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FUND COMMENTARY – Q4 2023

CT (Lux) American Smaller Companies



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Fund Manager
Since: 23/10/2018

Fund Information

You are investing in a fund that is actively managed in reference to the benchmark below. Please refer to the Prospectus and KIID for the Fund objective.

Fund Benchmark: Russell 2500 Index

Inception Date: 23/10/2018

Fund Currency: USD

Fund Domicile: Luxembourg

SFDR: Article 8*

Summary

- The Russell 2500 index returned 13.4% in dollars in the fourth quarter (Q4).
- Gross of fees, the fund returned 14.3%, beating its benchmark by 82 basis points (bps).
- Altimune, Kontoor Brands and Burlington Stores were among the key contributors. Carriage Services detracted.
- New positions included ATI, Altimune, Energy Recovery, Glaukos, J.M. Smucker and Service Corporation International.

Market Background

US small-cap equities registered strong gains in the Q4 and outperformed their large-cap counterparts, with the Russell 2500 posting 13.4% in US dollars, while the S&P 500 returned 11.7%. The sharp recovery in both large- and small-cap US equities over November and December came on the heels of three straight months of declines from August through October.

The asset class weakened in October, continuing a slide from mid-year highs that left many stocks at annual lows by month-end. Notable headwinds during the month included marked upward pressure on long-term US Treasury yields. The 10-year yield has climbed more than 400 basis points (bps) from its post-pandemic lows and in late October briefly reached 5% – a level last seen just before the global financial crisis in 2008. Uncertainty about the Q4 Treasury auctions compounded worries about rising yields amid fears the government may opt to auction long-term debt, which likely would drive 10-year yields even higher. Adding to the risk-off mood in October was rising geopolitical risk, as war broke out in Gaza. Meanwhile, Republican infighting in Washington DC resulted in House Speaker Kevin McCarthy being replaced Mike Johnson, with only a relatively narrow window left to resolve a budget impasse to avoid a government shutdown on 17 November.

November brought a sea change in sentiment, helped by signs that inflation may have cooled enough to forestall more rate hikes and perhaps even spur cuts. Bullish investors speculated that the Fed was mindful that the full effects of its historically rapid hikes since March 2022 had yet to be felt. They also found reassurance in tightening financial conditions – a narrative dubbed by market pundits as “bad news is good news”. A sharp decrease in the rate of consumer spending announced by the US Commerce Department, softer growth data in employment and manufacturing, and dovish interpretations of comments by Fed Chair Powell and other central-bank officials contributed to the optimistic outlook that rates would again be held steady at the mid-December meeting. The upward momentum continued into December despite ongoing uncertainty about the path of rates and elevated geopolitical risks, including continuing conflicts in Gaza and Ukraine. Although Fed officials cautioned during and after the December meeting that inflation remained too high and further tightening may be needed, markets rallied sharply as investors focused instead on how many cuts might be made in 2024, with published estimates almost doubling the Fed’s 75-bp forecast.

Amid the broad-based rally, 10 of the 11 sectors in the index registered gains on the quarter. Financials and consumer discretionary were the strongest sectors amid optimism that an economic downturn would be avoided in 2024. Real estate also outperformed, benefiting from the expectations of lower interest rates. At the other end, energy underperformed severely and was the only sector to post a negative return as oil prices weakened. The defensive consumer staples and utilities sectors posted gains but lagged the index amid the risk-on backdrop.

Performance

12M Rolling Period Return in (USD) - as at 31 December 2023

Past performance does not predict future returns and future returns are not guaranteed.

	12/22- 12/23	12/21- 12/22	12/20- 12/21	12/19- 12/20	12/18- 12/19	12/17- 12/18	12/16- 12/17	12/15- 12/16	12/14- 12/15	12/13- 12/14
Fund (Gross) %	22.69	-16.19	26.46	33.81	33.09	-13.31	18.51	15.20	-1.01	12.22
Index (Gross) %	17.42	-18.37	18.18	19.99	27.77	-10.00	16.24	20.74	-2.18	9.77

Source: Columbia Threadneedle Investments as at 31/12/2024. Gross of fee fund returns are time-weighted rates of return net of commissions transactions costs and non-reclaimable taxes on dividends interest and capital gains using pricing of investments which is either the last traded price or a bid basis. Cash flows are factored as of the end of the day and exclude entry and exit charges. Index returns include capital gains and assume reinvestment of any income. The index does not include fees or charges and you cannot invest directly in it. The return of your investment may change as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation.

The past performance information for the period prior to 23 October 2018 is from the American Smaller Companies Fund (a UK authorised UCITS fund launched on 14 November 1997), which merged into this Fund on 24 November 2018.

For detailed information on Fund Changes please see Significant Events - Threadneedle (Lux) Funds PDF available on www.columbiathreadneedle.com/en/changes

Gross of fees, the fund returned 14.3% in Q4, outperforming the benchmark Russell 2500 index by 82 bps.

Security selection drove the relative outperformance, led by choices in healthcare, technology and consumer discretionary. However, gains were moderated by detractor from our picks in communication services, industrials and materials. Sector allocation detracted moderately in aggregate. The underweight in financials was unhelpful, though the impact was largely offset by gains from the allocation to healthcare (which was an average underweight but ended the period overweight). The fund's cash position was a drag on relative returns in a strong quarter for the asset class.

At the stock level, a new position in Altimune was the top contributor. Shares in the biopharmaceutical company were lifted in December by the release of positive results for a phase-2 trial of pemvidutide, a weight-loss drug aimed at treating obesity in patients at higher risk of cardiovascular events. The company has identified cardiac safety as a key differentiator from other weight-loss drugs. Altimune's CEO further stated that the company is open to making deals with larger pharmaceutical companies to bring the drug to market.

Apparel company Kontoor Brands, owner of the Lee and Wrangler jean brands, was also a notable contributor. Shares rose in mid-October ahead of the firm's Q3 earnings release in early November. The stock received an analyst upgrade from "neutral" to "buy" during the month, with several positive drivers cited, including the firm's increasing market share, product diversification and value-based market positioning. Towards the end of October, Kontoor also announced a 4% increase to its quarterly dividend and provided positive updates on its climate goals, including the approval of its greenhouse gas emissions targets by the Science Based Targets initiative, which aims to drive positive climate action in the private sector.

Elsewhere, Burlington Stores added value as well. Shares surged in November in response to strong Q3 results. Burlington – along with several of its peers – is benefiting from shoppers seeking bargains amid ongoing high inflation, with highlights of the firm's earnings report including a double-digit year-over-year increase in revenue and strong growth in adjusted net income and earnings per share (EPS) year on year. Management reported a strong August and September, as well as higher merchandise margins, as key drivers of robust Q3 earnings but opted to maintain its previous Q4 guidance, citing "uncertainty in the external environment".

At the other end, key detractors included funeral and cemetery services provider Carriage Services. Having risen sharply at the end of June on news of a preliminary all-cash buyout offer from Park Lawn, the shares fully retraced this move in early October, hitting a 52-week low on reports that Park Lawn had withdrawn its offer and would no longer be participating in Carriage's strategic review process. Carriage subsequently confirmed that it was continuing to review its strategic options to maximise shareholder value.

Activity

In a busy quarter for activity, we opened several new positions, including ATI, Altimune, Energy Recovery, Glaukos, J.M. Smucker and Service Corp.

ATI (Allegheny Technologies) is a global supplier of melt and mill products for multiple industries, including aerospace, defence, electrical energy, oil, gas, chemical and medical markets. Key products include titanium and titanium alloys for aircraft engines, as well as nickel-based alloys and superalloys. ATI is transitioning to focus on aerospace and defence, and there is potential upside as it exits zero-margin businesses and gains market share due to customers diversifying away from Russian titanium. The firm's future growth should be supported by strong demand for commercial aircraft engines and increased demand for maintenance, repair and overhaul services. It should also benefit from growth in medical products that use titanium and niobium alloys and increasing demand for hafnium alloys used in semiconductors. Volume growth, sales mix improvement and reduced pension expenses should also help support margins and cash-flow conversion, increasing the potential for share repurchases and a reduction in leverage.

Altimune is a clinical-stage biotechnology company focused on developing novel treatments for obesity and liver diseases, such as non-alcoholic steatohepatitis and chronic hepatitis B. We initiated a position in Altimune as we have a positive view on its aforementioned phase-2 study for pemvidutide, the firm's lead asset. We believe further testing of the drug will show significant weight-loss benefits and provide proof-of-concept for pemvidutide in treating obesity, unlocking a significant commercial opportunity.

Energy Recovery is a fluid-dynamics and materials technology company. Its core products are pressure exchangers for utility-scale water desalination plants, but it also offers industrial wastewater treatment and commercial refrigeration. As average temperatures rise and water scarcity worsens across the globe, desalination will be an essential facet of climate adaptation. This will be a growth driver for Energy Recovery, which holds a near-monopoly position in pressure exchangers. The company also has potential to expand within commercial refrigeration, and there remain notable greenfield opportunities in the US and brownfield opportunities in Europe. Similarly, growth opportunities are promising in wastewater treatment, driven by municipal projects. As a result, we believe the company is well positioned for growth, and we took the opportunity to initiate a position after shares fell back following the announcement of a CEO transition.

Glaukos is an ophthalmic medical device company focused on minimally invasive surgical treatment of glaucoma and corneal degeneration (keratoconus). The company has a significant long-term opportunity to accelerate revenue growth and increase profitability through its iDose drug-delivery system, which is used to treat glaucoma. Given the limitations of rival products and low eye-drop compliance rates, the iDose implant has potential to take market share from existing treatments. Furthermore, given encouraging treatment data, we are optimistic that the FDA will certify iDose with a wide set of approved uses in the near future. If this occurs, it will enable Glaukos to offer iDose to a broad patient population, providing a recurring revenue stream through exchange procedures. iDose treatment lasts four times as long as its closest competitor, and, if the firm can improve the treatment's efficacy, it may be able to increase prices.

J.M. Smucker is one of the largest US food manufacturing and catering companies, with leading positions in growing categories such as coffee, cat food, pet treats, frozen sandwiches, peanut butter and fruit spreads. We took the opportunity to initiate a position after the share price fell amid concerns around the potential impact of weight-loss drugs on consumer preferences and the announced acquisition of Hostess Brands. While the Hostess Brands acquisition increases company leverage, we believe there is potential for J.M. Smucker to reduce its debt burden more quickly than expected. Margins should also be supported if the company achieves its synergy targets. Additionally, the firm boasts steadily increasing sales across its businesses, driven by pricing initiatives in the coffee segment, marketing support, improved production capacity in the consumer retail business and demand for cheap snacks in its pet business.

Service Corp. is the world's largest provider of funeral homes, services, cemeteries and crematoria; it also sells prearranged funerals in most service markets. We initiated a position amid a stock pullback after the firm's management lowered its full-year 2023 guidance in its Q2 financial results. We believe the stock is now well positioned due to secular industry growth trends related to aging demographics in the US and the increasing number of people opting to arrange and pay for funerals in advance. Additionally, the firm's management has a history of strong execution, which we believe will persist, and the company continues to drive shareholder returns through share repurchases and dividend increases.

We added to our holdings in Endeavor Group, Houlihan Lokey and Boston Properties, among others.

Turning to sales, we took some profits in Nutanix and Morningstar following strong year-to-date performance. Exits included Cable One, Patterson Companies, Lyft, Darling Ingredients, Hostess Brands and Bright Horizons.

Outlook

We remain constructive on the outlook for US equities in 2024 as inflation has fallen to a much lower rate, while the labour market and consumer spending continue to hold up relatively well, increasing the likelihood of a "soft landing" for the economy. Financial conditions have tightened considerably in the last 24 months due to the Fed's aggressive two-pronged monetary regime, characterised by increasing interest rates and unwinding its vast accumulated balance sheet. Although the Fed is far from declaring victory over inflation, the fall in headline consumer price inflation and recent signs of a loosening in the labour market have provided some reassurance that monetary tightening is having an effect. This has allowed the Fed to pause its interest-rate hiking cycle, although the terminal federal funds rate may remain elevated for longer than expected. Furthermore, persistent, entrenched inflation does still pose a risk, and there could be further downside should the economy enter a mild recession.

2023 was a strong year for financial markets, with inflation more than halving and growth remaining resilient, all while avoiding a much-feared economic recession. While there is still risk of a recession in 2024, concerns of a severe downturn have tempered. Inflation in 2024 is expected to continue its downtrend on fading energy pressure and softening labour markets as monetary tightening starts weighing on the growth outlook. This backdrop enabled the Fed to message a pivot in its final policy meeting of 2023. After holding rates steady (as expected), policymakers said they are pencilling in easing monetary policy in 2024.

Earnings growth estimates for Q4 of 2023, which will be reported in early 2024, have shown some level of analyst pessimism being baked into stocks as the US economy continues to grapple with slowing growth and as some economic tailwinds are easing. Analysts have lowered expectations for Q4 EPS growth by a higher margin than average, and negative EPS guidance is also running above historic averages, although the S&P 500 is still expected to eke out year-over-year growth for the final quarter and the whole of 2023.

Looking ahead to 2024 earnings, the picture is becoming incrementally more positive; healthcare, technology and communication services companies are all expected to deliver the strongest year-over-year earnings growth. No sectors are forecast to generate declining earnings in 2024, although energy and real estate are slated to produce the weakest levels of

year-over-year growth as lower energy prices and higher rates continue to put pressure on these sectors. Margins have started to recover as companies are seeing labour pressures and material inflation ease. On a year-over-year basis, the market is looking for a strong increase in earnings growth for 2024 as stocks face easier comparisons with 2023 and as the easing inflation picture is supported by a robust labour market and consumer spending.

Key Risks

The value of investments can fall as well as rise and investors might not get back the sum originally invested.

Where investments are in assets that are denominated in multiple currencies, or currencies other than your own, changes in exchange rates may affect the value of the investments.

The fund holds assets which could prove difficult to sell. The fund may have to lower the selling price, sell other investments or forego more appealing investment opportunities.

The fund may invest in derivatives (complex instruments linked to the rise and fall of the value of other assets) with the aim of reducing risk or minimising the cost of transactions. Such derivative transactions may benefit or negatively affect the performance of the fund. The Manager does not intend that such use of derivatives will affect the overall risk profile of the fund.

The fund applies a range of measures as part of its consideration of ESG factors, including the exclusion of investments involved in certain industries and/or activities. This reduces the investable universe, and may impact the performance of the fund positively or negatively relative to a benchmark or other funds without such restrictions.

The fund typically carries a risk of high volatility due to its portfolio composition or the portfolio management techniques used. This means that the fund's value is likely to fall and rise more frequently and this could be more pronounced than with other funds.

The risks currently identified as applying to the fund are set out in the "Risk Factors" section of the prospectus.

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