record, but Carthew notes that its overweight exposure to China has made the past year more difficult, and argues for **Abrdn Asia Focus (AAS)** instead.

Scottish Oriental Smaller Companies (SST) has done very well over the past five years and will be interesting to income seekers with its 4.8 per cent yield.

An open-ended option is **Fidelity Asian Smaller Companies (LU0702160192)**, which McDermott likes because it has “an experienced manager, a strong process, a great track record and [is] backed up by the infrastructure and research capability of a very capable fund house”.

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