MONTANARO

ASSET MANAGEMENT

Montanaro UK Smaller Companies Investment Trust

Quarterly Commentary – Q2 2021

Market review

For the English, football did not come home this summer. Instead, 2021 will be added to the years of hurt: red cards, metatarsals, the Hand of God, WAGs and yet more penalty heartbreak. For those not interested in the fortunes of the England football team, the first half of the year may also be remembered for something a little more relevant to the investment world. It's not coming home…but the money is!

After years of steady outflows from domestic UK equities, the tide seems to have turned. In the decade to the end of 2020, over £600 million was withdrawn from UK SmallCap funds, according to the Investment Association. Since the beginning of 2021, over £700 million has come back to the asset class, an indication that on a global basis the UK looks attractive as the economy reopens and the overhang of Brexit fades.

The Value rally, which has been the dominant force in equity markets since the approval of Covid-19 vaccines last November, cooled in the second quarter of the year. Equities traded higher as confidence in the economic recovery was bolstered by accelerating vaccination programmes. Europe made particularly good progress, catching up with high vaccination rates in the US and UK. SmallCap continued to benefit from the gradual unlocking of the economy and at the half-year mark, had outperformed LargeCap by 8%.

Portfolio

During the quarter the NAV of the Trust increased by 12%, an outperformance of 7% versus the benchmark index.

The strongest contribution during the quarter came from **DiscoverIE**, the designer and manufacturer of components for electronic applications, which saw record order book growth following a faster-than-expected recovery from the pandemic. **Cerillion**, the software-provider for telco operators, performed well following increased take-up of its SaaS products, alongside growth from existing customers. **Dechra**, the animal pharmaceuticals business, continued to benefit from the surge in pet ownership as a result of the pandemic.

The weakest contribution came from **Ideagen**, the supplier of Governance, Risk and Compliance software for highly regulated industries, which saw modest profit-taking after a good set of results. **Avon**, the manufacturer of protection masks, helmets and vests for the armed forces, drifted sideways following the departure of the CFO. **First Derivatives**, the database technology and consulting services provider, experienced selling pressure following a mixed set of results and concerns over increasing competition.

Outlook

At the beginning of April, we published a *"Letter to Investors"* in which we urged clients to remain calm in the face of a strong value-led market rotation. Guided by history, we suggested that such style rotations tended to be short-lived. This proved fortuitous timing – the Value style has since lost some of its momentum. This illustrates quite how difficult it is to time markets. Rotations, when they happen, tend to be swift.

We are moving into unchartered territory in the battle against Covid-19 with the ending of social and economic restrictions in some countries. Many people are likely to experience a mixture of emotions: relief that the pandemic may be coming to an end, contrasted by worries that cases will rise or that new variants of the disease will emerge. It would be no surprise if these anxieties manifested themselves in greater market volatility during the second half of 2021.

A catalyst for volatility could be that as economies reopen, inflation rises faster as pent-up demand is released. It is our view, however, that it will take a lot for central banks to bring to an end this long period of loose monetary policy. Whichever way the macroeconomic winds blow, we will continue to search for businesses with quality foundations that can grow over time and compound returns to their shareholders.