Montanaro UK Income Fund

Quarterly Commentary – Q2 2020

Market review

Global equity markets recovered sharply during the second quarter of 2020. The strength of this advance was somewhat surprising and seemed at odds with the reality of the most serious pandemic for at least a century: locked down populations; collapsed economies; and mounting death tolls.

At varying stages during the quarter, the economic picture looked particularly bleak: US industrial production registered the largest monthly decline since the Second World War; the Eurozone's PMI indicator fell to an all-time low; and in April, GDP in the UK plummeted by over 20%, the biggest monthly fall since records began. Yet markets continued their upward ascent, so much so that with a degree of political inevitability, Donald Trump felt emboldened to tweet once more about a favourite subject: "*Stock Market up BIG*".

What explained this juxtaposition? A culprit was soon identified, explained, as is so often the case in financial circles, by the use of a pithy acronym: TINA – There Is No Alternative. As the world shut up shop and economies crashed, Governments and Central Banks unleashed an unprecedented level of monetary and fiscal stimulus, estimated at some $15 trillion across the G10 countries plus China. Plummeting interest rates pushed investors into riskier assets that offered a return on their investment. "*Don't fight the Fed*", as the adage goes.

Alongside this, there was some evidence that the green shoots of a much hoped for "V-shaped" recovery were beginning to appear. Retail sales in the UK and US bounced back strongly in May as lock down restrictions were eased; housing markets picked up; even pubs reopened. These signs, coupled with a report from the IMF suggesting that the second quarter should be the nadir of the Covid-19 economic crisis, were reasons why SmallCap made up ground on its LargeCap peer. The asset class typically reacts with a higher degree of sensitivity to economic news. Improving data meant that over the quarter, SmallCap in the UK outperformed LargeCap by over 7%.

During the quarter, the NAV of the share class increased by 12%.

The strongest contribution during the quarter came from **Avast**, the desktop antivrius provider, which performed well as its recurring revenue business model saw no disruption from the crisis. **XP Power**, the provider of power solutions, rose after reporting strong order growth, driven in particular by the MedTech and semiconductor equipment end markets. **St James's Place**, the wealth manager, was boosted by the rally in financial markets and by news of relatively resilient net inflows.

The weakest contribution came from **Equiniti**, the back-office outsourcing conglomerate, which issued a profits warning as the impact of COVID was larger than originally anticipated. **Derwent London**, the REIT focused on Central London office development and investment, declined due to expectations of lower future demand. **Polypipe**, the supplier of recyclable plastic piping systems that are replacing carbon intensive cement alternatives, underperformed after the company issued new shares to further strengthen its balance sheet and to enable continued acquisitions.

Outlook (and dividend comment)

The returns posted by financial markets over the last few months should not disguise the fact that the outlook remains extremely uncertain. The most obvious risk is that the virus has not yet been fully contained; nor has a vaccine been approved, despite promising signs of progress from the University of Oxford, among others. Fears of a second wave are likely to ebb and flow in the months ahead.

Set against this is the reality that, on a global basis at least, the UK remains an unloved market and one that has lagged its international peers. For context, since the beginning of the year to the end of June, the S&P 500 has declined by 4%, while the FTSE 100 has fallen by over 18%. One reason for this may be that behind the spectre of Covid-19 lies the shadow of Brexit, an overhang that will remain until at least the end of the year.

Another point of worry for investors is the dividend landscape. Pay-outs will be significantly lower in 2020 than in previous years, with our own estimates suggesting a potential dividend fall of approximately 50% this year versus 2019. This decline needs placing in context. Firstly, many of our companies are cutting dividends not out of financial necessity (some have reduced dividends despite having net cash positions and/or conservative payout ratios) but rather because they prefer to be prudent in the face of the significant short-term uncertainty, overlaid with concerns that sending payments to shareholders in the current environment would send the wrong political message.

In addition, it is worth noting that the Fund benefited from a number of special dividends in 2019 (Cineworld, Jupiter, Taylor Wimpey, Victrex, Marshalls and Savills). This year’s decline therefore needs to be set against 2019’s exceptional year. Looking ahead, we expect dividend growth to increase sharply next year – as things stand – perhaps by as much as 60%, underpinned by the strong balance sheets and cash generative nature of the high quality companies that the Fund invests in. It would also not be a surprise if the Fund once again benefited from special payouts in 2021.

We have focused on increasing the quality of our companies rather than chasing yield. We will continue to focus on investing in companies that meet our “Quality” criteria: strong balance sheets; good cash flow; run by competent management teams. Our selective and conservative approach is, we believe, the best way of ensuring attractive returns over the long-term in a world where short term uncertainties have seldom been greater.