For professional investors only

25 years and counting: European Smaller Companies

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- **Smaller companies tend to have a bias towards growth over value – a key distinguishing feature of the asset class compared to large cap**
- **Europe has underperformed the US for a number of years, producing slower economic and profits growth – but it has started to outperform**
- **More than two decades has turned us into one of the largest small cap managers by assets in the market**

Columbia Threadneedle Investments is known for smaller company investment, and we are proud of it. In Europe, the European Smaller Companies strategy, which is our oldest strategy, marked its 25th birthday earlier this year in style: a return of more than 2,450% over two-and-a-half decades, way ahead of the benchmark index return of 650% (Figure 1)[1]. With such an illustrious history we feel we are well placed to answer some questions in the context of the current environment:

Why smaller companies?

Smaller companies tend to have a bias towards growth over value – a key distinguishing feature of the asset class compared to large cap. The logic is that it is easier to double your profits if your company earns €1 million than if it earns €1 billion. In style terms, small cap indices correlate better with growth indices than value indices, with greater weightings in technology and medical technology than traditional value sectors such as energy, utilities and banks.

As investors we need growth to keep returns expanding – over the long term, stock prices tend to follow earnings and profits; strong profits bring stronger share prices. Over shorter periods this doesn't always work. If growth becomes overvalued – rated at an excessive price-to-earnings multiple by the market, for example – there may be some correction. This happened in

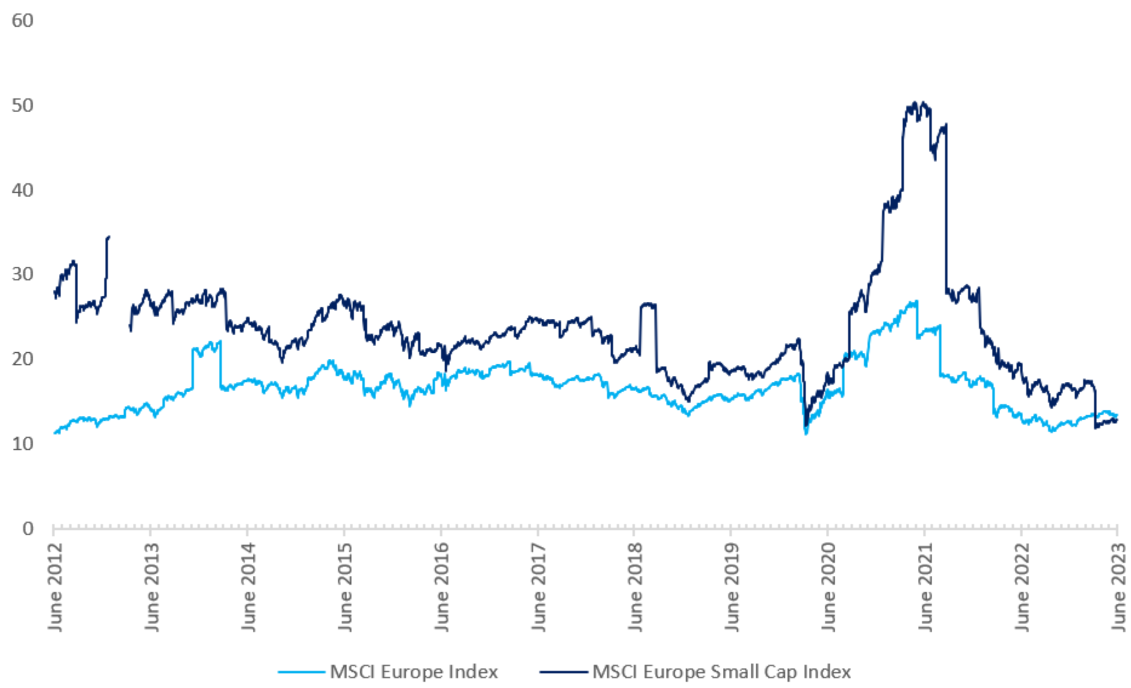
[1] Source: Columbia Threadneedle Investments and Factset, as at 31 March 2023. Past performance is not a guarantee of future returns

2022 as investors rotated away from growth to value, resetting the valuations of growth companies and small cap in particular.

The main reason for this was higher interest rates necessary to address inflation. Inflationary pressures came from supply chain bottlenecks and, most importantly, the effects of the Ukraine conflict – higher energy prices and shortages of key foodstuffs. Although there was an underlying impact on growth companies in operational and profit-and-loss terms, typically they were able to pass these costs on to their customers.

But the valuation impact was a key factor in market performance. The move to higher interest rates particularly affects companies where DCF (discounted cash flow) models are used to value long-term returns. These become less valuable if they are discounted at a higher rate. The market is effectively forced to become shorter term in mindset, no longer able to grant high valuations for long-term sustainable business models with repeatable predictable earnings. Figure 1 (below) illustrates the fall in European small cap valuations compared to European large cap.

Figure 1: on an absolute and relative P/E basis European small cap is again cheap



Source: Bloomberg, June 2023

Why Europe?

Europe has underperformed the US for a number of years, producing slower economic and profits growth. It has proved sensitive to the economic cycle and unhelpful external influences – fluctuating global trade, deglobalisation, the Covid pandemic and lockdowns, and the Ukraine war. But it has started to outperform – returns were ahead of the US in 2022 and this year has started well. Some of these sensitivities may well prove advantages – as China reopens its consumers are likely to buy more European consumer goods.

Many worry the world is now a different place. Ukraine and other issues brought an unwelcome dose of inflation and tighter monetary policies. So, what price Europe against this backdrop? The initial reaction was a setback. Ukraine is geographically close and Europe, with insufficient energy supplies, had to disentangle itself from Russian energy – a process which brought more costs and inflationary pressures than elsewhere.

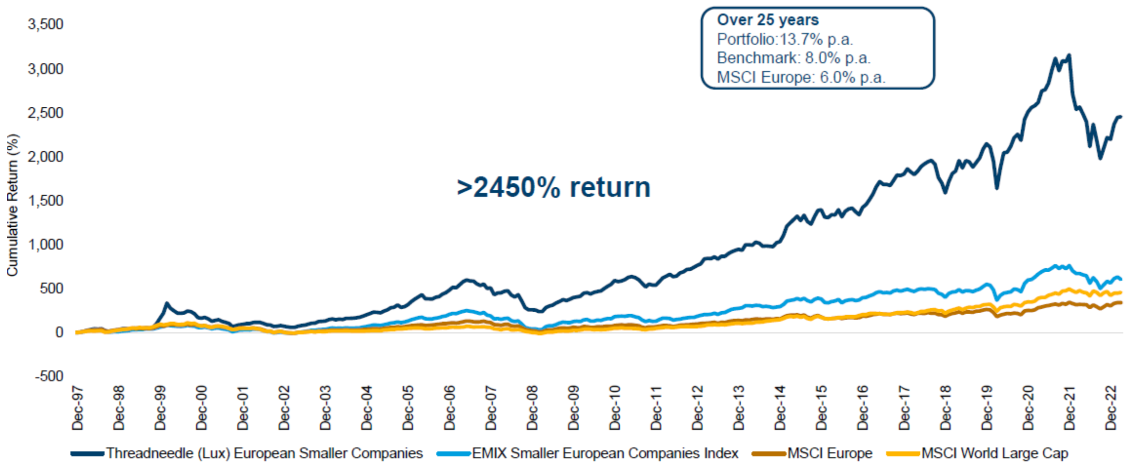
Europe has experienced a cost-of-living crisis and pressure on energy-intensive businesses – particularly those with limited pricing power, as they cannot pass on the extra costs and margins are squeezed, and those whose revenues or earnings are cyclical. But the disentanglement process is almost done and has proved remarkably successful. Gas and oil prices have reversed. If there is another inflationary squeeze it is more likely to be driven by wage-growth, and it is the US which has the tight labour market not Europe. So the Federal Reserve may come under more pressure than the European Central Bank (ECB).

Why Columbia Threadneedle for European smaller companies?

Successful work for our clients and a consistent dedicated approach over more than two decades has turned us into one of the largest small cap managers by assets in the market. But we cannot deny that the style trends in the market were unhelpful last year. Our contention is that this gives long-term investors a great entry point: our portfolio and companies are a whole lot cheaper than they were 18 months ago! The issue we faced is that interest rates have seen valuations take a knock, and the higher the valuation the harder the knock. So our portfolios – more expensive than the index, and deservedly so as we buy the best companies – derated by more than the index.

We have a bias towards quality – the best companies Europe has to offer. Why should this approach work so well now? In a higher-inflationary environment you need pricing power. In a higher interest rate environment, you need stronger balance sheets and earnings that can withstand interest costs. In a greener world you need greener products and services. Therefore, the factors key to our research are more important than before. We buy companies which are well financed and secure. Our green credentials come from strong MSCI fund ratings and a low carbon footprint – and funds such as our Threadneedle (Lux) European Smaller Companies fund are classified under SFDR (Sustainable Finance Disclosure Regulation) Article 8 for EU investors.

Figure 2: European Smaller Companies strategy: outperforming major indices



Source: Columbia Threadneedle Investments and Factset, as at 31 March 2023. >2,450% is cumulative returns since inception; 25-years figures are annualised. Past performance is not a guarantee of future returns. All data is geometric and is shown in EUR. Gross of fee fund returns are time weighted rates of return net of commissions, transactions costs and non-reclaimable taxes on dividends, interest, and capital gains using pricing of investments which is either the last traded price or a bid basis. Cash flows are factored as of the end of the day and exclude entry and exit charges. Index returns include capital gains and assume reinvestment of any income. The index does not include fees or charges and you cannot invest directly in it. The return of your investment may change as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation. Figures are that of a representative account. For illustrative purposes only and should not be considered an offer or solicitation to buy or sell. Inception date: 10 November 1997.

What the future holds

2022 saw a value rally at the expense of growth stocks, which has partly reversed in 2023. This saw the MSCI Small Cap Index produce a -23.3% total return in the six months to the end of June 2022 compared with -13.4% for the MSCI Europe Index[2]. The main sector in positive territory in both indices was energy, which is around double the proportion of large cap than small cap. This six-month period was the most damaging for us in terms of relative performance.

However, the problem is more closely linked to valuation methodologies. In the immediate future, our contention is that the picture looks brighter. Firstly, the impact of interest rate rises may well prove to be a one-off correction in valuation levels, much of which has already occurred. We are all getting used the fact that zero-cost money, nice though it may have been, was not sustainable – but that does not necessarily mean we will have super-high interest rates going forward. Long term, valuation levels follow earnings, and growth stocks, by definition, grow their earnings faster – they have just suffered as the value attached to these growing earnings has taken a knock.

There is perhaps another reason for optimism, at least in a relative sense. Many commentators believe a global recession looms, which is also borne out by our macroeconomic analysis and thinking. In a recession the riskier, less stable and more cyclical business models are likely to suffer disproportionately. Growth-type models, with more sustainable returns and less exposure to the economic cycle, are likely to stand up better and their earnings may well command a higher valuation because of this.

[2] Factset, as at June 2023

As such the outlook for growth stocks may well once again be more attractive. This will benefit smaller companies, which have a greater orientation towards that style than their larger peers. Our approach is arguably more exaggerated than that of the index. Our heavy use of Porter's Five Forces and focus on pricing power, economic moats and high-quality business models means we are more growth orientated even than the small cap index. Although this has translated – unfortunately but not unexpectedly – into disappointing relative returns over the 2022, a reversal of these trends, prompted by an end to the value rotation and an understanding that recession brings risks for fragile business models, may well benefit us.

Similar arguments can be made of the recent rise in inflation and its impacts on the market. Higher inflation has been disruptive in the short term, hurting economies and some business models. It is a major cause of higher interest rates. Its impact on value stocks will be more painful than for growth stocks, and more specifically the type of growth stocks that we hold.

Our long focus on pricing power and its advantages is even more important in the current macroeconomic environment. If we can find such companies, they can pass on any increasing raw material and production costs to their customers with little adverse impact. Value stocks unable to pass on higher costs to their customers (via higher prices) will squeeze margins, just as higher interest rates bite.

Finally, the small cap market has been here before and recovered. In 2013 the value rally was prompted by the ECB promising to "do what it must" to defend the euro. In 2016 the value rally was prompted by Brexit and the expectation that the surprising election of Donald Trump would reflate. On both occasions the rally petered out and our relative performance got back on track.

This time the rotation has been more savage, but the likelihood of a recession – prompting renewed interest in high-quality business models – means it may well not continue. Q1 has already seen some reversion to quality, and some repair of our underperformance.

Threadneedle Europe ex UK Small Cap Composite

GIPS Report

Columbia Threadneedle Investments EMEA APAC

Reporting Currency: USD

Statement of Performance Results

Calendar Year	Gross-of-fees Return (%)	Net-of-fees Return (%)	Index Return (%)	Composite 3-Yr St Dev (%)	Index 3-Yr St Dev (%)	Internal Dispersion (%)	Number of Portfolios	Total Composite Assets (mil.)	Total Firm Assets (bil.)
2022	-33.98	-34.55	-26.40	26.03	26.52	N.A.	≤ 5	1,847.9	114.86
2021	16.00	15.03	14.33	20.13	22.26	N.A.	≤ 5	3,217.0	161.32
2020	26.50	25.87	22.68	21.17	22.95	N.A.	≤ 5	3,004.3	149.82
2019	30.73	30.09	25.47	13.87	13.30	N.A.	≤ 5	2,762.0	140.52
2018	-15.44	-15.87	-17.79	14.10	14.51	N.A.	≤ 5	2,447.4	121.83
2017	42.23	41.54	34.97	13.11	13.50	N.A.	≤ 5	3,049.1	147.49
2016	-1.25	-1.74	3.38	13.88	14.64	N.A.	≤ 5	1,868.5	130.04
2015	18.33	17.75	10.80	12.12	14.53	N.A.	≤ 5	2,051.8	141.34
2014	-4.75	-5.22	-7.63	13.19	17.36	N.A.	≤ 5	1,622.5	148.22
2013	26.58	25.96	40.07	16.49	21.84	N.A.	≤ 5	2,268.8	147.97

Annualised Trailing Performance as of 31 December 2022

Period	Gross-of-fees Return (%)	Net-of-fees Return (%)	Index Return (%)
1 Year	-33.98	-34.55	-26.40
5 Years	1.38	0.73	1.27
10 Years	7.93	7.32	7.85
Inception	10.14	9.56	6.98

Inception Date: 31 December 1999

1. Columbia Threadneedle Investments EMEA APAC 'the Firm' claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS Standards. Columbia Threadneedle Investments EMEA APAC has been independently verified by Ernst & Young LLP for the periods 1st January 2000 to 31st December 2021. The verification reports are available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

2. The 'Firm' is defined as all portfolios managed by Columbia Threadneedle Investments EMEA APAC (prior to 1 January 2021, the firm was known as Threadneedle Asset Management) which includes Threadneedle Asset Management Limited, (TAML), Threadneedle International Limited, (TINTL), Threadneedle Investments Singapore (Pte.) Limited, (TIS), and Threadneedle Management Luxembourg S.A. (TMLSA), excluding directly invested property portfolios. The firm definition was expanded in 2015 to include portfolios managed by then newly established affiliates of Threadneedle Asset Management in Singapore. TAML & TINTL are authorised and regulated in the UK by the Financial Conduct Authority (FCA). TINTL is also registered as an investment adviser with the U.S. Securities and Exchange Commission and as a Commodities Trading Advisor with the U.S. Commodity Futures Trading Commission. TIS is regulated in Singapore by the Monetary Authority of Singapore. TMLSA is authorised and regulated in Luxembourg by the Commission de Surveillance du Secteur Financier (CSSF). On 1 July 2020, Threadneedle Asset Management Malaysia Sdn. Bhd (TAMM) was removed from the firm. Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies. Beginning 30 March 2015, the Columbia and Threadneedle group of companies, which includes multiple separate and distinct GIPS-compliant firms, began using the global offering brand Columbia Threadneedle Investments.

3. The strategy invests in shares of companies based in Continental Europe or that have significant operations there. The companies that the strategy invests in (at the time of purchase) will typically be outside the largest 300 companies in Europe (as measured by free market capitalisation). Derivative instruments may be used for efficient portfolio management and currency management. The primary use of derivatives is not designed to create a highly leveraged investment position. The composite was created June 30, 2006.

4. The gross-of-fees returns are time-weighted rates of return with cash flows at the end of the day. Returns reflect the reinvestment of dividends and other earnings and are net of commissions and other transaction costs. Composite returns are calculated by using underlying portfolio beginning of period weights and monthly returns. Periodic returns are geometrically linked to produce longer period returns. Net of fee returns are calculated by deducting the representative fee from the monthly gross return. Prior to 30th Sept 2022 the gross returns were calculated using daily authorised global close valuations with cash flows at start of the day, and were shown before management and custodian fees but after the deduction of trading expenses. Policies for valuing investments, calculating performance, and preparing GIPS Reports, as well as the list of composite descriptions, list of pooled fund descriptions for limited distribution pooled funds, and the list of broad distribution pooled funds are available upon request.

5. The dispersion of annual returns is measured by the equal weighted standard deviation of portfolio returns represented within the composite for the full year. Dispersion is only shown in instances where there are six or more portfolios throughout the entire reporting period. The Standard Deviation will not be presented unless there is 36 months of monthly return data available.

6. The three-year annualised ex-post standard deviation measures the variability of the gross-of-fees composite and benchmark returns over the preceding 36-month period.

7. The following fee schedule represents the current representative fee schedule for institutional clients seeking investment management services in the designated strategy: 0.85% on the first £50m; 0.75% on the next £100m; 0.65% on the next £350m; 0.6% thereafter. Gross of fee performance information does not reflect the deduction of management fees. The following statement demonstrates, with a hypothetical example, the compound effect fees have on investment return: If a portfolio's annual rate of return is 10% for 5 years and the annual management fee is 85 basis points, the gross total 5-year return would be 61.1% and the 5-year return net of fees would be 54.3%.

8. The benchmark for this composite is the EMIX Smaller European Companies Ex UK Index from Oct. 03 - (SSB Europe Extended Index (£) prior to this date), the change being made as the EMIX Smaller European Companies ex UK index better reflected the strategy's investment approach. The EMIX Smaller European Index Series covers smaller sized companies from Developed Europe (ex UK). Companies are selected on both size and liquidity criteria, ensuring that the smaller companies are no less liquid than the least liquid larger companies. Index returns reflect the reinvestment of dividends and other earnings and are not covered by the report of the independent verifiers.

9. Past performance is no guarantee of future results and there is the possibility of loss of value. There can be no assurance that an investment objective will be met or that return expectations will be achieved. Care should be used when comparing these results to those published by other investment advisers, other investment vehicles and unmanaged indices due to possible differences in calculation methods.

10. Prior to 31st March 2022 the composite was known as Threadneedle Europe ex UK Eq Small Co Composite. This was a name change only.

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