abrdn Global Smaller Companies Fund

abrdn

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Market Review

Global equity markets ended the quarter notably higher, supported by reduced inflationary pressures in most developed economies following a prolonged period of monetary tightening. The improved backdrop means that major central banks are close to the end of the rate-hike cycle. Nevertheless, they remain determined to keep inflation under control for now. Also, while economic data has generally been more robust than was feared, the risk of a global recession remains. In particular, investors continued to be concerned about the weak outlook for the Chinese economy – especially the country's property sector – and the implications for global economic growth. The ongoing wars in Ukraine and the Middle East are other key risks.

US equities ended markedly higher. Large technology companies fared especially well as they benefited from their exposure to the fast-growing area of artificial intelligence, with lower bond yields providing an additional tailwind for the sector. Inflationary pressures continued to ease over the quarter following a succession of interest-rate increases from the US Federal Reserve (Fed) since early 2022. In particular, the central bank's favoured measure of inflation, the core Personal Consumptions Expenditures Price Index, fell from an annual rate of 3.4% in October to 3.2% in November, which was lower than expected, but remained above the 2% target. The Fed kept the target range for the fed funds rate at a 42-year high of 5.25–5.50% over the period but, at its December meeting, signalled three rate cuts in 2024, with more easing to come over 2025 and 2026. The yield on 10-year Treasuries ended the quarter about 80 basis points (bps) lower at around 3.9%.

European equities rose over the quarter. Annual inflation rose from 2.4% in November to a lower-than-expected 2.9% in December (with the core rate declining from 3.6% to 3.4%, as expected) but remained above the European Central Bank (ECB)'s 2% target. Therefore, the ECB kept its main refinancing operations rate at a 22-year high of 4.5% over the quarter. The HCOB Eurozone Composite Purchasing Managers Index remained below 50 over the quarter, translating into a contraction in business activity (led by weakness in the region's manufacturing sector). Meanwhile, the yield on 10-year German Bunds ended the quarter about 90 bps lower at around 2.0%.

UK equities ended higher but underperformed most other regional indices. Annual inflation surprisingly fell from 4.6% in October to 3.9% in November but remained well above the Bank of England (BoE)'s 2% target. Moreover, annual core inflation was also below expectations, falling from 5.7% to 5.1% over the same time frame. The BoE maintained its Bank Rate at a 15-year high of 5.25% over the quarter. The yield on 10-year Gilts ended the quarter about 110 bps lower at around 3.5%.

In the Asia Pacific region, Japanese equities edged up over the quarter. Despite annual core inflation of 2.5% in November remaining above the Bank of Japan (BoJ)'s 2% target, the BoJ still has a relatively dovish monetary policy stance compared with other major central banks. However, the yen appreciated over the quarter, weighing on exporters, on hopes that the BoJ could soon change its stance and start raising rates.

Performance

The Fund underperformed the index over the quarter. Looking at individual stock drivers, Lattice was the main laggard. Its third quarter results were in line with market expectations. However, management cut fourth quarter guidance on the back of weaker demand for industrial and automotive applications. Until now, Lattice, which supplies FPGA semiconductors, has been relatively immune to softer macroeconomic conditions, therefore the guidance came as a surprise to the market. Whilst we have trimmed our weighting in Lattice several times, we reduced our position further on this news. Asics, a star performer in 2023, retreated despite reporting better than expected results and announcing an ambitious mid-term plan. Investors switched out of weak yen beneficiaries to domestically orientated stocks. Finally, Paylocity and Fox Factory's shares also weighed on performance. Paylocity sold off in sympathy with lowered guidance from its peer, Paycom. Whilst Paycom's outlook downgrade largely reflected company specific measures, notably it's move towards a self-service payroll product, Beti, the quality of Paylocity's results and comments regarding customer growth were not supportive of the share price. Fox Factory's shares fell after management announced a surprise acquisition.

On a more positive note, Deckers reported a stellar set of results as both of the company's core brands, Hoka and Ugg, displayed strong sales momentum. Management upgraded guidance and pointed to new product releases in Spring 2024. Altair's share price jumped on the back of a broker initiation report, highlighting the company's sustainable 20% cash flow growth as Altair gains share in the simulation and analysis market through its differentiated capabilities in high performance computing and data analytics. Napco recovered strongly following a solid set of results. Sales of both equipment, cellular networks and locking systems, and services tracked above expectations. Crucially, management outlined measures taken to establish new accounting procedures, including hiring Deloitte as its auditor, which puts to bed issues that the company experienced in the previous quarter.

Risk factors you should consider before investing:

a. The value of an investment can fall as well as rise and is not guaranteed. An investor may get back less than they put in. Past Performance is not a guide to future performance.

b. The fund invests in equities and equity related securities. These are sensitive to variations in the stock markets which can be volatile and change substantially in short periods of time.

c. A concentrated portfolio may be more volatile than a more broadly diversified one.

d. The shares of smaller companies may be less liquid and more volatile than those of larger companies.

e. The use of derivatives carries the risk of reduced liquidity, substantial loss and increased volatility in adverse market conditions, such as a failure amongst market participants. The use of derivatives may result in the fund being leveraged (where market exposure and thus the potential for loss by the fund exceeds the amount it has invested) and in these market conditions the effect of leverage will be to magnify losses. The fund does not make extensive use of derivatives.

Activity

In portfolio activity, we initiated positions in Nextracker, Regional, Advanced Drainage and Azimut. Nextracker is the largest provider globally of single row solar trackers - devices which allow solar panels to follow the movement of the sun and thereby increase yield. Another new addition, Regional, a Mexican bank, boasts one of highest and most consistent returns profile of all the banks in the small-cap universe. The current macro and political backdrop in Mexico is supportive for the stock, as interest rates are expected to decline and the political environment remains neutral. Elsewhere, we initiated a position in Advanced Drainage. The company's competitive advantage lies in its local manufacturing, strong distributor relationships and high vertical integration including sourcing of recycled resin. In Italy, we switched out of Fineco Bank and into Azimut, an independent asset management company. In recent years, the company has diversified its operations geographically, notably in emerging markets, and by product.

We exited our holding in Darling Ingredients as it faced pressure regarding falling renewable diesel margins and fears of overcapacity in the industry. Concerns have been exacerbated by Darling's higher debt position, lower-than-expected operational efficiency and integration challenges on new acquisitions. We also exited our holding in Envista, the US dental supply business. The company reported weaker-than-expected third quarter results and downgraded guidance on the back of rising headwinds in the North American market.

Portfolio positioning and outlook

From a top-down perspective, there are several variables in 2024 which have the potential to shape markets. Not least, politics, which return to centre stage as more than 70 countries go to the polls, representing over half the world's population and almost two thirds of global market cap. More than usual, policy actions globally will play an important role in determining market outcomes.

In terms of monetary policy, the direction of interest rates is clearer now, and is an area where we could see meaningful geographic disparity. Slowing economic growth, US fiscal deficit concerns and the rising cost of debt servicing are supportive of rate cuts in the US. Likewise in Europe and the UK. However, the pace at which inflation moderates and the sustainability of growth are both factors worth monitoring and may temper consensus' aggressive interest rate forecast. Whether inflation returns to pre-pandemic levels is uncertain given near-term pressures in the shipping market as both the Panama and Suez canals face issues as well as longer-term changes to labour markets. Growth drivers, too, bear watching.

Outside of the US and Europe, there is scope for emerging market countries to cut rates more than in developed markets as inflation has been held in check to a greater degree. Japan, being the exception, may raise rates. These differences in rate policy are already reflected in currency moves and are likely to influence investment returns further. One final area to mention regarding policy is China. The outlook is highly dependent on government stimulus; therefore, China's market remains somewhat unpredictable for 2024. As always, how these measures play out at the stock level is key. .

Fom an asset class perspective, we note that small-caps have outperformed large-caps since Powell's speech at the end of October, indicating peak rates. We expect this outperformance to continue as the valuation discount for small caps relative to large caps remains extended and small caps typically perform better in a recovery cycle.

Cumulative and Annualised performance as at 31/12/2023

	3 Months %	1 Year %	3 Years (p.a.) %	5 Years (p.a.) %
Standard Life Global Smaller Companies Fund	6.7	8.2	-3.9	6.5

Discrete annual performance year to 31/12

	2023	2022	2021	2020	2019
Standard Life Global Smaller Companies Fund	8.2	-35.5	27.1	24.5	23.9

Fund performance has been calculated net of Annual Management Charge.
Source: abrdn

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