

Montanaro European Income Fund

Quarterly Commentary – Q3 2020

Market review

“It was the best of times, it was the worst of times”. There was a Dickensian feel to the third quarter of 2020. The world saw its first \$2 trillion company: the market capitalisation of Apple has doubled in just two years, making it more valuable than the entire FTSE100. Co-incidentally, national debt in the UK also exceeded £2 trillion. These are remarkable times.

For much of the quarter, a handful of US technology stocks led global equity markets higher despite a period of considerable angst. Investors became spooked by the dreadful coronavirus death toll which surpassed one million globally; the economic cost of the pandemic; and worries that the virus was again spreading among populations after an easing of lockdown restrictions over the summer.

The last few months made it clear that countries are not all on the same trajectory as they grapple with the impact of Covid-19. By extension, neither are their investment markets. Asia had a particularly strong quarter, helped by China’s apparent success in containing the virus which has allowed life to return to something approaching normality. In major Chinese cities, underground train usage was just 10% below pre-Covid levels. In contrast, London’s tubes were operating at less than 60% of normal capacity. By the same token, European stock markets were the poor performers on the world stage over the quarter.

The economic relevance of this is stark and may be one reason why SmallCap outperformed LargeCap during the quarter. The sharp decrease in economic activity has placed pressure on sectors such as Energy and Financials, both of which declined sharply over the summer months. SmallCap is underweight these areas of the economy. A further tailwind for the asset class has been its domestic focus: smaller companies have benefitted from localised upticks in business activity, even as global trade remained stagnant.

Portfolio

During the quarter, the NAV of the share class increased by over 9.5% (in GBP).

The strongest contribution during the quarter came from **Nolato**, the contract manufacturer of silicon and plastic moulded devices and components, which saw progress in its Integrated Solutions Division and good performance in its Medical Division including a beneficial acquisition in US. **Knowit**, the Swedish IT services

provider and management consultant, benefited from the increased demand for IT infrastructure which led to high growth during the quarter. **Avanza**, Sweden's leading online broker and pension provider, benefitted from stock market volatility and increased trading volumes.

The weakest contribution came from **ENAV**, the Italian provider of air traffic control and navigation services, which continued to suffer from reduced air travel as a result of Covid-19. **Amundi**, the European asset manager, saw profit taking after a strong period of performance. **Galenica Sante**, the integrated healthcare provider in Switzerland, saw pockets of trading weakness in their pharmacies due to lower footfall.

Outlook

The immediate outlook for consumer businesses that rely on customer footfall – restaurants, hotels, cinemas, theatres – looks bleak if lockdown restrictions tighten during the winter months. For those working in these industries, some of the suffering may be exacerbated by the easing of government aid at the end of October unless further support is offered. Providing support for the needy and protection for the vulnerable, whilst opening up the economy all at the same time is a difficult balancing act.

Other industries, such as Healthcare and Technology, where we are structurally overweight, are operating at more normal levels as the demand for healthcare solutions has been brought into sharp focus by the virus, while the drive towards digitisation has been accelerated as interactions of all types are increasingly undertaken remotely.

Amid this unprecedented crisis, income investors are trying to understand the impact of Covid-19 on dividend distributions. Since we last shared our forecasts at the end of the second quarter, government support to businesses and staff has reduced (although this may be reversed) and the second wave of Covid-19 is leading to new lockdown measures across the Continent. As such, we have seen consensus earnings estimates for 2021 drift downwards and dividend forecasts have followed suit.

Despite this, our current estimates suggest that the Fund's 2021 pay-out will be 60% higher than that experienced in 2020, while there may be scope for some special dividends to also be paid next year, which would boost this growth further. We have continued to focus on increasing the quality of the Portfolio rather than chasing yield.

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