

Montanaro UK Income Fund Quarterly Commentary – Q1 2021

Market review

The impact of “Pfizer Monday” continued to be felt in the first quarter of 2021. This harks back to Monday 9 November 2020, when Pfizer and BioNTech announced the first effective Covid-19 vaccine, a “*great day for science and humanity*”. It was also a good day for investors in those businesses which had suffered most from the economic consequences of Covid-19. It unleashed the most dramatic rotation in equity markets in living memory. Value and Low Quality bounced back strongly at the expense of Quality and Growth, a dynamic that continued unabated in Q1.

As an indicator of how extreme this rotation has been, in the UK, SmallCap Growth has underperformed Value by 24% since November 2020, which compares to a c.30% underperformance experienced in both 2009 and 2013. *So if history is any guide, the current rotation may already be largely complete in the UK.* To add weight to this view, a recent survey published by Bank of America suggests that, by mid-March, most Fund Managers were overweight Cyclical and Commodities with the largest underweight in Technology since the start of the Bull Market in 2009.

Given our “Quality Growth” style, unsurprisingly we have underperformed since last November. We avoid highly cyclical areas such as high street retail, restaurants, hotels, airlines, oil & gas, materials, metals & mining etc. which helped us going into Covid. These same lower quality “Value” companies have bounced back sharply in recent months. We never like to disappoint you and do not enjoy such periods of underperformance, even if our Funds are holding up in absolute terms. Our investment approach will continue to remain consistent.

Portfolio

During the quarter, the NAV of the share class increased by 3%.

The strongest contribution during the quarter came from **Vistry**, the housebuilding and partnership business, which rose as demand for new houses continues to recover and synergies from the recent acquisition are higher than expected. **Kainos**, the provider of digitisation services to the public and corporate sector, rose on the back of a positive trading update in which they upgraded guidance. **Savills**, the global real estate services firm, recovered after the company released full year results which were better than expected reflecting the increasing size of the less transactional business, a balanced exposure to different end markets, a broad geographical split and the resilience of the business model.

The weakest contribution came from **Avast**, the global cyber security provider for consumer desktops, which suffered from the style rotation away from “stay-at-home” winners. **Marshalls**, the UK’s leading hard landscaping manufacturer, experienced profit taking after a strong run. **FDM**, the UK provider of IT professionals, drifted as they suggested that the impact of Covid may continue to hinder growth during 2021, prior to a stronger recovery in 2022.

Outlook

In a recent *“Letter to Investors”*, we urged our clients to remain calm in the face of the market rotation that has occurred. This is a message that we reiterate here. Style rotations are typical of the recovery period that comes immediately after a Bear Market - think of March 2003, March 2009 and 2012/13. Fortunately, these rotations tend to be short-lived. We have lived through several such periods before - after all, Montanaro is celebrating its 30th anniversary this year. Today, we are more convinced than ever that investing in high quality, small growth companies with strong management teams will deliver strong returns over any medium term period.

As far as our dividend expectations go, we now expect the Fund’s distribution to increase by c. 58% in 2021 vs 2020. This is a significant upgrade to our forecast of +38% made at the start of the year. Approximately one third of the upgrade is due to companies demonstrating their positive outlooks by announcing better dividends than were expected, while two thirds of the upgrade is due to active changes we have made to the portfolio during the quarter to increase the yield, such as increasing weightings in the housebuilders and asset managers, and introducing high-yielding quality names like Admiral.

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