Montanaro UK Smaller Companies Investment Trust

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 outperformed LargeCap by over 7%.

Portfolio

During the quarter the NAV of the Trust increased by 12%, an underperformance of 5% versus the benchmark index as certain cyclical areas of the market enjoyed a strong bounce. Since the beginning of 2020, MUSCIT has outperformed by over 8%.

The strongest contribution during the quarter came from **XP Power**, the provider of power solutions, which rose after reporting strong order growth, driven in particular by the MedTech and semiconductor equipment end markets. **Liontrust**, the asset manager, was a direct beneficiary of the rally in financial markets. **4imprint**, the supplier of promotional merchandise, experienced a pickup in orders as lockdown restrictions were eased in the US.

The weakest contribution came from **Advanced Medical Solutions**, the manufacturer of wound care products, sutures and sealants, which declined as COVID-19 reduced the number of elective surgeries and A&E visits. **Cranswick**, the leading supplier of fresh pork meat products, saw profit taking after holding up well in the sell-off. **Big Yellow Group**, the market leader in the self-storage sector, experienced selling pressure despite the business proving to be relatively resilient during the initial months of the lockdown.

Outlook

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.

It may be premature to extrapolate the returns of the second quarter. Markets may need time to digest earlier gains from a rally boosted by stimulus and investors suffering from "FOMO" (Fear of Missing Out). As we continue to talk to our companies, it is increasingly clear that any recovery is unlikely to be equally felt. Consider the good fortunes, for example, of online retailers who have been able to continue business almost as usual, compared to their long-suffering high-street competitors, whose shops have been closed for several months. As always, there will be winners and losers.

We will continue to only invest in companies that meet our strict "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.