SilverBullet
31 January 2024

SilverCross Global Small-Cap Fund

Investment Philosophy

SilverCross Global Small-Cap Fund invests in a portfolio of 25-35 high-quality smaller companies. It invests in companies with defensible business models across global developed markets.

The Manager applies four core principles in its stock selection. Its aim is to drive attractive long-term investment returns in excess of the benchmark while keeping portfolio turnover low.

Core Selection Principles

Create Value with a sustainable business model.

Compound Growth thanks to a scalable business model.

Undervaluation implies an asymmetric risk / reward profile.

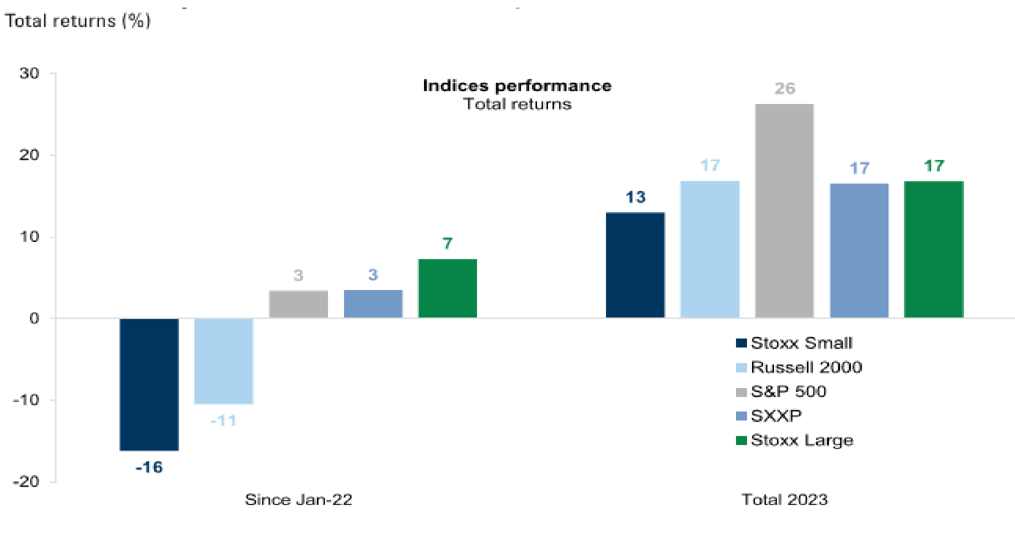
Insider Ownership ensures alignment with management.

About The SilverBullet

A "silver bullet" refers to a straight-forward solution perceived to have high effectiveness. With this newsletter we aim to offer a mix of thought-provoking research and small-cap insight.

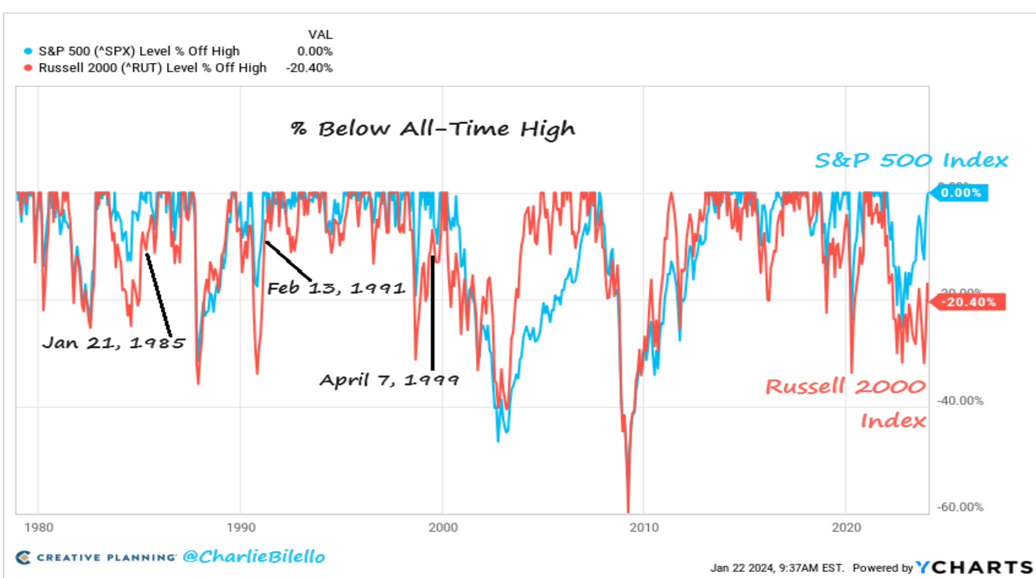
Small-Caps: after rain comes sunshine

Since interest rates began to rise in early 2022, small-caps - smaller publicly traded companies - have faced significantly greater challenges on the stock markets compared to large-caps - the well-known large companies, including the Magnificent Seven. While the well-known large-cap indices in America (think of the Dow Jones and S&P500 indices) have already risen to record highs again after a sharp decline in 2022, the global small-cap index is still 11-16% lower.



Source: Datastream, Goldman Sachs Global Investment Research

The difference in performance between large-caps and small-caps is greater than ever at a time when the S&P500 index is at an all-time high. The American Russell 2000 small-cap index is still about 20% below its all-time high. The chart below clearly illustrates the significant difference in performance between the two indices.



[1]Annualised

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Fund Details

Managers since July 2014:	David Simons & Chris Andrews
Inception date:	30 July 2014
Currency:	EURO
Share Class:	A
Management Fee:	1.15%
Total Expense Ratio:	1.40%
Minimum Investment:	100,000
ISIN code:	NL0010832242
Bloom-berg:	SCGSCFA NA

The last times that situations like this occurred, small-caps performed significantly better than large-caps in the following year:

April 7, 1999 (Russell 2000 -19.2% below all-time high): S&P500 +14.3% versus Russell 2000 +36.5% in the following twelve months

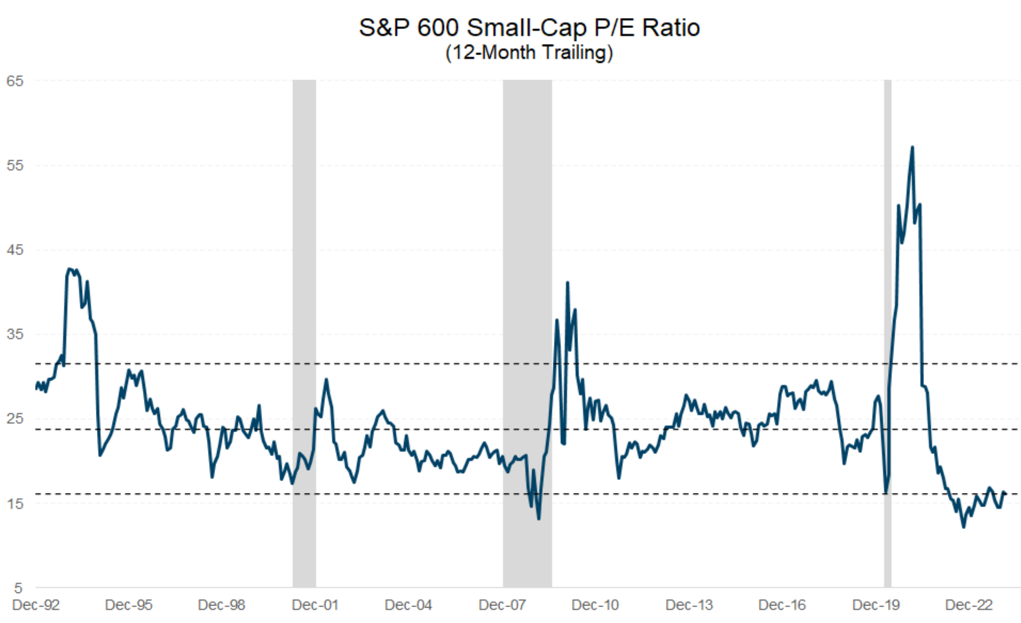
February 13, 1991 (Russell 2000 -13.5% below all-time high): S&P500 +12.1% versus Russell 2000 +35.5% in the following twelve months

January 21, 1985 (Russell 2000 -13.3% below all-time high): S&P500 +17.4% versus Russell 2000 +18.2% in the following twelve months

The well-known saying that historical returns are no guarantee for the future is clear. However, a repetition of this trend seems likely.

What is the situation with the absolute valuation of small caps?

The valuation of small-caps is currently low. For U.S. small-caps represented in the Russell 2000 index, the price-to-earnings ratio is slightly under 16x for 2023. The large-cap S&P500 index is trading at over 24x earnings. Especially in the small-cap segment, there are numerous unprofitable companies. SilverCross does not invest in loss-making businesses. The MSCI World Small-Cap index is trading at 15x expected earnings in 2024, compared to a 15-year average of 17.7x. SilverCross, however, does not invest in loss-making companies.



How can we explain the significant difference in returns?

The main reason is the rise in interest rates. In 2022, it not only led to declines in the stock market, bonds, and real estate but also caused a substantial decline in the valuation of small-caps, which continued in 2023. Profits at smaller companies have not significantly worsened. Only eight out of the 28 companies in the SilverCross portfolio experienced a profit decline of more than 5%. Three of those companies were actually purchased because their stock prices had dropped significantly due to an expected - albeit temporary - decline in profits: SiteOne, Colliers, and a third company in which we have not yet completed our investment. The other 20 have mostly improved profitability significantly and also have good prospects for the current year. As a result, small-caps are now as cheap compared to large-caps as they were during the Great Financial Crisis in 2008. See the chart below.

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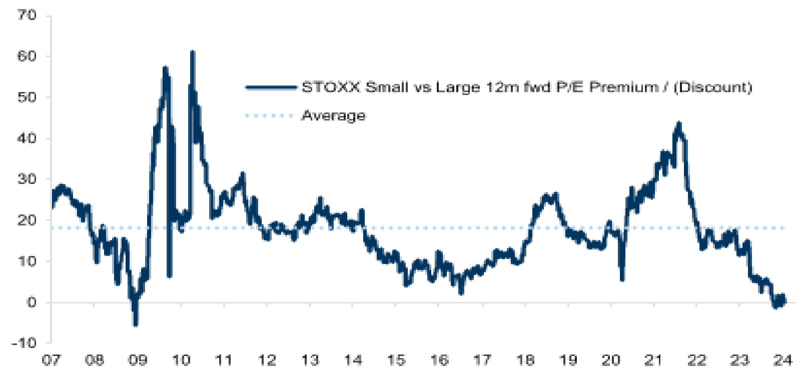
12m fwd P/E Premium / (Discount) STOXX Small vs STOXX Large

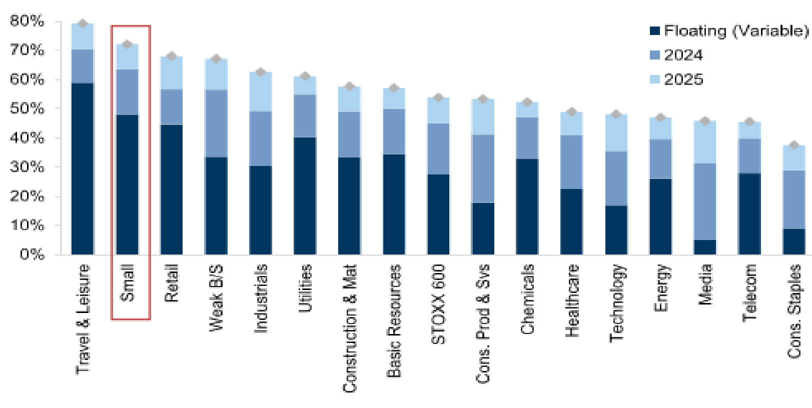


Source: IBES, Datastream, Goldman Sachs Global Investment Research

Due to the increase in interest rates, private equity firms have faced difficulties in financing acquisitions, leading to fewer bids on publicly listed companies.

Smaller companies generally carry slightly more debt than larger companies. This debt is often financed with variable interest rates. For instance, 38% of the debt of companies in the Russell 2000 (excluding financials) is variable, compared to only 7% for companies in the S&P500 index. The impact of the rise in interest rates on net results is thus felt more quickly.

% share of the total debt floating* and refinanced in 2024-2025



*Bloomberg classification of Floating vs. Fixed Debt (%)

Source: Bloomberg, Goldman Sachs Global Investment Research

It is often argued that small-caps are more sensitive to economic fluctuations because they operate less internationally, limiting their ability to offset weakness in one country with strong development in another. While this is a possible explanation, smaller companies increasingly operate internationally, sometimes even globally. Sensitivity is more significantly determined by the business model and resilience of a company, which is what SilverCross evaluates in every company.

If the rise in interest rates has been the main reason for the absolute and relative underperformance of small-caps compared to large-caps, the next question arises.

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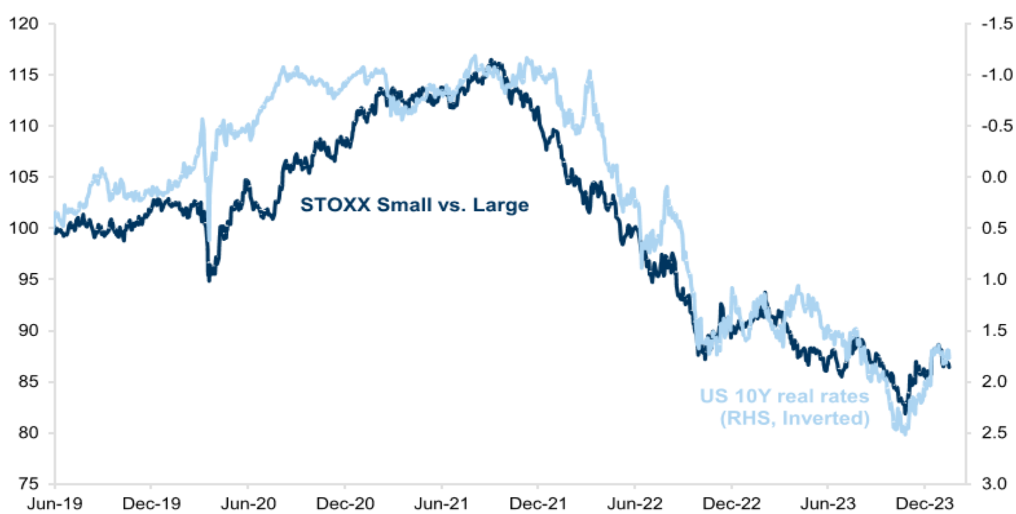
Quo vadis?

In November and December of 2023, interest rates declined rapidly, and indeed, small-caps saw a faster increase in value compared to large-caps. The challenge lies in the fact that we don't have a crystal ball to predict interest rates. As the saying goes, "prediction is very difficult, especially about the future." We leave that to economists, such as those at Goldman Sachs. They predict that interest rates have peaked by now.

Based on current inflation trends in Europe and America, it seems logical to assume that central banks' policy rates will be lowered in 2024. The bond markets have at least anticipated this by the end of 2023. In January, there was a retreat from that anticipation, causing small-caps to face challenges once again.

The chart below clearly illustrates the significant correlation between interest rates and the relative valuation between small and large-caps. The chart reverses the interest rate development to highlight the correlation effectively.

Price performance STOXX Small vs STOXX Large (indexed to 100 on Jan-19), US 10Y real rates (RHS, Inverted)



Source: Datastream, Goldman Sachs Global Investment Research

Once the actual decline in interest rates occurs, or at least stabilises at the current level, investors will likely refocus on the growth of individual companies, which is expected to improve. This improvement is anticipated due to growth in consumer income, helping to recover some of the previously lost purchasing power.

Private equity firms are also likely to become more active again after a 30% decline in their activity in 2023. They traditionally focus on smaller companies. Companies are also able to re-activate their M&A strategies.

Although fund flows in investment funds have been negative for years, those for mid and small-cap funds have been more significant than large-caps since the beginning of 2022.

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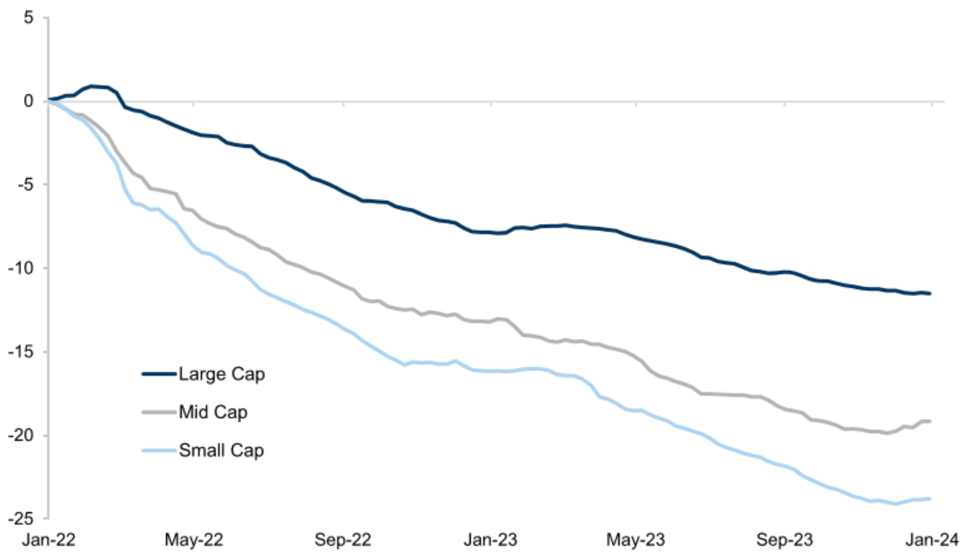
EPFR data for Flows into Small, Mid and Large Cap European Equity Funds



Source: EPFR, Goldman Sachs Global Investment Research

The aphorism "flows follow performance" is clearly evident here. Investors tend to buy what has performed well and sell what has performed poorly. This phenomenon was once studied by Fidelity among its large customer base. It revealed that most investors in Fidelity funds achieved a long-term return lower than the funds in which they invested. The timing of buying and selling was to blame – in other words, investors bought what had performed well and sold their investments after a period of disappointing performance: Buy high, sell low.

The cause of this seemingly irrational behaviour? Emotion.

What to do now?

Small-caps have just come out of their second-longest period of underperformance relative to large-caps since 1926, reaching a particularly noteworthy level. Together with historically low valuations and signs of economic recovery, we believe that the time to invest in small-caps has rarely been more attractive than now. However, low valuation alone is insufficient for stock price appreciation.

What could be the catalyst to drive small-cap stock prices higher? We believe the key factor will be accelerating earnings growth. Since the end of the COVID-driven demand explosion, many companies have reduced their inventories, cut costs where possible, and optimized business processes. Even a slight increase in demand can have a disproportionate effect on profitability. That's where the surprise element lies.

Should we wait for this? It's always challenging. Once the good news is published, stock prices have already risen. Investing is anticipating – buying in times of economic weakness and selling during moments of euphoria. Comfortable? No. A recipe for attractive returns? Certainly.

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How is SilverCross positioned to benefit from a recovery in small-caps?

Across the board, the valuations of companies in the SilverCross portfolio have declined, often to the lowest valuation levels at which the companies have traded in the past 10-15 years. At the same time, each of the companies in the portfolio has excellent growth prospects. Trends such as industrial automation, digitization of work processes, and the transition to a greener economy will drive demand for the products and services of these companies. Many companies in the SilverCross portfolio have recurring customers and revenue, for example, through monthly subscriptions to software packages or through the purchase of replacement parts for machines, aircraft, or recreational vehicles.

While we cannot predict when the positive outlook will translate into stock price increases, we have confidence in the solid financial position, committed entrepreneurs, and leading positions of the companies in the SilverCross portfolio. The companies in the fund are now available at a substantial discount compared to a few years ago. This discount will not always persist. The combination of high quality and exceptionally low relative valuation creates a rare opportunity for an attractive long-term return.

Even in the stock market, the adage holds true: after rain comes sunshine.

Kind regards,
David Simons & Chris Andrews

About the authors

David Simons and Chris Andrews are the founders and portfolio managers of SilverCross Global Small-Cap Fund. SilverCross is an asset manager based in Amsterdam, The Netherlands. It is focused on managing a high-conviction global small-cap equity portfolio.

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