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# Small but mighty

## Why European equity investors should consider a meaningful small-cap allocation

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# Why invest in European smaller companies

- We believe European equity investors should have a meaningful allocation to smaller companies for several reasons:
  - since January 2001, small caps have outperformed their larger peers across all regions, with their performance especially strong in Europe
  - historical data indicates that incorporating an active small-cap approach slightly increases overall risk but significantly enhances risk-adjusted returns
  - the asset class provides diversification benefits as part of a broader portfolio.
- Despite this, while smaller companies represent 14% of the European equity market capitalisation, investor allocations to small-cap funds or strategies account for only 7-10% of European equity portfolios.
- Currently, attractive valuations and earnings growth, combined with the potential for outperformance in a rate-cutting environment, present an opportune time to allocate or increase existing holdings in small caps.

# Contents



# Introduction

Head of Smaller Companies, Andrew Paisley, leads our European Smaller Companies strategy, with assistance from Tzoulianna Leventi. Both are part of our dedicated Smaller Companies Team, based in Edinburgh.

We take a bottom-up approach, investing in companies with attractive quality, growth and momentum characteristics, and holding these companies for the long term. To aid this approach, the team uses our proprietary quants screening tool to steer research efforts towards the most attractive opportunities.

**Andrew Paisley**
Head of Smaller Companies

**Tzoulianna Leventi**
Investment Manager

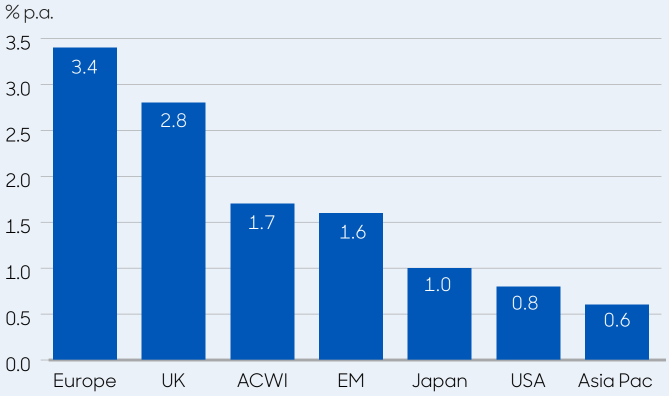
**Graham McCraw**
Senior Equities Investment Specialist

# Small caps have outperformed in all regions

## ...but nowhere more so than Europe.

MSCI defines small caps as the bottom 14% of each market. Since January 2001, when data began, the asset class has outperformed large caps in every region and globally.

### Small-cap outperformance relative to larger peers, since 2001

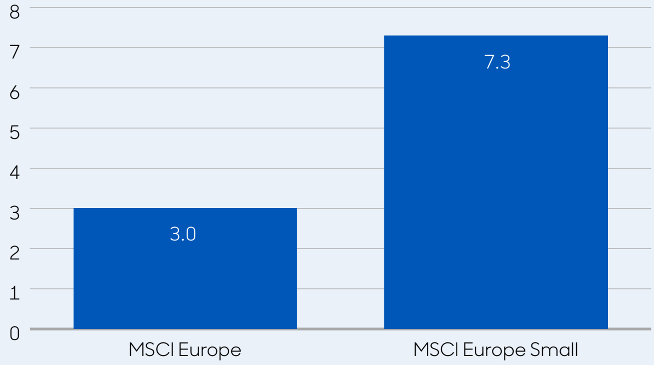



Source, Morningstar Direct, 01/10/01-31/10/24. Annualised relative outperformance of MSCI Small Cap Index vs broader MSCI Index Past performance does not predict future returns.

What drives this performance? First, it's easier to grow earnings from a smaller base. Second, many smaller companies are often nimble and agile, allowing them to respond to changing market dynamics and capitalise on emerging trends. Finally, smaller companies receive less attention from analysts and investors. This can lead to undervaluation and the potential for meaningful price appreciation when the companies deliver.

Europe is the standout performer, followed by the UK (the largest constituent of the European universe at 32%).

### Earnings CAGR (20 years)




Source: Factset, 31/12/04 to 29/12/23.
Last 12 months, earning per share and total returns (USD) Past performance does not predict future returns.

The 7.3% compound annual growth rate (CAGR) earnings growth is high in a European context and internationally, with the S&P500 Index delivering 6.2% CAGR over the same period.

Superior earnings growth has also been a key driver of long-term returns, for European small and large caps.

However, this is just index-level data. Skilled active managers have the potential to add significant alpha over the long term, as demonstrated by several of aberdeen Investments' flagship small-cap strategies (we'll come to that).

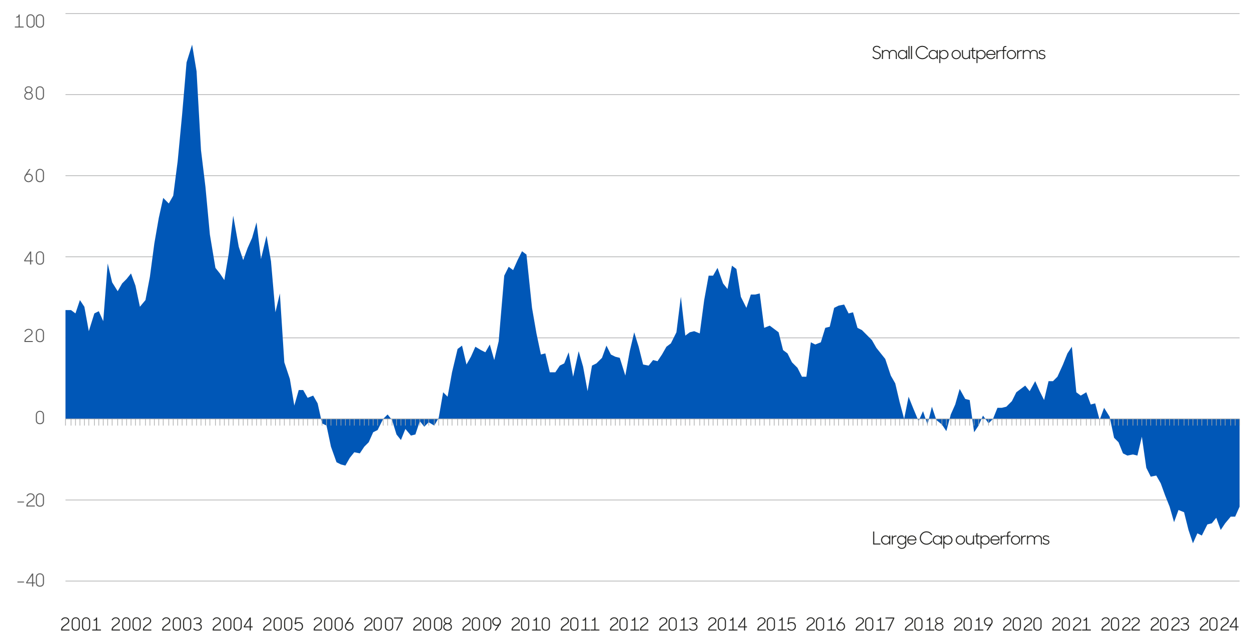
# 3.4%p.a.

European small caps have outperformed large caps by 3.4% p.a. since January 2001.

Source, Morningstar Direct, 01/10/01–31/10/24. Annualised relative outperformance of MSCI Small Cap index vs broader MSCI index  Past performance does not predict future returns.

# Why smaller companies don't outperform all the time

## MSCI Europe Small versus MSCI Europe (rolling three-year returns)




Source: Morningstar Direct, 31/12/2024. Past performance does not predict future returns.

Small caps don't always outperform. For example, recent years have been challenging, as we can see from the rolling three-year performance chart MSCI Europe Small versus MSCI Europe Index, which represents large caps. However, recent years have not been the norm, with small caps outperforming 75% of all rolling three-year periods.

This recent underperformance was due to several factors: the rapid rise in inflation and subsequent dramatic climb in interest rates, the war in Ukraine, supply-chain disruptions, and several additional macroeconomic concerns. But there's another factor at play: index composition.

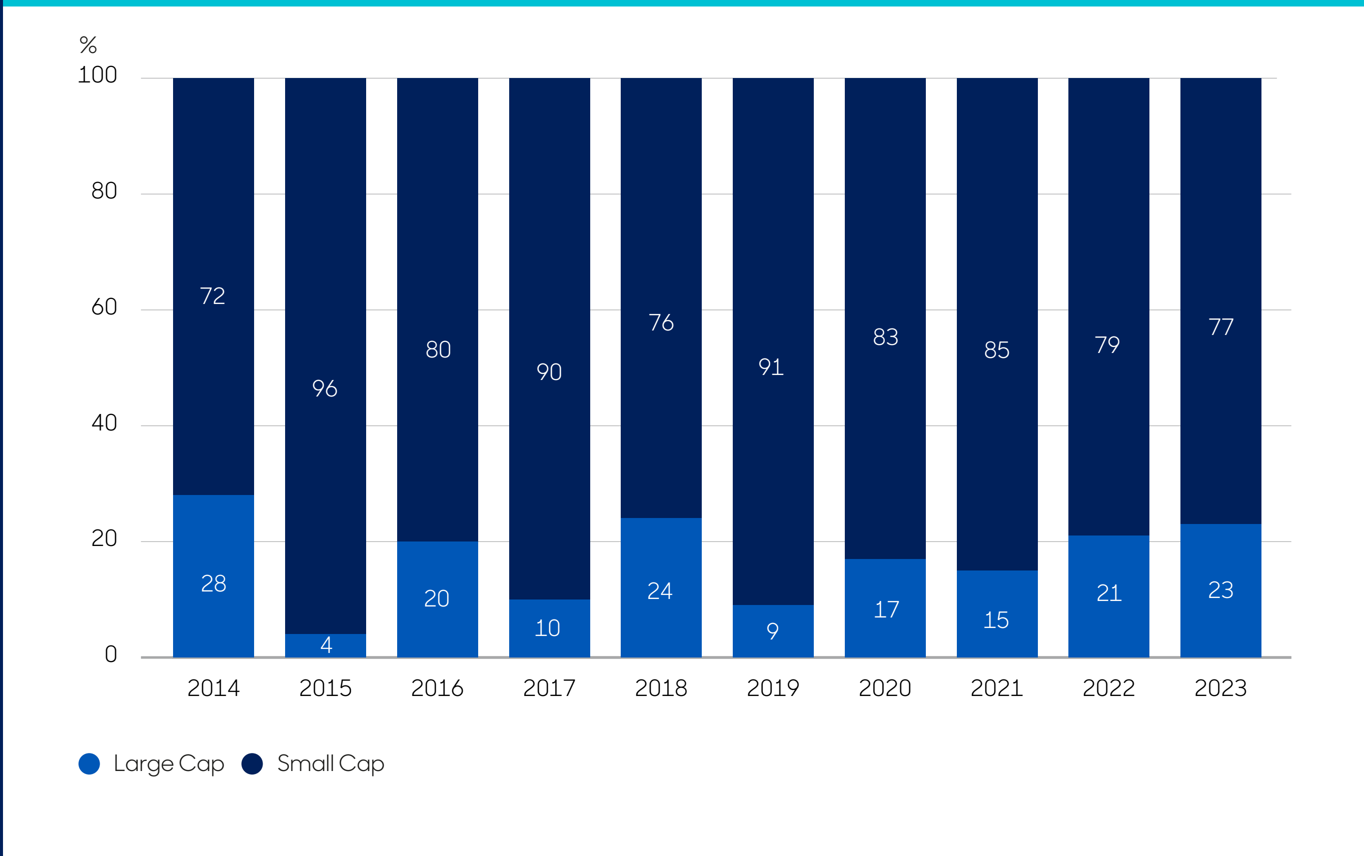
Over the last three years, a few heavyweight names have driven the large-cap index, with Novo Nordisk, Shell, Novartis, SAP, and HSBC all up over 50%.

By contrast, the sheer weight and diversity of smaller companies mean it's impossible for a handful of names – no matter how well they perform – to drive the entire index.

This brings us to the importance of an active approach.

# An asset class where active investing can thrive

## European equities – what percentage of the 100 highest returning stocks are large caps and small caps?




Source: Aberdeen Investments, Factset, 31/12/202. Past performance does not predict future returns.

Looking at stock-level returns, on a discrete annual basis, the highest returns often come from lower down the market cap spectrum. The chart above shows the percentage of the top-performing 100 European stocks (combining MSCI Europe and MSCI Europe Small Cap) by market cap. As we can see, small-cap outperformers heavily outweigh large caps. This trend has even been evident over the last three, difficult years.

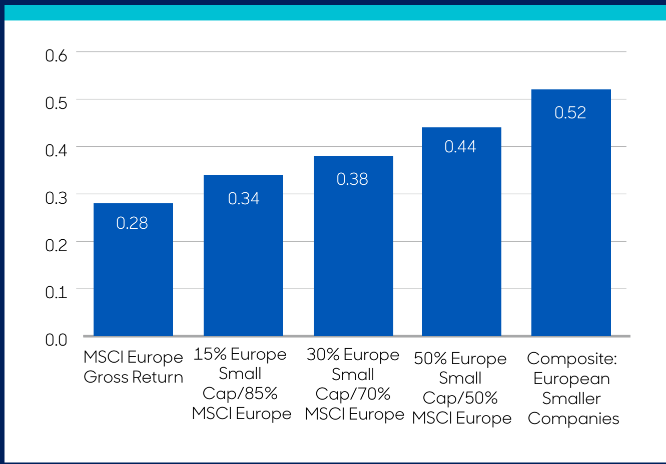
This, though, doesn't tell the whole story. Over the past five years, only 40% of stocks in the European small-cap index have outperformed, highlighting the need to be selective. That's why skilled active managers can potentially deliver compelling returns above the benchmark.
They can pick the winners from the laggards in the small-cap universe.

# The return argument is compelling, but what about risk?

## Impact on standard deviation


Source: Aberdeen Investments, MSCI, 01/10/2007/01/10/2024.
Past performance does not predict future returns.

## Impact on risk-adjusted returns




Source: Aberdeen Investments, MSCI, 01/10/2007/01/10/2024.
Past performance does not predict future returns.

Smaller companies are inherently riskier than their larger, more established peers. Over the long term, however, we believe small caps' higher returns and attractive diversification benefits more than compensate for the additional risk.

Plus, much of this risk is tied to early-stage companies that have yet to deliver a profit or that operate in highly cyclical parts of the market. When you filter out these businesses – as we do – the risk level of the remaining subset isn't as high as many imagine. Importantly, these companies also have the potential to deliver substantial returns over time.

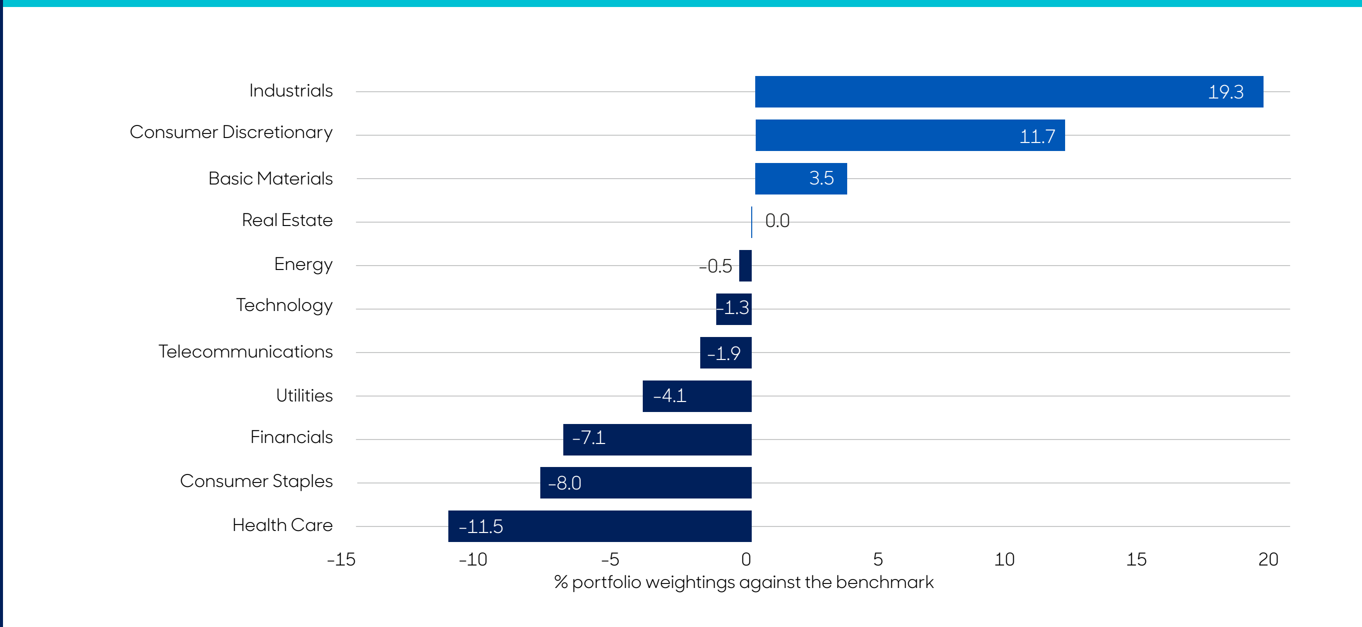
What about the European strategy? Since its inception, the strategy has recorded a higher standard deviation than the MSCI Europe Index (18.7 versus 14.9). This is more volatile and riskier than the broader market index (see first chart above).

Nonetheless, we think it's a mistake to focus on standalone volatility. It's important to consider how blending different assets can have a positive effect. We should also consider the risk-adjusted returns of separate portfolios. Indeed, data on blended portfolios shows investors could make a meaningful allocation to the asset class without significantly increasing overall risk. Investors have also been rewarded with higher risk-adjusted returns (see second chart above). This demonstrates that a diversified approach can reduce the volatility of individual assets while still offering an attractive return.

> **Over the long term, small caps' higher levels of return and attractive diversification benefits more than compensate for the additional risk.**
>
> **Andrew Paisley**
> Head of Smaller Companies

# Diversification benefits

## Euro Small Cap strategy vs Euro Large Cap

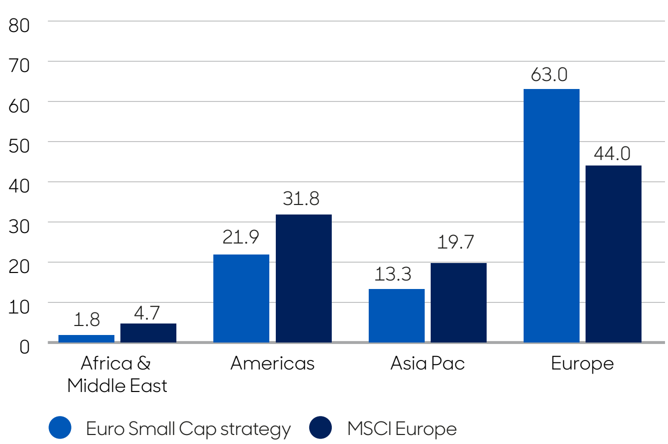



Source: Aberdeen Investments, MSCI. Relative weight of Aberdeen European Smaller Companies strategy vs MSCI Europe 31/10/2024.
Past performance does not predict future returns.

A meaningful allocation to small caps can offer significant diversification benefits. Due to their revenue sources and sector allocations, small caps give investors access to different risk characteristics compared to large-cap stocks. Additionally, small caps tend to be more domestically focused than larger peers and often operate in the most dynamic areas of the European market, notably industrials and consumer discretionary.

This diversity is reflected in our small-cap strategy, which you can see in the charts on this page.

## Revenue exposure %




Source: Factset & Aberdeen Investments as at 30/09/2024.

# How much should investors allocate to European small caps?

## 7%

According to Morningstar, only 7% of the total European equity fund assets under management (AUM) are invested in smaller companies

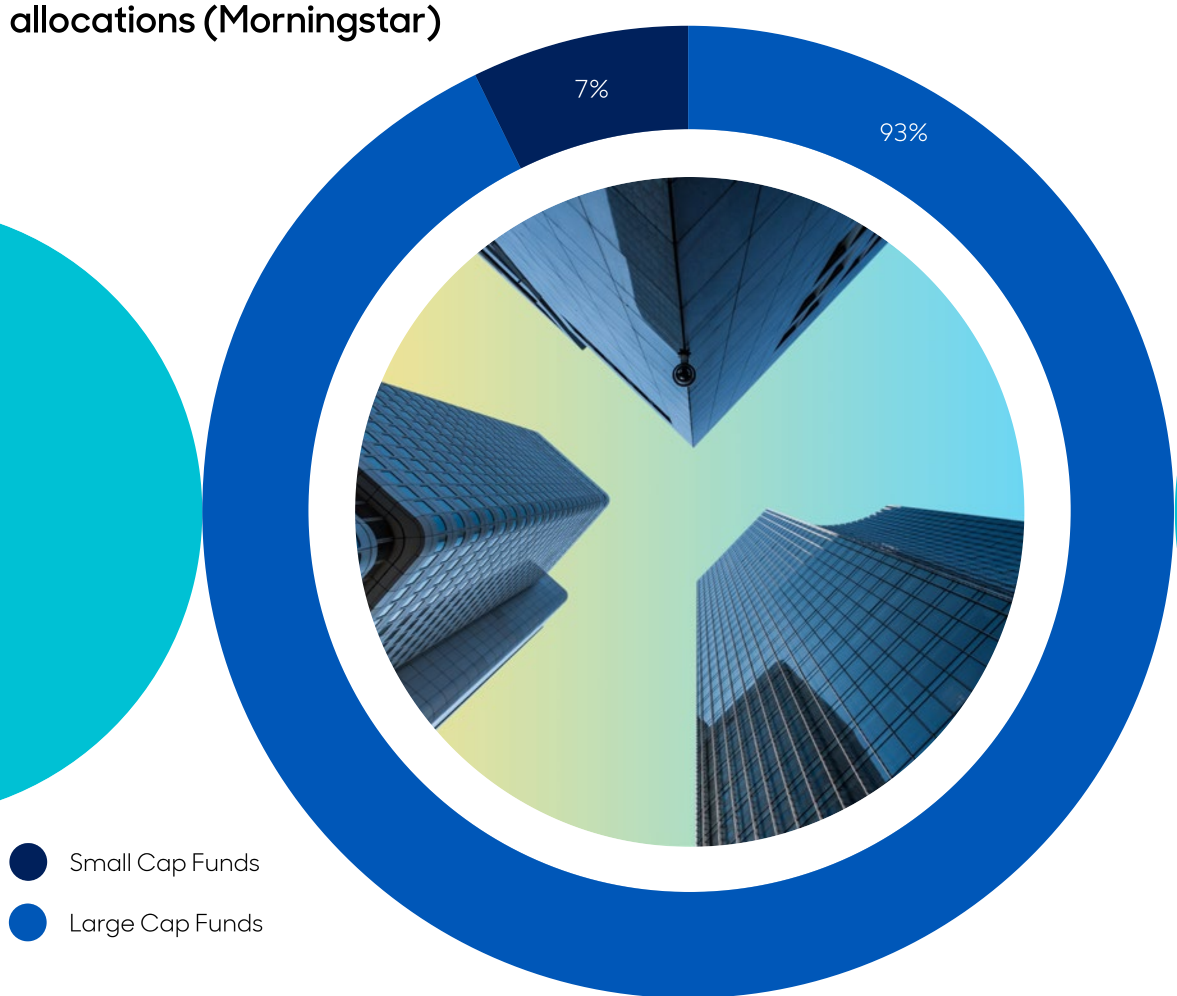
## 10%

eVestment data shows only10% of total strategy AUM is invested in small caps

## 14%

These percentages are below the 14% weight that small caps represent within the broader European equity market cap, as defined by MSCI.

### Proportion of all European Equity allocations (Morningstar)



# Is now the time to invest?

**We believe an allocation to the asset class should be long-term and strategic. However, two factors currently heighten the attractiveness of small caps: valuations and rate cuts.**

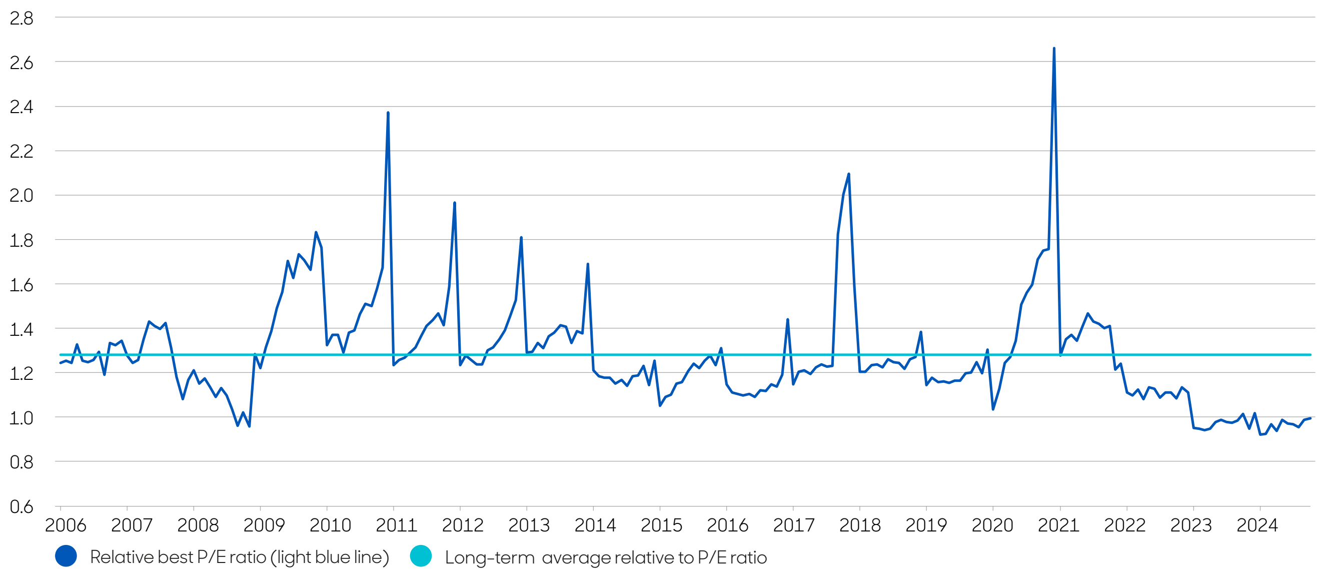
## 1. Valuations

European small caps are the cheapest of all regions, trading at a 12-month forward price earnings (P/E) ratio of 13.7x.

The last time relative valuations compared to large caps were around this level was 2008, during the height of the Global Financial Crisis (see chart). This was a period of significant stress in financial markets, and the outlook for smaller companies was challenging.

Today, while there are risks, we think the outlook for smaller companies versus large caps is far more favourable than it was in 2028. This makes current valuations especially compelling.

### Relative 12-month forward P/E of MSCI Europe Small vs MSCI



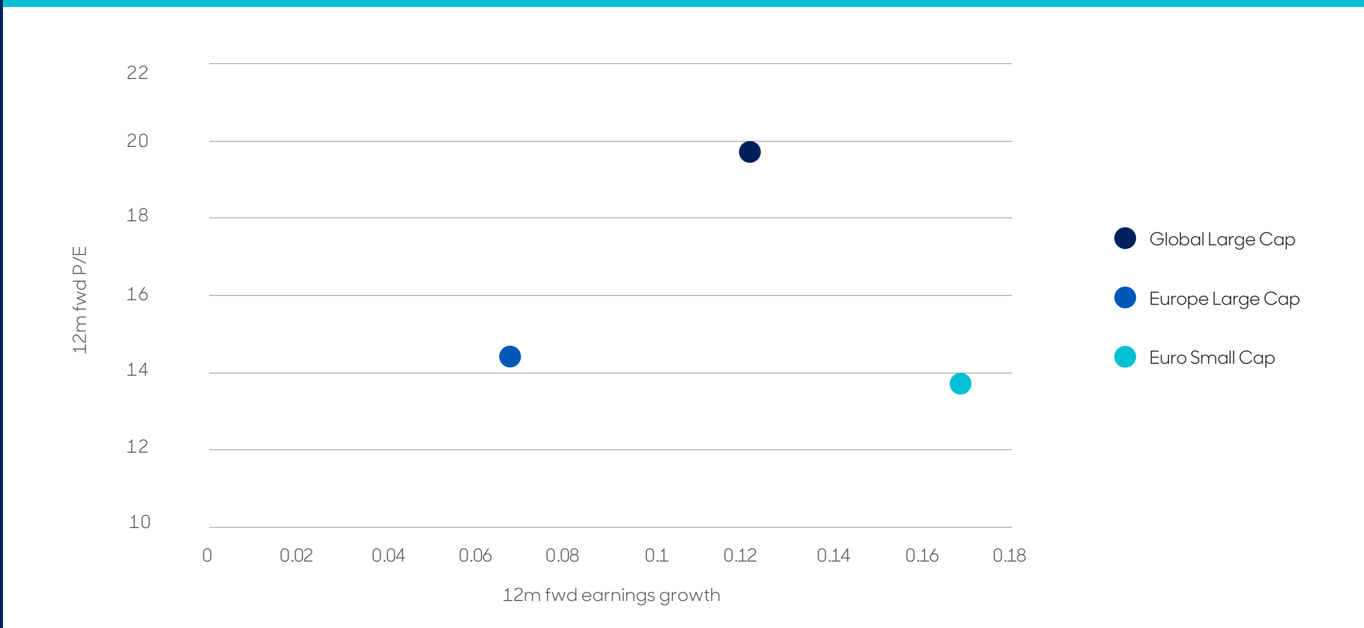

Source: Aberdeen Investments, factset, 31/12/2024. Past performance does not predict future returns.

# 2008

The last time European small caps were this cheap relative to larger peers

# Is now the time to invest?

## 12-month forward-earnings growth and valuations




Source: Aberdeen Investments, and Bloomberg, 31/12/2024. Past performance does not predict future returns.

### Growth and valuations

One common reason clients won't invest is the belief that 'Europe is cheap, but it lacks growth'. This might be true when considering gross domestic product or large-cap growth. However, smaller companies are different. On a forward-looking basis, European small caps are expected to grow more quickly than global equities while trading at a lower valuation (see chart above).

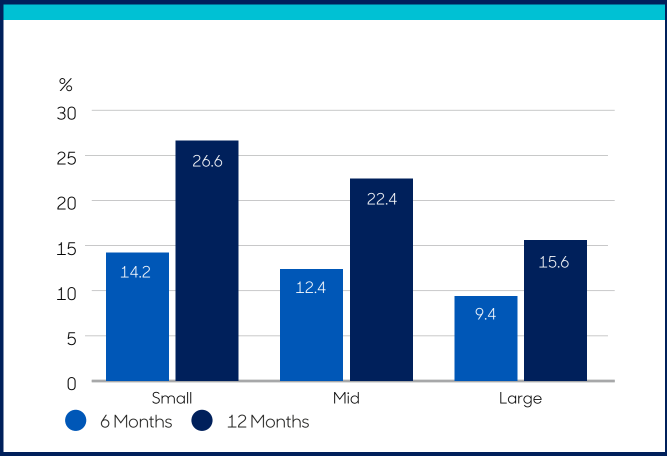
# Is now the time to invest?

## 2. Rate cuts

Historical data shows small caps outperform large caps when interest rates are falling. The first graphic shows the performance of US small, mid and large caps after six and 12 months following a rate cut. The outperformance is clear. This data refers to the US, but we believe there are enough similarities with their European counterparts to draw similar conclusions. The second confirms similar outperformance in the UK over 12 months, as measured by the FTSE 100, 250 and Small Cap indices.

Note: we use US and UK data as it is the longest timeframe available (1950s and 1970s, respectively). European Central Bank data only reaches back to the formation of the euro on 1 January 1999. While there have been several rate-cutting cycles, this period is not long enough to draw statistical conclusions.

### US data since the 1950s




Source: Federal Reserve Board, Haver Analytics, Centre for Research in Security Prices. The Chicago Booth School of Business, Jeffries, William Blair, as of 31/10/2023.

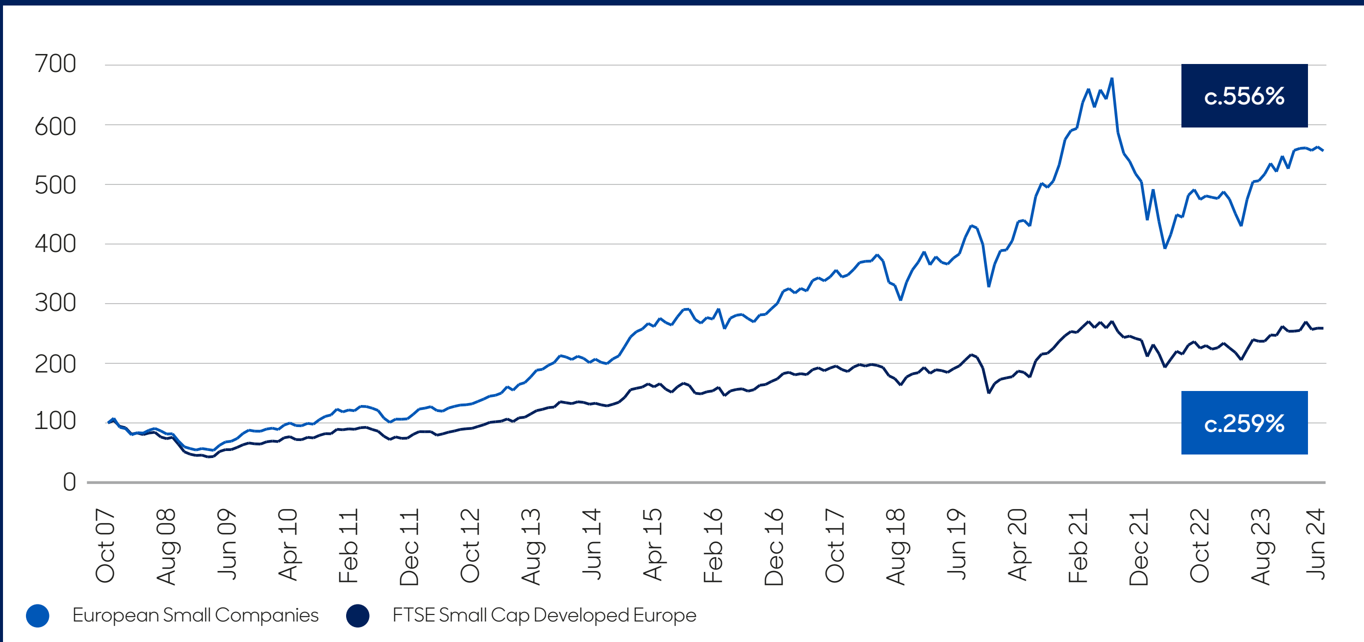
### UK data since the 1970s


Source: Berenberg 31/10/2024.
Past performance does not predict future returns.

While expectations of rate cuts have been pared back in the US, Europe and the UK are likely to continue cutting in the second half of the year due to weak economic growth. This should benefit European small caps over their large-cap equivalents.

# What's our approach?

## The European strategy has consistently outperformed over the long term




Source: Morningstar 31/12/2024. Past performance does not predict future returns.

## Strategy performance

| 1 Year to 31 December | 2024 | 2023 | 2022 | 2021 | 2020 | 2019 | 2018 | 2017 | 2016 | 2015 |
|---|---|---|---|---|---|---|---|---|---|---|
| European Smaller Companies strategy | 9.25 | 12.38 | -35 | 34.1 | 15.47 | 40.1 | -12.39 | 21.64 | -4.16 | 35.64 |
| FTSE Small Cap Developed Europe | 5.75 | 11.42 | -20.56 | 25.73 | 0.36 | 31.59 | -15.09 | 17.73 | 0.08 | 21.1 |

Source: Morningstar Direct, 31 December 2024, euros total returns.
Performance Data: European Smaller Companies strategy in euro, Benchmark – FTSE Developed Europe Small Cap Index (EUR).

Since the 1990s, we've been applying the same process to manage smaller companies. We launched our European strategy in 2007. We favour quality, growth stocks with clear earnings growth visibility and business momentum. We also invest in businesses with robust profitability, good cash flow, strong management, and sound ESG (environmental, social and governance) standards. High barriers to entry, unique growth drivers and pricing power are also attractive characteristics.

We've found that consistently applying our investment approach through different market cycles, combined with hard work and focusing on the long term, helps us deliver significant long-term outperformance. The result? Our European portfolio's 4.8% per annum (p.a.) outperformance over 17 years.

We haven't always outperformed – no active manager has – and there have been times when our style was out of favour. However, these periods have been relatively short. Over the long term (rolling five-year periods), we've outperformed 100% of the time, by an average of over 4% p.a.

# Final thoughts...

European smaller companies remain underrepresented in investor portfolios. We believe they are missing out. Small caps have outperformed large caps over the long term in every region and globally, with Europe leading the pack. Many small caps are nimble and agile, able to capitalise on changing market dynamics and respond to the ever-evolving investment landscape. They also offer diversification benefits thanks to their varied revenue sources, while many operate in niche markets not found in the large-cap space.

Risk will always be a concern for investors. However, this can be mitigated through an active investment approach and blended portfolios. A focus on high-quality, profitable companies has also been a profitable approach.

With current attractive valuations and the potential for outperformance in a rate-cutting environment, we believe it is an excellent time for investors to consider increasing their holdings in European small caps.

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