# European smaller companies

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- **Higher interest rates have hampered the share price performance of growing smaller companies. But interest rates have not necessarily impacted operating performance of these companies**
- **Inflation is falling, interest rates are peaking, and corporate earnings are growing – making small cap valuations attractive**
- **This supports renewed outperformance where companies demonstrate quality and growth**

Interest rates and the cost of capital are key to the performance of growing smaller companies. Most investors buy smaller companies for growth, not for value. There are several reasons for this, including:

- The risks of buying a lower growth model at a cheap valuation are higher in smaller companies
- Balance sheets are more vulnerable
- Business models are more focused and less diversified
- Liquidity is a challenge, so investors may find selling the shares expensive or difficult to execute if bad news breaks

This means it is safer to focus on quality and growth, buying reliable business models with sustainable and repeatable earnings, and ultimately strong growth. The trade-off is that such companies command higher valuations.

These factors are always important, but become more so when interest rates are high, and when the economic background deteriorates.

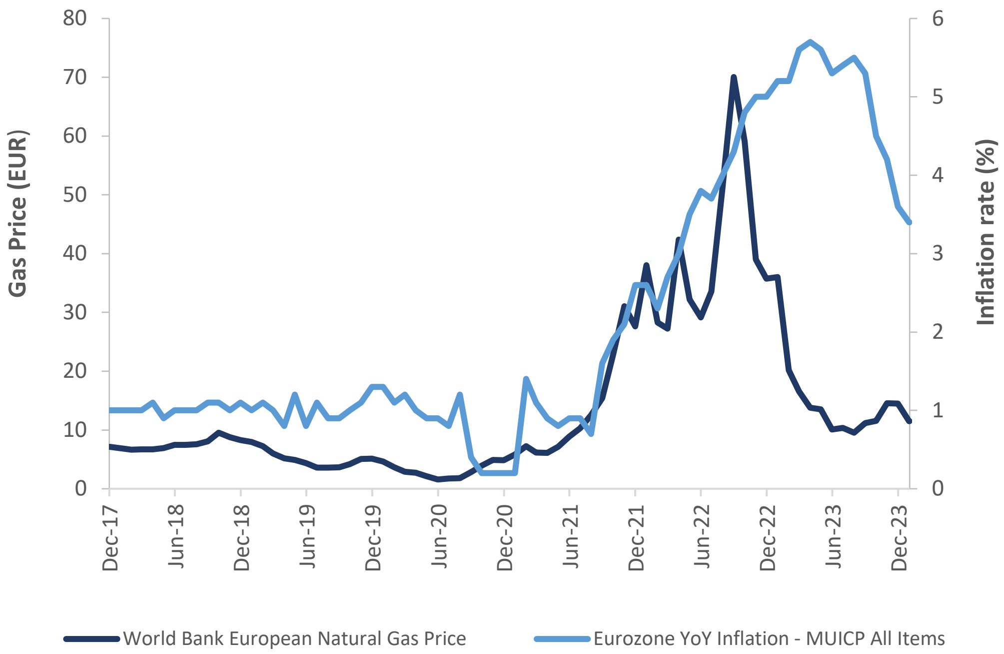
Growth companies are typically valued using discounted cash flow (DCF) models, where interest rate assumptions are an integral part of the equation. Put simply, a DCF model values the future stream of cash earnings, discounting the value of later earnings using interest rates. Higher interest rates mean future profits below those earned currently. A previously highly valued stream of long-term returns is worth less if discounted at a higher rate.

The past two years have seen increases in interest rates, driven by inflation. As restrictions from the Covid-19 pandemic were relaxed and demand picked up, supply chains came under pressure, boosting inflationary pressures. This was exacerbated by the Ukraine war as oil and gas prices surged and western nations sought energy independence from Russia. The long era of low inflation and low rates came to an end. Supply chains have since adjusted, but in addition to a prolonged stand-off with Russia, new threats have appeared – the conflict in Israel and Gaza, spilling over into Red Sea attacks and further issues with Iran and its allies, in addition to tensions with China over Taiwan. We see a trend against globalisation (near/onshoring), and towards greater government stimulus.

Central banks initially underestimated the inflation problem and had to quickly raise rates to reflect the new risks. Now, despite the geopolitical uncertainty, the trend towards higher interest rates may be over.

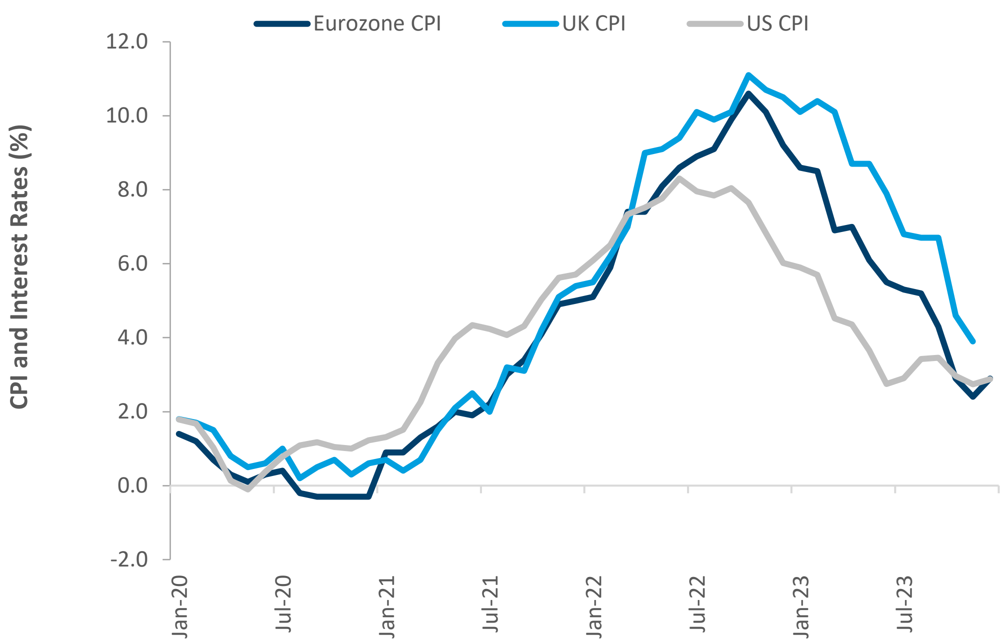
In Europe natural gas prices drove inflation higher than in the US. The recent fall in the gas price should bring lower inflation in Europe (Figures 1 and 2), and a peak in rates.

Figure 1: European gas prices have peaked and inflation is now falling




Source: Bloomberg, December 2023

Figure 2: European inflation is now falling




Source: Bloomberg, December 2023

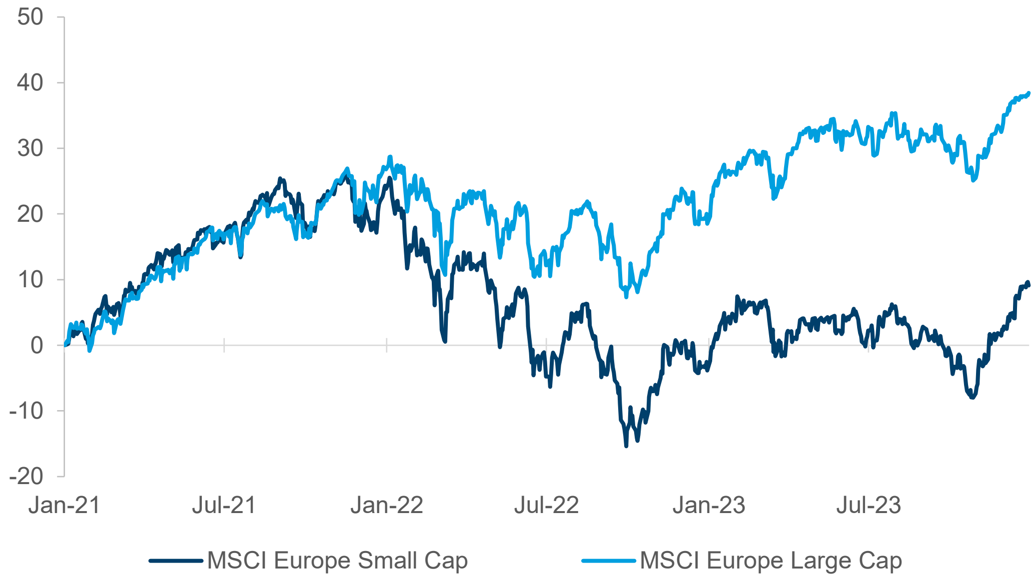
Eurozone GDP stagnated over 2023. Higher inflation and interest rates were a major cause, impacting capital investment and consumer confidence. High inflation meant disposable income was more stretched, while higher interest rates pushed up mortgage and rent costs. Consumers and businesses therefore tightened their belts. If interest rates have peaked, while this austerity may not reverse quickly, we have probably reached the low point.

Counter-intuitively, lower growth is good for growth stocks – just so long as the company can continue to expand, bucking the slowing trend in the wider economy. This may be tough to achieve, but if it is the company will price at a premium – first as its growth is rarer and second because weakening economic growth is likely to prompt lower interest rates, boosting DCF valuations. If we can find companies which are withstanding higher interest rates – i.e., where the impact has been on valuations alone and not the underlying business – they are good investments, and the setback has created an interesting buying opportunity.

### Smaller company performance versus large

Over the past three years, smaller companies have underperformed large cap (Figure 3). They came under greater pressure owing to their growth orientation, as well as a lower representation in the sectors that benefited from the changed environment – oil stocks (a beneficiary of higher prices) and banks (greater interest margins). Weakness in markets has a greater effect on smaller company share prices compared with larger companies, as asset allocators moved to underweight a perceived riskier or more volatile asset class. If oil prices, inflation and interest rates have peaked, this perfect storm may well have blown over.

Figure 3: Cumulative returns of MSCI Large Cap and Small Cap indices

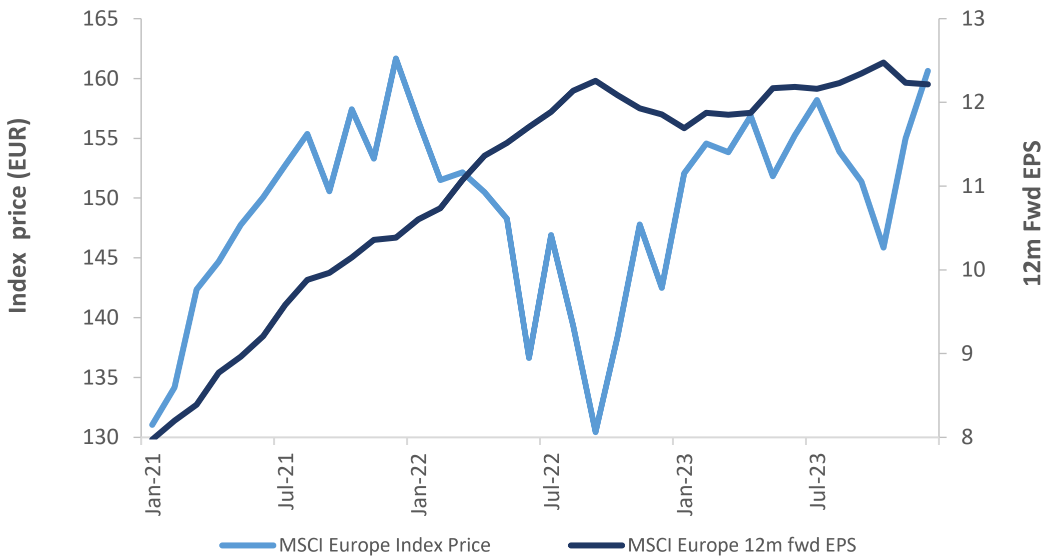



Source: Bloomberg, December 2023

### Valuations

Despite the weak economic backdrop and geopolitical volatility, eurozone earnings per share revisions were positive through 2023 (Figure 4). Europe now looks attractively valued, particularly compared to the US. Smaller companies will benefit from this as much as their larger counterparts.

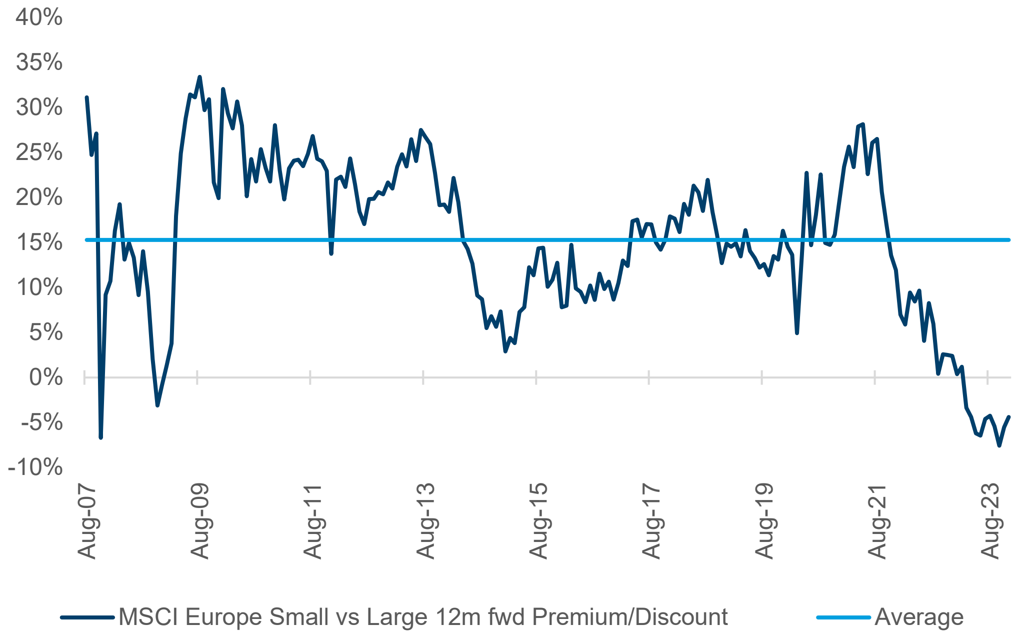
Figure 4: European earnings continue to see upgrades




Source: Bloomberg, December 2023

As performance has lagged large caps, smaller companies in Europe are looking more interesting in relative valuation terms than at any point since the global financial crisis (Figure 5).

Figure 5: European small cap is trading at a discount for the first time since the GFC

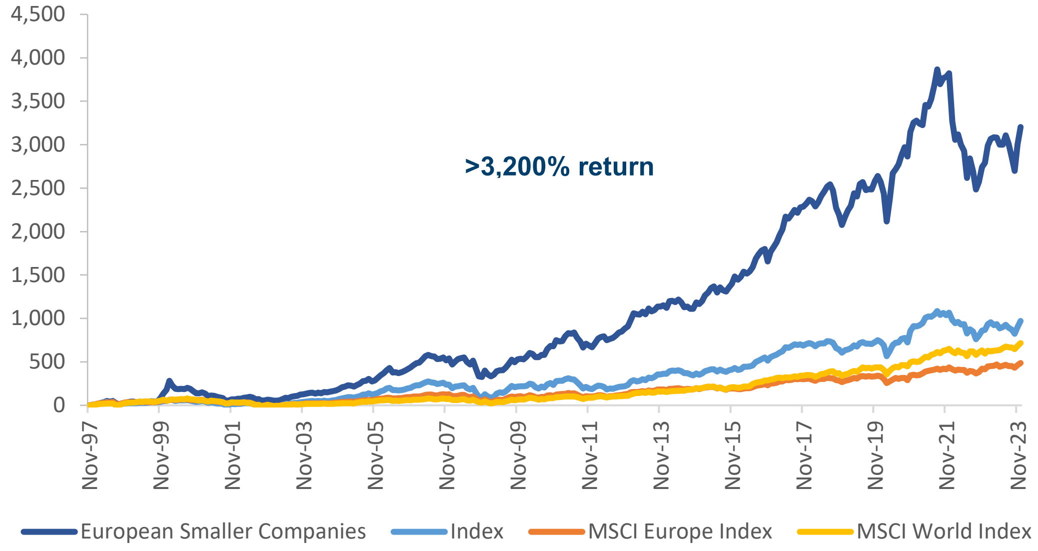



Source: Bloomberg, December 2023

### Columbia Threadneedle Investments performance

Our smaller company team has an enviable long-term track record. The performance of our European smaller companies strategy, which celebrated its 25-year anniversary in 2022, is illustrated in Figure 6.

Figure 6: Long-term outperformance of European smaller companies strategy




Source: Columbia Threadneedle Investments and Factset, as at 31 December 2023. >3,200% is cumulative returns since inception. 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.

As discussed, 2022 was a perfect storm – and our portfolios were not immune. While many of our companies registered successes operationally, valuations took a knock. Our strategy of playing to the strengths of smaller companies, buying companies with sustainable and predictable business models generating high and growing returns, was worse hit than the index.

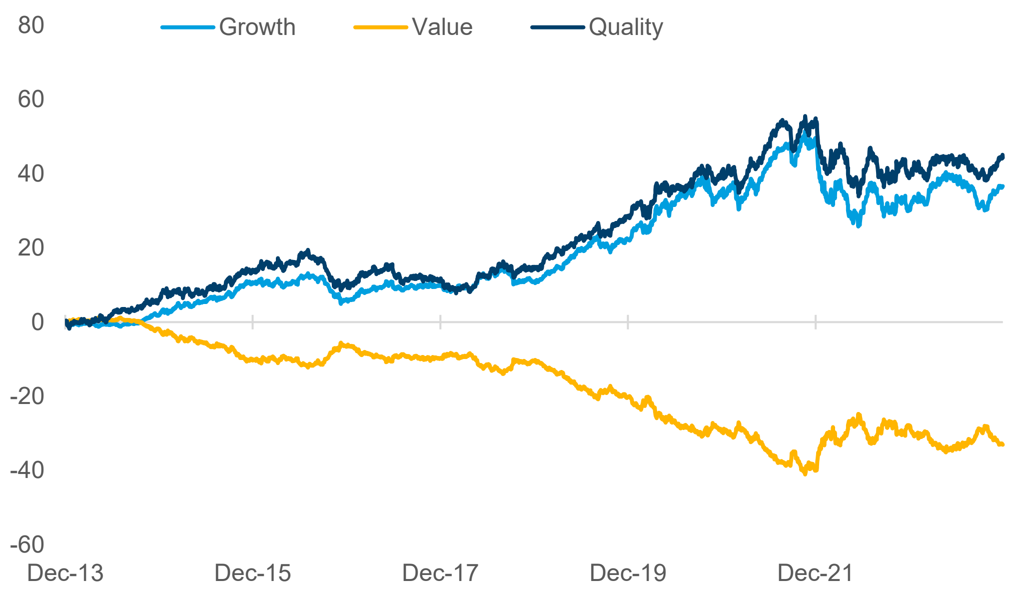
But our contention is that the storm is over. The macroeconomic environment may return at least partially to previous trends, growth may once again warrant superior valuations, and high-quality companies regain their premium status.

We have not been inactive in light of a changing market environment. Our process has always been flexible, playing to the strengths of individual members and the team. We now use extra rigour to reassess companies where bad news may have prompted share price falls. We work alongside large cap colleagues who have detailed knowledge of industries and companies in Continental Europe. We also work with our industry-leading UK equity team who help us identify the very best in that market. Increasingly, we work with an in-house team of specialists providing leading research on the largest sectors in the market where a global perspective is important. Our contact with these teams is deeper and the teams bigger than they were before, making these resources even more valuable in our quest to achieve the best for client portfolios.

**Outlook**

We continue to focus on higher quality, growing businesses which can thrive whatever the macroeconomic backdrop. Higher interest rates – and thus discount rates – mean we must be ever more critical of valuations of such stocks.

Figure 7: Quality outperforms growth and value over the longer term




Source: Bloomberg, December 2023. Price return of MSCI Europe style indices normalised against MSCI Europe Index.

We remain cautiously optimistic; valuations are attractive in both absolute and relative terms, and quality is back in favour - falling inflation and peaking interest rates will benefit our small cap portfolios.

# 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.) |
|---|---|---|---|---|---|---|---|---|---|
| 2023 | 21.06 | 20.05 | 17.55 | 23.57 | 21.68 | N.A. | ≤ 5 | 1,937.5 | 122.45 |
| 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 |

**Annualized Trailing Performance as of December 31, 2023**

| Period | Gross-of-fees Return (%) | Net-of-fees Return (%) | Index Return (%) |
|---|---|---|---|
| 1 Year | 21.06 | 20.05 | 17.55 |
| 5 Years | 8.92 | 8.15 | 8.77 |
| 10 Years | 7.45 | 6.81 | 5.98 |
| Inception | 10.58 | 9.98 | 7.40 |

Inception Date: December 31, 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 2022. 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.

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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. Returns are calculated net of non-reclaimable withholding taxes on dividends, interest, and capital gains and are shown before management and custodian fees but after the deduction of trading expenses. 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. Returns were gross of withholding tax. 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 is the MSCI Europe ex UK Small Cap Index. Prior to 30th July 2023 it was the EMIX Smaller European Companies Ex UK Index, the change being made as EMIX decommissioned its indices. The MSCI Europe ex UK Small Cap Index captures small cap representation across 14 Developed Markets (DM) countries in Europe. With 732 constituents, the index covers approximately 14% of the free float-adjusted market capitalization across European Developed Markets excluding the UK. 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.

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