MONTANARO
ASSET MANAGEMENT

Montanaro UK 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 1.2%.

The strongest contribution during the quarter came from **XP Power**, the provider of power solutions, which rose after reporting growth in orders from semiconductor and healthcare segments. **Diploma**, the global specialist distributor of industrial and medical equipment, gained after announcing a large and accretive acquisition.

DiscoverIE, the designer and manufacturer of components for electronic applications, rose on the back of a resilient trading performance as well as upgraded 5-year financial targets.

The weakest contribution came from **4imprint**, the supplier of promotional merchandise, which drifted lower due to negative sentiment regarding US Covid-19 infection levels. Both **Taylor Wimpey** and **Vistry**, the UK housebuilders, declined due to concerns around the potential impact of a second Covid-19 wave on demand for houses.

Outlook (and dividend comment)
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 – both sectors to which we have increased the fund's exposure over the last six months – 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 UK. The Brexit deadline is also ever closer. 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 40% 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.

Sentiment towards the "unloved" UK market is likely to be poor in the months ahead. Yet markets have a habit of looking through bad news. As the second wave coincides with the Brexit deadline, it may not be long before markets begin to look into 2021 with a greater degree of optimism, particularly if the UK strikes a trade deal with Europe and a workable vaccine emerges. To quote Charles Dickens once more: *"while there is infection in disease and sorrow, there is nothing in the world so irresistibly contagious as laughter and good humour".*

The views expressed in this article are those of the author at the date of publication and not necessarily those of Montanaro Asset Management Ltd. The information contained in this document is intended for the use of professional and institutional investors only. It is for background purposes only, is not to be relied upon by any recipient, and is subject to material updating, revision and amendment and no representation or warranty, express or implied, is made, and no liability whatsoever is accepted in relation thereto. This memorandum does not constitute investment advice, offer, invitation, solicitation, or recommendation to issue, acquire, sell or arrange any transaction in any securities. References to the outlook for markets are intended simply to help investors with their thinking about markets and the multiple possible outcomes. Investors should always consult their advisers before investing. The information and opinions contained in this article are subject to change without notice.