Montanaro European Income Fund

Quarterly Commentary – Q4 2021

Market review

A “Santa Rally” capped off another good year for equity investors in 2021. This, despite the threat of the Omicron variant which worried financial markets in the lead-up to Christmas and led to heighted levels of price volatility. Investors across almost all geographic markets enjoyed positive equity returns for the year, with only the New Zealand and Hong Kong indices posting negative returns – New Zealand suffering from its extended covid lockdown and Hong Kong a victim of political instability. In Europe, almost every sector posted healthy returns, the leader being IT while the laggard was retail, the only area of the market to post negative returns for the year.

To some extent the strength of returns was surprising given the numerous issues that threatened the economic trajectory: supply chain bottlenecks; labour shortages; and rising inflation. Indeed, during the fourth quarter, inflationary pressures overwhelmed a strong earnings season, leading to the underperformance of SmallCap versus LargeCap, while Growth stocks significantly lagged Value.

Portfolio

During the quarter, the NAV of the share class increased by 6% (in GBP). For the year, the NAV increased by 19%.

The strongest contribution during the quarter came from **NCAB**, the PCB board supplier, which rose after acquiring Elmatica, a key competitor in the Nordics. The company also posted strong growth in Q3, alongside a stock split and an extraordinary dividend. **Thule**, the manufacturer of sports and outdoor goods, delivered positive results despite ongoing supply chain and logistic constraints. **Beijer Alma**, the Swedish manufacturer of industrial springs and cables, released strong Q3 results and made a bolt-on acquisition after the results.

The weakest contribution came from **Edenred**, a specialist payment solutions business, which was impacted by the reimposition of Covid-related restrictions in Europe. **Bakkafrost**, the Faroese salmon farming company, declined as it continued to face high mortality rates amongst Salmon into Q4. **MTU Aero Engines**, the German aircraft engine maker, continues to be battered by the Omicron variant causing investors to doubt a travel recovery.

Outlook

There is a seasonality effect to markets and 2022 has started as it so often does, with the underperformance of Growth versus Value. The predominant reason for this has been a continuation of inflationary fears – indeed inflation in the US has reached a 40-year high. On this point we will only reiterate what we have said before: we are not economists and do not spend too much time worrying about the macro. We focus on the quality and growth opportunities of our individual companies and construct the Portfolio on a bottom-up basis.

That said, clients have recently been asking us about the potential impact of inflation and interest rates on the Fund, so here are a few thoughts. The first thing to note is that the SmallCap effect has held true throughout periods of both rising and falling interest rates and during all but galloping inflationary environments (>12%); so we are convinced that investing in Smallcap makes sense, no matter how the macro winds are blowing.

Secondly, the balance sheet strength of the companies in the Portfolio significantly reduces refinancing risk from rising interest rates. Finally, for the sectors that will likely be more susceptible to inflation, such as the housebuilders, industrials and consumer sectors, our focus on Quality should mean that our companies are relatively well placed to deal with it. Indeed, one of the key attributes we look for when assessing Quality is pricing power – the ability to pass on cost increases to customers. While there is no doubt that inflation and supply chain disruptions are having some impact on operations, we feel that the companies in the Fund are relatively well placed to deal with these challenges.

We wish all of you a very Happy New Year and every success in 2022!

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.