



# VT Downing Small & Mid-Cap Income Fund

Took over sole management

April  
2021

Lead manager  
Josh McCathie

After joining as an analyst in 2018, Josh took over as lead manager of the VT Downing Small & Mid Cap Income Fund in April 2021. It is a focused 30-50 stock portfolio of small and mid-cap equities listed in the UK. The fund specifically invests outside of the FTSE 100, looking at companies from c. £100 million up to c. £4 billion market cap.

We asked Lead Manager, Josh McCathie why investors should consider UK small and mid-cap companies as a source of income.

## Small and mid-cap diversification benefits

Josh believes there is a greater and more diverse pool of interesting companies to choose from than those at the very top of the market spectrum. “Importantly, that exposure to small and mid cap income offers greater diversification benefits,” he says.

The majority of IA UK Equity Income sector is focused on large cap equities. “The top 15 dividend payers by absolute value account for 65% of all UK dividends, so naturally there is a concentration around these names,” he says. “These are drawn from industries largely perceived as low growth, such as banks, tobacco, oil & gas, and mining. Broadening the investment universe across the market cap spectrum not only offers diversification from those top 15 dividend payers, but also offers a greater mix of exciting industries.”

## Offering a total return approach

Josh acknowledges that the UK equity income sector is a crowded space and is keen to point out what differentiates this fund from peers.

“A benefit of focussing across the market spectrum allows the fund to take a more total return approach to investing and this is done by three approaches to income,” he says. “Firstly – core yield – what an investor would typically expect from an equity income fund. Those companies that offer a premium yield and a track record of sustainable inflation plus growth.”

“Secondly – income incubators – companies with a lower initial starting yield but are generating high returns on capital and accelerated earnings progression. Assuming that dividends will grow at an accelerated rate on the back of earnings progression and excess returns generated.”

The final point concerns ‘return compounders’ which Josh believes is the real sweet spot. “These businesses have a considerable starting yield but also earn high returns on invested capital that create a strong compounding affect from both strong earnings and dividend progression.”

He adds, “The blend of these three approaches to income generates not only an attractive yield but also a greater total return proposition which should grow income and capital in real terms.”

## The value hunt

Josh says another attractive feature of investing in this part of the market is the opportunity to buy companies at a discount.

“Further down the market cap spectrum the level of research and attention given to companies is considerably lower than their large cap counterparts,” he explains. “This creates inefficiencies that mean companies’ growth drivers and future returns aren’t fully appreciated. In turn, it creates the opportunities to invest in good businesses at discounts to intrinsic value that the fund can own over the long term.”

## A focused portfolio

The fund adopts a high conviction approach to income investing in a focused portfolio of 30-50 companies.

The rationale behind this lies in focussing the portfolio towards those best ideas that can compound returns over time. Josh explains, “Given the wider investment universe and unconstrained approach, the portfolio can be concentrated on those areas where we have competence and potentially an “edge” on our companies’ future successes. A focused portfolio offers the right balance of diversification and exposure to our best ideas.”

### For more information about the VT Downing Small & Mid Cap Income Fund

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