LIONTRUST
COURAGE · POWER · PRIDE

Multi-Asset

March 2024

US small caps are overlooked and undervalued

John Husselbee
Head of Multi-Asset

The Magnificent Seven behemoths have been dominating investment markets and have been given added momentum over the last 18 months or so by the growth in AI (artificial intelligence). This was reinforced by the recent earnings season in the US.

While the share price growth of the Magnificent Seven has rewarded investors, we believe it will pay to focus on small caps in the US, as elsewhere in global markets, going forward. US smaller companies have underperformed significantly amid the monetary tightening seen in the last two years. This is to such an extent that they currently offer attractive valuations at significant discounts versus their historical levels.

We have been leaning towards a positive view of US smaller companies for some time. And in our most recent (1st quarter of 2024) tactical asset allocation (TAA) review, we raised our rating from a neutral three to a positive four, based on a scale of one to five, with one being the most bearish and five the most bullish. The arguments in their favour are not different from three months ago but they have become even more compelling.

Against the backdrop of a strong US economy, US smaller companies offer positive fundamentals. Furthermore, it is anticipated that interest rates will be cut by the Federal Reserve this year, which will provide further support. As smaller companies, they present higher risk but they do tend to be quicker out of the blocks in a recovery and we are firm believers in a small cap premium over the longer term.

We also believe that US small caps should continue to benefit from President Biden's key bills, such as the Inflation Reduction Act and Infrastructure Investment and Jobs Act. It is a point understood by active managers, most of whom tend to be overweight smaller companies.

Outlook for cash cut

In our 1st quarter TAA review, we also reduced our conviction level for cash from a neutral three to one. This was an aggressive cut but we felt it was the right move because inflation appears to have peaked and is falling. The next logical step is for interest rates to fall, and a reduced running yield on cash will make the asset class less attractive.

Past performance does not predict future returns

We had raised the score for cash from two to three in the 2nd quarter of 2023. Cash had become more attractive after the interest rate hikes of the current cycle but the real return that can be achieved on cash is low and capital markets may provide a better alternative for those with a longer time horizon or greater risk budget.

The biggest enemy to savings is inflation. Cash can be a useful safe harbour in the short term, but it represents an active decision to not invest. Over the medium to long term, staying in cash means missing out on the long-term benefits of investing in markets, which includes generating 'real' inflation-beating returns. Over the long term, equities have outperformed cash, bonds and inflation.

The role of multi-asset investing

Our investment process is long term in nature and is designed to be both patient and disciplined. Our TAA views generate targets that we build towards within our funds and portfolios over time, increasing positions when valuations of the asset classes are attractive. Our core approach is to buy low and we will not overpay for assets, however highly they score. Diversification should still be the cornerstone of investment portfolios.

Over the longer term, a multi-asset approach enables investors to build funds and portfolios that are in line with their attitudes to risk. They can invest in equities to reap the higher returns over the longer term while tempering the risk with exposure to other asset classes.

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested.

The Funds and Model Portfolios managed by the Multi-Asset Team may be exposed to the following risks:

Credit Risk: There is a risk that an investment will fail to make required payments and this may reduce the income paid to the fund, or its capital value. The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay;

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss;

Liquidity Risk: If underlying funds suspend or defer the payment of redemption proceeds, the Fund's ability to meet redemption requests may also be affected;

Interest Rate Risk: Fluctuations in interest rates may affect the value of the Fund and your investment. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result;

Derivatives Risk: Some of the underlying funds may invest in derivatives, which can, in some circumstances, create wider fluctuations in their prices over time;

Emerging Markets: The Fund may invest in less economically developed markets (emerging markets) which can involve greater risks than well developed economies;

Currency Risk: The Fund invests in overseas markets and the value of the Fund may fall or rise as a result of changes in exchange rates.

Index Tracking Risk: The performance of any passive funds used may not exactly track that of their Indices.

Any performance shown in respect of the Model Portfolios are periodically restructured and/or rebalanced. Actual returns may vary from the model returns.

The risks detailed above are reflective of the full range of Funds managed by the Multi-Asset Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.

Disclaimer

This document is issued by Liontrust Fund Partners LLP (2 Savoy Court, London WC2R 0EZ), authorised and regulated in the UK by the Financial Conduct Authority (FRN 518165) to undertake regulated investment business.

It should not be construed as advice for investment in any product or security mentioned, an offer to buy or sell units/shares of Funds mentioned, or a solicitation to purchase securities in any company or investment product. Examples of stocks are provided for general information only to demonstrate our investment philosophy. The investment being promoted is for units in a fund, not directly in the underlying assets.

This information and analysis is believed to be accurate at the time of publication, but is subject to change without notice. Whilst care has been taken in compiling the content, no representation or warranty is given, whether express or implied, by Liontrust as to its accuracy or completeness, including for external sources (which may have been used) which have not been verified.

This is a marketing communication. Before making an investment, you should read the relevant Prospectus and the Key Investor Information Document (KIID) and/or PRIIP/KID, which provide full product details including investment charges and risks. These documents can be obtained, free of charge, from www.liontrust.co.uk or direct from Liontrust. If you are not a professional investor please consult a regulated financial adviser regarding the suitability of such an investment for you and your personal circumstances. All use of company logos, images or trademarks in this document are for reference purposes only. 2024.03