Investment companies | July 2024

US SMALL-CAP EQUITIES
TIME TO SHINE?

THEMES

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

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EDISON

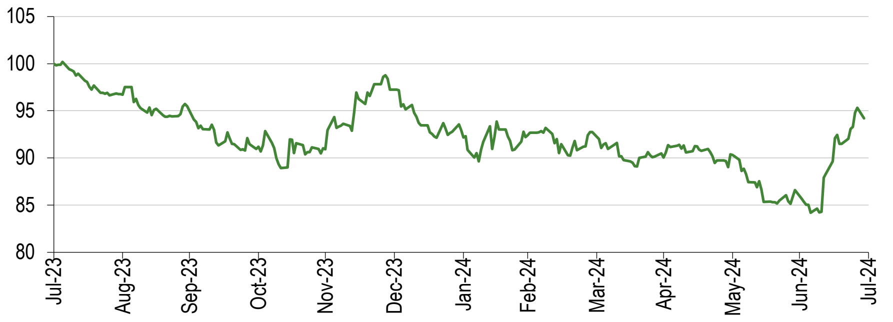
US small-cap equities

Time to shine?

31 July 2024

In this report we consider whether the recent move into US smaller-cap stocks is sustainable. The valuations of these companies are certainly more attractive than those of larger-cap businesses, but valuation alone is not a catalyst for a shift in stock market leadership. However, we see potential for a re-rating of small-cap stocks if there is a reduction in US interest rates. For investors interested in gaining exposure to US small-cap companies, we highlight two specific North American smaller company funds and four global smaller company funds with meaningful US exposure. We also highlight examples of listed private equity firms which could, to some degree, be supported by lower US interest rates and higher US small-cap share prices.

Is there a change in market leadership? Performance of US 2000 SMID-cap index/US 1000 large-cap index over the last 12 months



Source: LSEG Data & Analytics, Edison Investment Research

Will US SMID-cap momentum continue?

US smaller-cap stocks have been out of favour with investors, with mega-cap technology stocks, in particular, making the headlines. In 2023 the share prices of the so-called 'magnificent seven' – Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA and Tesla – rose on average by more than 100%. The positive trend has largely continued into 2024, supported by further gains in artificial intelligence-related stocks and the increasing appeal of passive funds, whose inflows fuel further gains in the largest stocks in a rising market.

While the US 1000 index is still ahead of the US 2000 index in the year to date, in the five trading days between 9 July and 16 July, there was a significant c 9.5pp performance differential between the two indices in favour of smaller-cap stocks, and this momentum has continued. The catalyst for the change in market leadership was weaker-than-expected US inflation data, prompting an increase in the probability of a September 2024 interest rate cut as measured by the CME FedWatch tool. A successful bid by Donald Trump for a second term in office could also be considered a positive for small-cap stocks given his 'pro-business' stance and the potential for lower taxes and decreased regulation. However, his lead in the polls has narrowed following President Joe Biden stepping down, paving the way for much younger Vice-President Kamala Harris to fight for the Democrats to remain in the White House.

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Companies featured in this report

Brown Advisory US Smaller Companies (BASC)
JPMorgan US Smaller Companies (JUSC)
Edinburgh Worldwide (EWI)
Herald Investment Trust (HRI)
Smithson Investment Trust (SSON)
The Global Smaller Companies Trust (GSCT)
APAX Global Alpha (APAX)
ICG Enterprise Trust (ICGT)
HarbourVest Global Private Equity (HVPE)
NB Private Equity (NBPE)
Pantheon International (PIN)
Partners Group Private Equity (PEY)*

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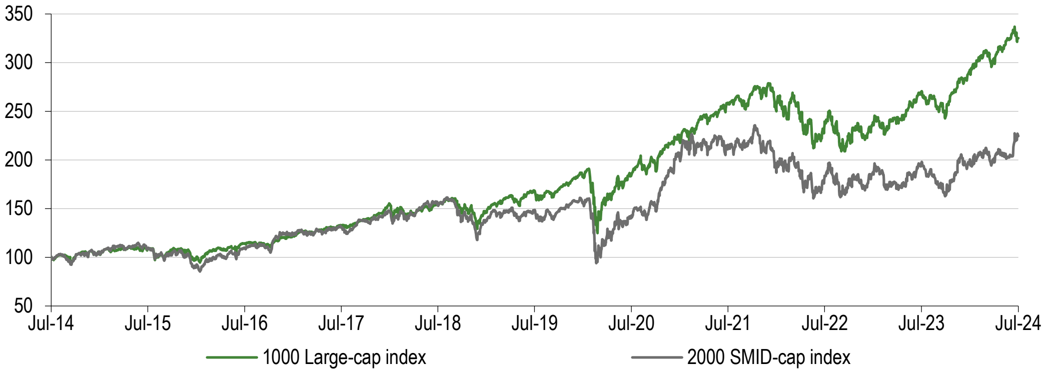
The US stock market backdrop

The US 2000 SMID-cap index has trailed the US 1000 large-cap index for most of the year, continuing the longer-term trend of underperformance, which started in Q121, a year before the US Federal Reserve started raising interest rates. However, smaller stocks have performed relatively better since early July 2024, which coincided with cooler US inflation data, leading to increased hopes of lower US interest rates. Also, investor expectations are high for US mega-cap technology stocks given how well they have performed, so any earnings or guidance shortfall is likely to put pressure on US large-cap indices.

Exhibit 1: Performance of US indices (last 10 years, rebased)



Source: LSEG Data & Analytics, Edison Investment Research. Note: At 29 July 2024.

Lower interest rates typically have a larger benefit to smaller-cap businesses, as their prospects are more likely to be tied to the strength of the US domestic economy, and lower rates generally result in higher investor risk appetite, which benefits small-cap equities. Looking at the US stock market and the largest 3,000 listed companies, the top 1,000 make up 95% of the total value, with the next 2,000 worth less than Apple, which is the number one listed US company, with a market cap of $3.3tn. Therefore, even a moderate re-allocation away from US large/mega caps into small caps may have a significant impact on small-cap companies' share price performance. In addition, a lower cost of capital could lead to an uptick in M&A due to increased appetite for smaller US firms, either from larger corporations or private equity buyers.

While a second term in office for Trump, who considers himself pro-business, could see higher tariffs on imported goods due to the US-China trade tensions, negatively affecting corporate profits, these should have a disproportionate effect on larger businesses. Meanwhile the prospects for corporate tax cuts and deregulation could provide a boost to the broad US equity universe.

Valuation: Small cap-shares look relatively attractive

Analysts are debating whether the change in market leadership is sustainable – will smaller-cap companies continue to outperform, or will investors return to their preference for large-caps stocks, particularly the mega-cap technology names? Valuations certainly add to the case for smaller companies. As shown in Exhibit 2, large-cap US companies look considerably less attractive in terms of forward P/E, price-to-book and price-to-sales multiples, while offering a lower dividend yield. It should be noted that although growth expectations for 2024 favour large-cap stocks, looking at 2025 estimates, small- and mid-cap stocks are expected to generate superior earnings growth versus large-cap stocks.

Exhibit 2: Valuation of S&P indices at 30 June 2024

Index	Forward P/E (x)	Price-to-book (x)	Price-to-sales (x)	Dividend yield (%)
S&P 500 (large cap)	21.1	4.8	2.8	1.4
S&P 400 (mid-cap)	15.2	2.5	1.4	1.6
S&P 600 (small cap)	14.5	1.8	1.0	1.9

Source: SPGlobal

Selected closed-end funds with US small-cap exposure

In Exhibit 3, we show the two members of the AIC North American Smaller Companies sector along with the four out of five funds in the Global Smaller Companies sector that have a meaningful exposure to US small-cap stocks. Given the different strategies employed by the six funds, a comparison between their NAV total returns is not straightforward. On a superficial level, except for the last 12 months, JPMorgan US Smaller Companies has delivered the highest returns. In an environment of heightened investor risk aversion, all five of the companies are trading at a discount. Any narrowing of the discounts amid improved sentiment towards US small-cap stocks, coupled with gearing, which is employed by some of the trusts, could amplify their potential returns.

Exhibit 3: Selected funds with US small-cap exposure at 25 July 2024*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
North American Smaller Companies										
Brown Advisory US Smaller Cos	159.0	4.6	(3.0)	25.3	126.2	(11.4)	1.0	No	100	0.0
JPMorgan US Smaller Companies	268.4	5.0	5.1	35.2	206.2	(5.1)	0.9	No	104	0.7
Average	**213.7**	**4.8**	**1.1**	**30.2**	**166.2**	**(8.2)**	**1.0**		**102**	**0.3**
Global Smaller Companies										
Edinburgh Worldwide	593.2	(9.7)	(49.4)	(13.8)	113.5	(8.3)	0.7	No	113	0.0
Herald Investment Trust	1,170.3	17.5	(6.6)	56.0	213.0	(11.6)	1.1	No	100	0.0
Smithson Investment Trust	2,004.8	0.4	(12.8)	29.4		(11.8)	0.9	No	100	0.0
The Global Smaller Companies Trust	789.3	9.8	4.1	30.7	136.1	(9.1)	0.8	No	105	1.7
Average	**1,139.4**	**4.5**	**(16.2)**	**25.6**	**154.2**	**(10.2)**	**0.9**		**104**	**0.4**

Source: Morningstar, Edison Investment Research. Note: *Performance at 24 July 2024 based on ex-par NAV. TR, total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

Brown Advisory US Smaller Companies (BASC) aims to achieve long-term capital growth by investing in a diversified portfolio primarily of quoted US smaller and medium-sized companies. The trust's managers seek undervalued businesses with the following attributes: durable growth; sound governance; and scalable go-to-market strategies. BASC's portfolio has a notable allocation to healthcare stocks, which make up around a quarter of the fund.

JPMorgan US Smaller Companies (JUSC) aims to provide investors with capital growth by investing in US smaller companies that have a sustainable financial competitive advantage. The trust's manager focuses on companies that are trading at a discount to their perceived intrinsic value, and that have strong management teams. More than a quarter of the fund is invested in industrial stocks, and this is the largest overweight exposure versus its benchmark.

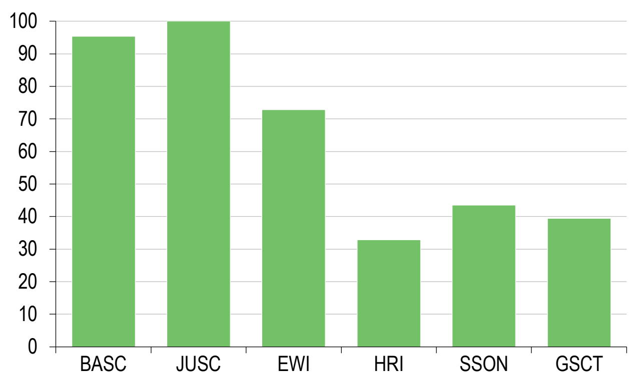
Edinburgh Worldwide (EWI) is a Baillie Gifford fund. Its manager aims to generate capital growth from a global portfolio of initially immature entrepreneurial companies, typically with a market capitalisation of less than $5bn at time of initial investment, which are believed to offer long-term growth potential (up to 25% of the portfolio can be invested in private companies). Around three-quarters of the fund is invested in North America, across 25 subsectors, with the three largest being aerospace & defence, software and biotechnology.

Herald Investment Trust (HRI) aims to generate capital growth via investing in smaller quoted companies in the global technology, multimedia and communications sectors. The manager seeks companies that offer long-term growth potential, typically over a five-year horizon or more and generally have a market cap below $3bn at the time of purchase. Given some investments are in higher-risk, early-stage companies, with the potential for above-average growth, stock-specific risk is reduced by having a diversified portfolio.

Smithson Investment Trust (SSON) is managed by Fundsmith. It aims to generate long-term capital growth by investing in SMID-cap companies with a market cap of £500m to £15bn at the time of investment. The trust's managers seek companies with an established successful track record, such as having a dominant market share in a niche product or service, or having brands or patents that would be difficult to replicate, and that are trading at a discount to their intrinsic value. Companies that are heavily leveraged or require debt financing, or that operate in innovative and rapidly changing industries are avoided. Just under 50% of the fund is invested in the US and the largest sector exposure (c 40%) is industrials.

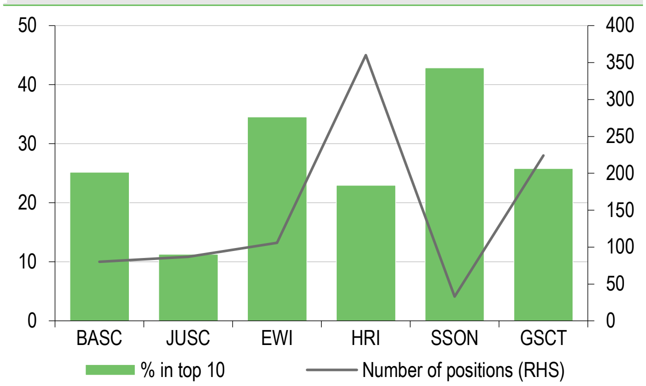
The Global Smaller Companies Trust (GSCT) is a Columbia Threadneedle fund. Its manager aims to generate a high total return by investing in smaller companies worldwide. A notable feature of this fund is that it is number five on the AIC's list of dividend heroes, having increased its annual distribution for the last 54 years. Around 40% of the fund is invested in the US.

Exhibit 4: North American portfolio exposure (%)



Source: Morningstar, Edison Investment Research

Exhibit 5: Percentage of the portfolio in the top 10 holdings and the total number of positions



Source: Morningstar, Edison Investment Research

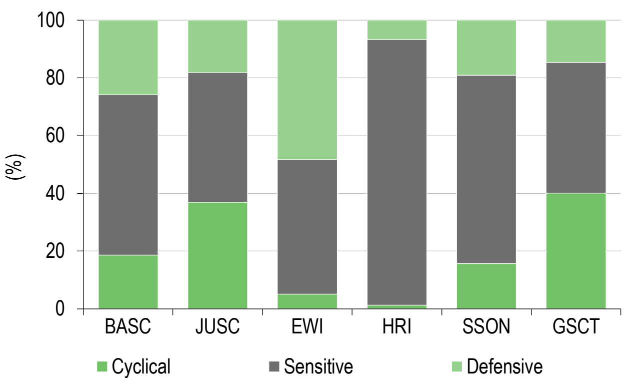
Of the four global smaller company funds, EWI has the largest US exposure (Exhibit 4). Looking at all six funds, SSON has the most concentrated portfolio with 33 holdings, while HRI is by far the most diversified with 360 holdings (Exhibit 5). A higher portfolio concentration generally means that fund performance is more driven by company-specific developments rather than macroeconomic drivers. The top 10 positions make up, on average, around 27% of the funds.

Exhibit 6 shows the selected funds broken down by economic exposure. During a market rally, those funds with a higher weighting to cyclical sectors may fare better. However, small-cap growth stocks have derated in an environment of higher interest rates; hence, an easier Federal Reserve monetary policy could also favour companies with growth strategies.

JUSC and GSCT have the highest cyclical sector exposures, but if the moderately cyclical (sensitive) sector exposures are also taken into account, HRI is the fund that is most leveraged to an economic recovery. EWI has the highest defensive exposure of the selected funds.

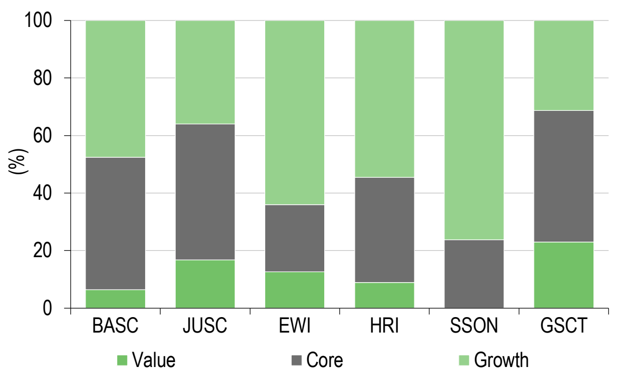
Using Morningstar classifications, the selected funds all have modest/zero value biases and SSON and EWI have the largest biases to growth strategies (Exhibit 7).

Exhibit 6: Portfolio breakdown by economic exposure



Source: Morningstar, Edison Investment Research. Note: Using latest available Morningstar data. Morningstar classifies cyclical sectors as basic materials, consumer cyclical, financial services and real estate. Sensitive sectors are communication services, energy, industrials and technology. Defensive sectors are consumer defensive, healthcare and utilities.

Exhibit 7: Portfolio strategy using Morningstar data

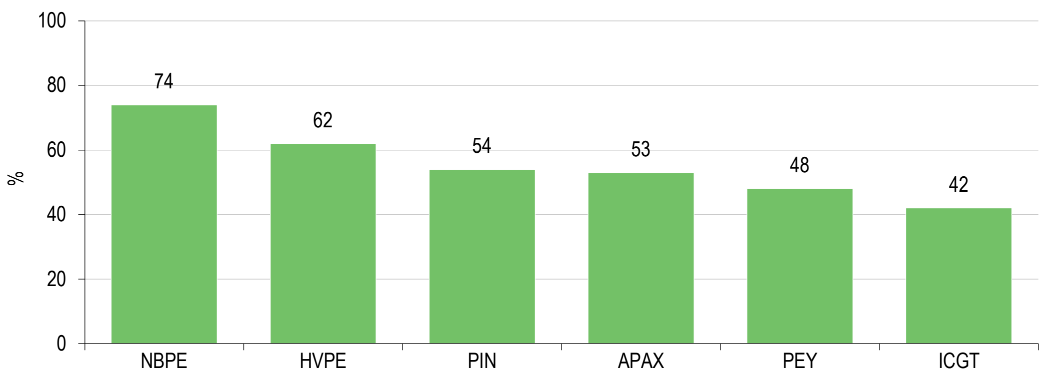


Source: Morningstar, Edison Investment Research. Note: Using latest available Morningstar data.

Selected private equity funds with US exposure

Investors may also seek exposure to US-based small-cap stocks through private equity (PE) firms, as PE-backed businesses are normally the size of a listed small cap. Investing through PE funds comes with certain advantages, as well as some shortcomings, which we describe in detail in our February 2023 thematic report, updated in March 2024. Investors have access to several PE funds listed on the London Stock Exchange, and examples with meaningful exposure to the US include: NB Private Equity (NBPE), ICG Enterprise Trust (ICGT), Pantheon International (PIN), HarbourVest Global Private Equity (HVPE), Partners Group Private Equity (PEY) and APAX Global Alpha (APAX); see Exhibit 8.

Exhibit 8: Selected PE funds' North American exposure (% of portfolio)*



Source: Company data, Edison Investment Research. Note: *Based on latest available data: June 2024 for NBPE; May 2024 for PIN and PEY; March 2024 for APAX; January 2024 for HVPE and ICGT.

NBPE has the strongest bias towards the US among the selected PE funds, with 74% of the portfolio allocated to North American companies. It focuses on co-investments, which involve the acquisition of a minority stake alongside the lead sponsor. As a result, NBPE had a fairly diversified portfolio of 87 positions at end-December 2023. ICGT's, PIN's and HVPE's portfolios include investments in funds managed by other PE managers, resulting in even more diversified portfolios. While we note that higher diversification could potentially reflect public market movements to a higher extent, as they are less dependent on intrinsic developments of individual companies, it is important to note that HVPE and PIN have meaningful exposure to other asset types (HVPE – 31%

allocation to venture capital and growth equity; PIN – 19% to growth equity and 5% to special situations), and ICGT has the lowest exposure to North America among the funds we present (42%). Finally, PEY and APAX are direct investors, usually securing control over portfolio companies. Here, we note that APAX has 22% of its portfolio allocated to debt rather than equity investments.

A pick-up in M&A activity would likely support listed PE funds by giving them greater exit opportunities. This in turn could prove supportive for their NAV total returns if they can sustain the historical long-term track record of realising investments at an uplift to prior carrying value. A re-rating in US small caps should also assist the valuations of their holdings, though we note that PE valuations tend to be less volatile (both to the upside and to the downside) than public equities, as the former are valued based on a blend of public multiples and private M&A transactions, often on a quarterly basis (PEY is an exception as it values its holdings every month). Moreover, changes in public multiples may require some time to feed into private M&A transactions as the expectations of sellers and buyers gradually converge. Finally, the above-mentioned PE funds have (on average) outperformed the 2000 US SMID-cap index over the last 10 years by c 4.1pp pa, as their performance is to a significant degree determined by a focus on particular sectors benefiting from secular themes, as well as the PE managers' active value-creation approach and 'buy-and-build strategy. Therefore, portfolios of listed PE companies are not a simple beta play on the small-cap universe.

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