

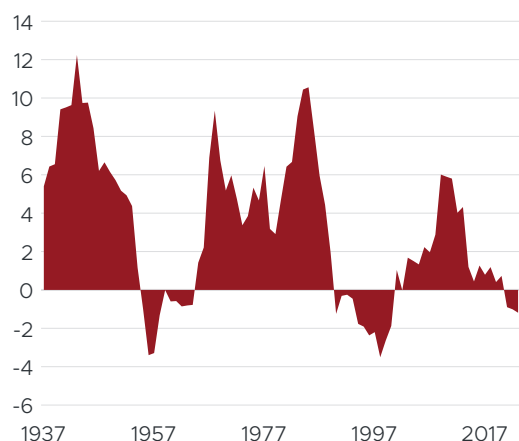
Investment roadmap

OCTOBER 2024

AT A GLANCE

- The main article explores **the case for small-cap stocks in the US**. This sector has underperformed large-cap stocks in recent years, in part because of their concentration in less ‘fashionable’ parts of the market – financials, industrials and real estate rather than technology. In addition, more smaller companies are now privately owned rather than publicly quoted, and they have been more vulnerable to higher short-term interest rates, reflecting limited access to fixed-rate funding in capital markets. However, a very significant valuation discount has now opened up relative to large-cap stocks, and it appears that the peak in the rate cycle has been reached. Saranac has had very limited exposure to small-cap stocks in recent years, but we acknowledge that the arguments are strengthening for some exposure to be taken.
- **Global equity market** multiples remain extended, still largely the result of US megacap valuations. Markets outside the US are on equity multiples in line with or below historical norms, despite the recent rallies. These lower ratings appear to reflect warranted differences in corporate earnings prospects rather than a clear misvaluation signal.
- **Global economic growth** remains subdued, notably in China and Europe. However, US growth is holding up, and we believe the ‘recession scare’ a few weeks back was exaggerated. The global inflation background is subdued given downbeat growth, and we view market pricing of inflation – close to central bank targets – as appropriate.
- The **Chinese policy easing** last month was unexpected and substantial, but we are sceptical that it will be sufficient to overcome material economic and political headwinds. The equity market has rallied very strongly, but to some extent this reflects a short squeeze, with investors being forced back into the market. We are not chasing the market rally from here.
- The Fed has signalled that further **policy-rate cuts** will be implemented, and markets are now pricing a sustained multi-year easing process. While we think that discounted US rate cuts are somewhat aggressive, the direction of travel is clear. The easing process is likely to be more dampened in the UK and Europe, but the path to monetary easing is clear in these regions too.
- An important theme underlying Saranac’s multi-asset positioning has been the relatively low expected returns, by historical standards, of equities over fixed income. However, while **risk premia** remain low (in credit as well as equity markets) we do not regard the structure of market pricing as speculative.
- We continue to hedge **elevated political risk** through a gold position, and more recently through a higher exposure to the energy sector.

Chart 1: Trailing 10-year relative performance of US small caps vs large caps



Source: Professor Kenneth French Data Library, Saranac.

Historically, small-cap stocks—typically defined as companies with a market capitalisation below \$2 billion—have delivered superior long-term returns compared with large caps.

Small-cap stocks: turning point or false dawn?

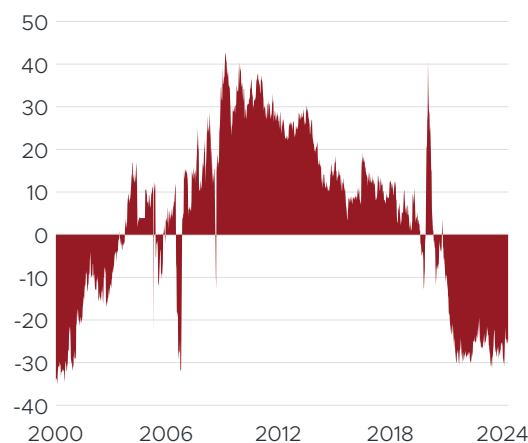
The dominance of large-cap stocks—particularly a select few mega-cap technology companies—has created a number of challenges for investors. The obvious one being that global equity markets have become too dependent on those few dominant players to drive overall market returns, while the diversification benefits of investing in broader equity markets have diminished. Amidst this backdrop, small-cap stocks have struggled to keep pace, prompting the question whether we are due a reversal of this trend or whether there are structural shifts that have led to the underwhelming returns in recent years.

Historically, small-cap stocks—typically defined as companies with a market capitalisation below \$2 billion—have delivered superior long-term returns compared with large caps, a phenomenon widely known as the “small-cap premium”. However, in recent years, this premium has failed to materialise, and the relative underperformance of small caps has widened the valuation gap between small- and large-cap stocks. This article explores the causes of small-cap underperformance, the historical context for their longer-term outperformance, and the potential for a resurgence, particularly in light of recent shifts in monetary policy and the broader macroeconomic environment.

The small-cap premium: historical context and academic foundations

The notion that smaller companies should demand a risk premium over larger stocks first emerged over three decades ago. Eugene Fama and Kenneth French, two of the most influential voices in modern financial theory, in 1992 demonstrated that small-cap stocks have historically generated higher risk-adjusted returns than large-cap stocks. They showed that small caps, on average, have outperformed large caps by 2.85% per year since 1927. This outperformance has held true across long investment horizons, with small-cap stocks outperforming large caps roughly two-thirds of the time over the course of any 10-year period. The rationale behind this premium, they argued, lies in the higher risk associated with shares of small companies, which tend to be more volatile, less efficient, and more vulnerable to the macroeconomic

Chart 2: Relative valuation discount / premium between large caps and small caps (%)



Source: Bloomberg, Saranac.

The rapid growth of these technology giants has driven a significant portion of overall market returns, contributing to the widening gap between large and small caps.

environment. To compensate for these risks, investors have historically expected—and received—higher returns from small-cap investments.

Despite the academic evidence, small-cap stocks have faced significant challenges in recent years. For more than a decade, large-cap stocks, particularly in the technology sector, have outperformed small caps by a wide margin, leaving small-cap stocks at a significant valuation discount to their large-cap peers. While the more recent rally in small caps has led to some narrowing of that discount, earnings multiples for the S&P600 Small Cap index remain some 25% below those of the large-cap S&P500 index. There were only few occasions historically when the asset class appeared this cheap, most recently during the global financial crisis when the S&P600 index fell in excess of 50%, and prior to that during the dot.com bubble at the turn of the century when large-cap technology stocks were grossly overvalued. We do not think either period is a good representation of today's market backdrop, making the valuation discount stand out even more.

Market composition and the tech factor: impact on small-cap performance

One of the primary reasons for the recent underperformance of small-cap stocks is the changing composition of major stock indices, particularly the dominance of a small group of mega-cap technology companies. The S&P500, for instance, has become increasingly concentrated in just a few companies, often referred to as the Magnificent 7. Today, these companies represent more than 30% of the index's total market weight, making it the most top-heavy it has been in its 100-year history.

The rapid growth of these technology giants has driven a significant portion of overall market returns, contributing to the widening gap between large and small caps. The Russell 2000 Index, which tracks the performance of the smallest 2,000 companies in the US stock market, has much less exposure to technology. Instead, small-cap indices are heavily weighted toward sectors such as financials, industrials, and real estate, all of which have underperformed relative to the tech sector in recent history. Moreover, the concentration of the market in a few large technology companies has reduced

Chart 3: US large caps vs US small caps (1994 = 100)

Source: Bloomberg, Saranac.

Many high-growth companies, particularly in the technology sector, are opting to stay private well into their business lifecycles.

the effectiveness of diversification. Small caps can be useful in balancing portfolios and reduce dependence on large-cap stocks. However, as large-cap tech companies have come to dominate the market, this diversification benefit has diminished.

The impact of private markets on small-cap growth

Another factor impacting the returns of broader small-cap indices is the increasing tendency for companies to remain private for longer. In previous decades, some of the most successful companies, including Apple, Amazon and Microsoft, went public relatively soon after they were founded, offering early investors the opportunity to benefit from their rapid growth. Today, however, many high-growth companies, particularly in the technology sector, are opting to stay private well into their business lifecycles.

This trend is most visible in the rise of private “unicorns” such as SpaceX, Stripe and ByteDance, which have raised billions in private markets without the need to offer shares to the general public. As a result, public market investors have been deprived of access to some of the most innovative and potentially lucrative investment opportunities.

Economic sensitivity, interest rates and the small-cap struggle

The macroeconomic environment has also played a critical role in the recent struggles of small-cap stocks. Over the past decade, large-cap companies have benefited from a prolonged period of historically low interest rates, which allowed them to borrow cheaply to finance growth initiatives. This has included mergers and acquisitions, research and development, and large-scale capital expenditures, all of which have contributed to their strong growth in earnings.

By contrast, small-cap companies typically have less access to debt markets and are more vulnerable to rising interest rates. Their financing structures often rely more heavily on floating-rate debt, which makes them particularly sensitive to changes in the interest rate environment. As interest rates rise, the cost of borrowing for small-cap companies increases, putting additional pressure on their bottom lines.

This dynamic was particularly evident in 2022 and 2023 when central banks across the globe embarked on an aggressive rate-hiking cycle in response to persistent inflationary pressures. Over the course of these two years, the Fed raised interest rates by more than 500 basis points, pushing the federal funds rate to its highest level in decades. This dramatic rise in borrowing costs has been especially challenging for small caps, many of which are more heavily leveraged and more dependent on external financing than their large-cap counterparts.

To put this into perspective, approximately one-third of companies in the Russell 2000 Index have significant floating-rate debt exposure, compared with just 6% of companies in the S&P500. As interest rates rose, these companies saw their financing costs increase dramatically. Moreover, small-cap companies tend to have lower credit ratings and higher default risk, making it more expensive and difficult for them to access the bond market for long-term, fixed-rate financing. These factors combined to create a significant headwind for small-cap performance over the past few years.

However this month the U. Federal Reserve has lowered borrowing costs by 0.5% while signalling that more cuts are to come. Similarly, other central banks have started to ease monetary policy as inflation rates have normalised. For small-cap stocks, these interest rate cuts could serve as a significant tailwind. Not only do lower interest rates reduce the cost of capital which should in turn lift stock market valuations, they are likely to experience immediate relief from falling borrowing costs. While this will be the case for all companies, large or small, rate cuts should have a disproportionate impact on the fundamentals of smaller companies given their reliance on floating-rate debt financing. In the short-term this should lead to improved profitability, stronger cash flow, and ultimately better stock performance.

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Opportunities for diversification and alpha generation

Despite the challenges of the past years, small-cap stocks can still offer compelling opportunities for investors seeking diversification and the potential for alpha generation. One of the primary advantages of small caps is their relatively low correlation with

large-cap stocks, which makes them a useful tool for reducing overall portfolio volatility. While large-cap technology stocks have driven much of the market's returns in recent years, small caps can offer exposure to different sectors and industries that are not as heavily represented in large-cap indices.

Beyond that the small-cap universe tends to be less efficiently priced than their large-cap peers. There are significantly less analysts covering small-cap companies, and there is often less publicly available information about their operations and financials. This creates opportunities for active investors to exploit pricing inefficiencies and generate excess returns. Research shows that small-cap portfolio managers outperform the Russell 2000 Index 69% of the time over any given 10-year period, a statistic many large-cap managers can only fantasise about.

Moreover, small-cap stocks have historically provided investors with early-stage access to companies that have the potential to grow into future large-cap leaders. While there clearly is a trend for smaller companies to stay private for longer, the market of initial public offerings has not vanished, offering investors the opportunity to participate in the above-average growth rates often associated with smaller companies.

The outlook for small-cap stocks

While some of the factors resulting in the lacklustre returns of small-cap stocks in recent years are unlikely to reverse, there are reasons for cautious optimism. As short-term interest rates continue to decline, the cost of capital for small-cap companies will decrease also. At the same time the interest burden should fall which in turn will help cash flow generation and profitability.

Furthermore, small caps are currently trading at historically attractive valuations relative to large caps. The valuation gap between the two groups is the widest it has been in decades, with small caps trading at a 25% discount on a forward P/E basis. Historically, valuations have been a reasonably good predictor of longer-term returns, and while they tell us little about the short-term outlook for the asset class, today's starting valuations bode well for the outlook for small caps longer-term.

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Lastly, small-cap stocks continue to provide investors with exposure to companies that have the potential to grow into future market leaders. While some high-growth companies are staying private for longer, the public markets will eventually gain access to the next generation of innovative businesses. For investors with a tolerance for volatility, the potential rewards from investing in small caps could be substantial.

The key question remains whether we are witnessing a turning point for small-cap stocks or if this is simply another false dawn. While some of the structural challenges will persist, the combination of attractive valuations, falling interest rates and resilient global growth means there are reasons to remain optimistic about the future of small-cap investing.

Public markets

EQUITIES



- Asset class outlook +

Valuation



Earnings



Positive

Infrastructure &
Resource Scarcity;
MedTech; Japan

Negative

Low quality, high
valuation companies;
Emerging Markets

Market background

The beginning of September was a carbon copy of how August started. After the tense start following a bout of share price weakness, markets were quick to recover. The Federal Reserve implemented the first rate cut of this cycle opting for 0.5%. Encouraging macro prints in the US seemed to point to the emergence of a 'goldilocks' scenario. The Global Equity Strategy ended the month down 0.3%.

Targeted exposure

We favour a number of longer-term themes spanning numerous sectors. The AI theme is still prevalent and comments from tech firms suggest the momentum continues. There has been a clear shift in focus towards energy supply but software has still to draw much attention. As health systems need to become more efficient to cater for an ageing population, we continue to favour medical technology. At a country level, we continue to favour the Japanese market.

GOVERNMENT BONDS



- Asset class outlook +

Short maturity



Long maturity



Positive

US 2-5Y TIPS, UK Gilts,
Australian Sovereign
and Agency bonds
across tenors

Negative

>5 year European
sovereign bonds,
Japanese government
bonds

With investors pricing in more rapid rate cuts, it was a strong quarter for sovereign bonds. The 10-year US Treasury yield dropped by 62bp to 3.78%. The US yield curve inverted for the first time since mid-2022, as the 2-year yield dropped by 111bp down to 3.64% at the end of the quarter. This was on the back of a first "jumbo" 50bp interest rate cut, and as the market priced Fed funds to drop to 3% by the end of 2025. UK Gilts underperformed US Treasuries, as the 10-year Gilt yield declined by a more modest 17bp down to a 4% level. This was driven by a more cautious approach to rate cut by the Bank of England, as services inflation and wage growth continued to show signs of stickiness.

Targeted exposure

After an uninterrupted 4-month long USD bond market rally, we trimmed the interest rate duration of our bond portfolios by taking profits on US treasury and US agency MBS positions. With inflation break-evens back to 2%, we maintain a balanced exposure between nominal and inflation-linked bonds. We now view the market pricing for interest rate cuts in US to be on the aggressive side, limiting the prospects for further duration gains in our view. Conversely, we think the Bank of England's and Royal Bank of Australia's rate cutting cycle are underpriced, offering attractive duration return prospects.

Public markets

CORPORATE AND EMERGING MARKET DEBT

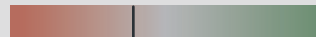


- Asset class outlook +

Investment grade credit



High yield



SUB



EM debt



Positive

AAA/A securitisation,
£IG credit

Negative

Long-dated US High
Yield, Emerging High
Yield Sovereign

In September, \$ credit continued to outperform € and £ credit, powered by the outperformance of the US Treasury market. \$IG returned +1.7% in September vs +1.2% for €IG and +0.3% for £IG. As such the \$IG market yield fell by 20bp to 4.75%, compared with a 1bp decline to 5.24% for £IG, leading to a ~50bp yield differential last seen in September 2023. \$HY spreads ended the month close to cyclical tightness, whilst € and £ HY spread continue to offer attractive relative value.

Targeted exposure

We now think that £IG credit offers compelling relative value against \$IG, both from a duration and spread level perspectives. As such, we rotated some USD fixed income positions towards GBP IG credit to capture the attractive yield differential that has appeared between both markets, especially as the cost of currency hedging remaining close to 0 over the next few months. We maintain a preference for subordinated debt over HY, but we favour short-dated high-yielding instruments following the decline in spreads, preferring to take duration risk in the sovereign allocation. Emerging High yield spread trade at tight levels unseen since the 15-year low of 2018.

Public markets

HEDGE FUNDS



Despite the volatility in month of September, the hedge fund industry on average ended up positive with the fundamental equity long/short universe leading the pack outperforming the broader market benchmark (MSCI TR). Alpha in the equity long/short universe was primarily driven by the long side. From a factor standpoint, China, Asset Selection, Consumer Discretionary, Healthcare, Medium-Term Momentum and Energy led the positive contributions.

Recent commentary from Goldman Sachs notes that after five straight months of net selling, global equities were modestly net bought by hedge funds in September, driven by risk-on flows with long buys outpacing short sales. Macro products saw the largest net buying since November 2023 – driven by long buys and short covers. On the other hand, single stocks were net sold for a fifth straight month driven by shorts in information technology, staples, utilities, and consumer discretionary. US Info Tech long/short ratio now stands at 1.61, which is around the lowest level in the past decade.

Goldman Sachs' prime brokerage desk recently reported that the overall gross and net leverage for the full prime brokerage book both rose in September and are near one-year highs. Regional positioning wise, hedge funds aggressively rotated into Asia stocks, which saw record net buying in September led by China and Hong Kong. On the other hand, North America was net sold for a fifty straight month. Chinese equities were net bought by hedge funds for eleven straight sessions into month-end and at a record pace, led by H-shares, A-shares, and to a lesser extent ADRs. Chinese equities now make up 5.9%/9.2% of Goldman Sachs' total global gross/net exposures on the prime book.

Public markets

CURRENCIES

Dollar



Euro



Sterling



Yen



Market background

The main recent feature in currency markets has been the weakness in the US dollar, primarily reflecting the stronger likelihood of aggressive interest-rate cuts than in other major countries. The weakness has been most evident against the yen, where (fitfully) monetary policy appears to be moving in the opposite direction. Dollar depreciation against European currencies has been much less pronounced.

Targeted exposure

The market has strongly discounted a faster rate of monetary easing in the US compared with other countries, and this factor is likely already to be better discounted – as evidenced by material short positioning in the US currency. The global political background seems to favour the dollar as a safe haven currency, but electoral uncertainty in the US may, for a period, work in the opposite direction. We continue to look for additional strength in the Japanese yen.

COMMODITIES

Gold



Industrial metals



Energy



Softs



Market background

The divergences between precious metals and other commodities has persisted. Gold has remained a very strong performer, supported by lower bond yields, significant central bank purchases, and an unsettled global political background. Cyclical industrial metals have typically sold off since the spring, as global manufacturing and construction sectors have remained depressed, although Chinese policy stimulus provided some support at the end of September. The oil price has risen on greater Middle East political risk, without breaking up clearly from the broadly flat trend of the past few years. Agricultural commodities have remained weak.

Targeted exposure

Support for the gold price is likely to be sustained, given rising global political tensions, falling interest rates and diversification away from the US dollar. We also expect oil prices to hold up. Industrial metals are likely to remain under pressure until the global economy picks up. We expect uranium prices to recover further, with the potential for large gains given demand/supply imbalances in the sector.

Private markets

ALTERNATIVE SOURCES OF RETURN

Secondaries

Undercapitalisation of the secondary market has created a structural imbalance between supply and demand, creating an attractive environment for long-term allocation to secondaries

Special situations

Favourable market environment given the likely stress corporates will face in a higher rate environment

Venture capital

Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

Infrastructure

Attractive, long-term asset class given supply chain issues, regulatory initiatives and geopolitical uncertainty are driving demand for new / the development of infrastructure higher

Real estate

As cap rates have expanded and lending has tightened, we see opportunities to acquire high-quality assets at attractive entry prices GP stakes and financing

GP stakes and financing

Opportunity for higher yield and greater structural protection as a result of limited GP liquidity

Real assets

At risk from weak growth environment

Private debt

A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

Leveraged buyouts

Softened valuations, reduced debt levels, and increasing focus on corporate carve-out opportunities has created a window for investors to deploy into operationally focused private equity strategies

Mid-market growth

A prolonged period of weak/negative earnings growth as a result of a weak economic environment and increased cost of capital will see valuations struggle in the short term

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We founded Saranac Partners to do things differently. To create a community based around like-minded people, shared wisdom and collective learning. To work as partners, creating compelling opportunities and effective solutions. To offer unfailing support, honest challenge and thoughtful inspiration.

Our business combines the personal touch of a private office with the capability and breadth of a large institution. Our firm has strategic shareholders, outstanding technology, broad capabilities and the highest standards of corporate governance. Saranac Partners is a signatory to the United Nations Principles of Responsible Investing (UNPRI).

OUR SERVICES

We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.

 **Strategy.** Planning, governance and oversight

 **Financing.** Access to diverse sources of capital

 **Investments.** Allocation and deployment of capital

 **Corporate advisory.** Supporting corporates and business owners

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