As the Smaller Companies sector strengthens, Standard Life's Ruairi McDonald explores the outlook for the asset class

Ruairi McDonald, Investment Development Manager, Standard Life

The environment of high interest rates and inflation has led to a particularly challenging period for smaller companies. It's a sector of the equity market that has been unloved by investors – a small wonder given the investment returns experienced from a highly concentrated large-cap market over the past number of years!

Why do higher interest rates affect smaller companies? Smaller companies, as an asset class, typically have higher debt than their large-cap counterparts, making them adversely exposed to the higher-for-longer interest rate environments globally. The market view is that the impact of higher interest rates is felt greater by smaller companies in terms of obtaining credit and servicing existing debt than it is by mid and large-cap companies.

How are Standard Life's actively managed Smaller Companies Funds managed?

The investment process underpinning the funds is long established and focuses on three key areas when selecting companies:

1. Focus on **quality** to enhance return and reduce risk, e.g. companies with good margins & return on capital, attractive industry characteristics, sustainable competitive advantages, strong balance sheets, management pedigree, execution and track record, and ESG.
2. Look for sustainable **growth**, e.g., – companies with profitable growth, market share gains, ability to expand margins, ability expanding into new markets.
3. **Momentum** – run your winners and cut your losers.

The funds intentionally avoid investing in small-cap companies that are highly indebted, loss making, deeply cyclical and speculative.

Underlying small-cap company fundamentals have largely been ignored over the past three years. So, the focus on quality, growth and momentum has been challenged, as you can see from the performance of the Global and European Smaller Companies funds – the two most popular of the three actively managed funds that we offer.

Source: FE fund info, October 2024. Performance is net of annual management charge. **Past performance is not a reliable guide to future.**

What's the outlook for the smaller companies funds?

We have seen a strong recovery across the funds from early November 2023, but volatility did begin to resurface in August and September.

Despite recent volatility, the funds have once again started to outperform their respective benchmarks.

Source: FE fund info, October 2024. Performance is net of annual management charge. **Past performance is not a reliable guide to future.**

The monetary policies of global central banks are changing, and interest rates are now trending on a downward trajectory. The ECB started reducing rates earlier this year and is likely to reduce rates further. The US Federal Reserve has begun its cutting cycle. The extent to which the Fed cuts rates remains unclear as employment remains strong and the likelihood of a soft landing (raising interest rates to reduce inflation without causing a recession) remains intact, so far.

While risks remain for small caps, and equity markets in general, the outlook is brighter for smaller companies. Let's take a look at the European and Global Smaller Companies Funds.

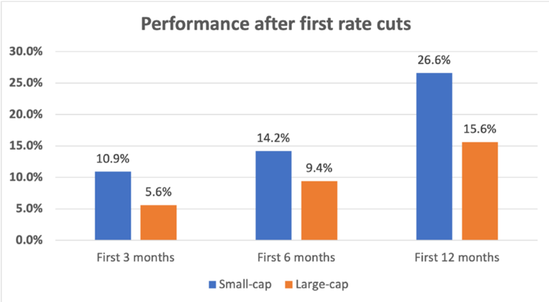
Let's look at Europe

Several factors have driven the medium-term underperformance of small caps, but higher interest rates have been a key factor. The worsening European economic picture has also weighed on the asset class.

...but could rate cuts spur a comeback?

Falling inflation and slowing growth allowed the European Central Bank to cut interest rates in October from 3.50% to 3.25%. Will this be a catalyst for small-cap outperformance? It's too early to tell – but, over the past 11 months or so, the fund is ahead of its benchmark.

Historical data is supportive. The following chart shows the performance of US small and large caps after three, six and 12 months following a rate cut. The outperformance is clear. True, this data only refers to US equities, but abrdn believe there are enough similarities with their European counterparts to draw similar conclusions.



Source: abrdn, Federal Reserve Board, Haver Analytics, Centre for Research in Security Prices. The Chicago Booth School of Business, Jeffries, William Blair, as of 31 October 2023. **Past performance is not a reliable guide to future.**

Setting expectations in US small caps

US economic growth has shown much greater resilience than Europe, benefiting from easing supply chain pressures, lower energy costs, and increased productivity. However, tighter credit conditions and reduced household savings have tempered this growth, balancing the likelihood between a soft landing and a mild recession as inflation moderates.

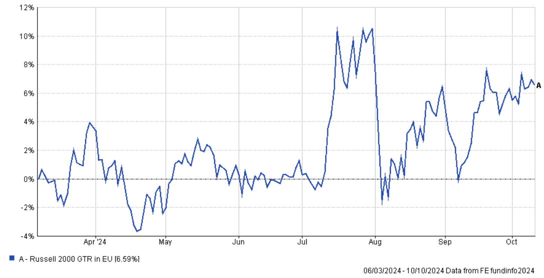
Regarding the markets, small caps have struggled to capture investor attention amidst the continued dominance of large cap growth stocks. While the initiation of a new Fed rate cut cycle may offer some support, sustained outperformance by small caps will hinge on avoiding a recession and bolstering positive underlying fundamentals within smaller companies.

Historically, small cap stocks have posted average returns of 14% and 27% over the six-month and one-year periods following the first rate cut. Large cap stocks have yielded returns of 9% and 16% over the same periods.

Against this backdrop, abrdn believe the outlook for small cap stocks remains positive for several reasons:

- Small cap stocks trade at a significant discount compared to their larger counterparts. They expect a broadening out of the market away from the Magnificent Seven as investors grow more confident in the direction of the Fed's rate policy.

We witnessed an aggressive bounce back earlier in the year for US Small Caps, as witnessed in the chart of the Russell 2000, as the US Federal Reserve signalled interest rates will start to fall. Fears around a slowing US economy in early August and again in September, eroded these gains. But they have bounced back.



Source: FE fund info, October 2024

- Corporate balance sheets are flush with cash, often triggering merger and acquisition activity, with smaller companies historically benefiting.
- Higher-quality companies continue to be inexpensive relative to lower-quality companies, which is a core investment tenant of the actively managed smaller companies funds.

Final thoughts

History shows that small caps outperform large caps when central banks start to cut rates. Valuations are also historically attractive, while growth as an investment style, looks inexpensive.

We recently launched the **Vanguard Global Small-Cap Index Fund** as an investment choice, bringing our small companies range of funds to four - three actively managed funds and one passively managed, index-tracking fund. Details of this new addition can be found on our adviser website.

Please keep an eye out for an invite to our Smaller Companies webinar on the 28th of November at 10am. We will be joined by Andrew Paisley, Head of Smaller Companies with abrdn, who will provide a detailed overview and outlook for the Smaller Companies Funds.

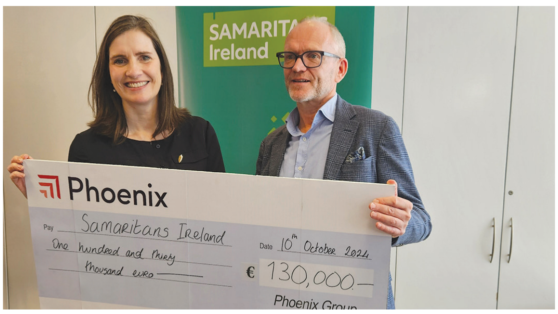
Standard Life raises €130,000 for Samaritans Ireland

FOLLOWING 18 months of fundraising, staff at Standard Life have raised over €130,000 for Samaritans Ireland, one of Ireland's leading mental health charities. Staff rallied together to complete personal challenges, host golf tournaments, food meals and important mental health workshops. Sarah O'Toole, Executive Director at Samaritans Ireland thanked Standard Life for their incredible contribution, as the cheque was handed over on World Mental Health Day.

"This donation is key to ensuring we achieve our vision of fewer lives being lost to suicide." Samaritans volunteers answer over 400,000 calls and emails a year from people who are feeling suicidal or just struggling to cope with everyday issues, like loneliness, mental health issues, relationship problems. This partnership with Standard Life also highlights the incredible work companies are doing to promote positive mental health and wellbeing and to raise awareness of our service."

Standard Life's partnership with Samaritans Ireland is central to the company's mission to help people secure a life of possibilities. Reflecting on the partnership, Nigel Dunne, CEO Standard Life, "*People across Ireland are affected by suicide and mental health issues on a daily basis. As a company, we really wanted to support a cause which is at the heart of communities nationwide. "We are delighted to support Samaritans and the lifesaving work it does and want to encourage anyone in need to reach out for support if they need help."*

Samaritans operates a 24-hour freephone helpline for anyone in need of emotional support on 116 123 or email jo@samaritans.ie



Nigel Dunne, CEO Standard Life International, proudly delivers a cheque for €130,000 to Sarah O' Toole, Samaritans Ireland.