MONTANARO

ASSET MANAGEMENT

Montanaro UK 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 3.3%, outperforming the benchmark by 1.2%. The Fund had another excellent year. It returned a total of 25%, outperforming its benchmark by 7.5%, and it continues to be the top-performing UK Income Fund, against all SmallCap and LargeCap UK income funds, over both 5 years (out of 78) and 10 years (out of 69). It is also second (out of 85) over 3 years.

The strongest contribution 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. **Big Yellow Group**, the market leader in the self-storage sector, announced a very solid set of results with revenue growth of 24% driven by strong operational performance and the acquisition of Armadillo. **LondonMetric**, the FTSE 250 REIT that owns a logistics platform alongside a grocery-led long income portfolio, performed well after announcing a good set of results, the positive impact of acquisitions and an accretive equity raise.

The weakest contribution came from **James Fisher**, the marine services provider, which traded significantly lower after the company issued a profit warning caused by several one-offs that occurred in a short period of time across all divisions, leading to a significant profit shortfall. **Genuit Group**, the leading supplier of plastic pipes and ventilation systems for the construction sector, underperformed following a trading

update showing strong demand and good revenue growth, but operating margin slightly affected by cost inflation and supply chain issues. Annual profits are expected to be in line with consensus and margins to recover in early 2022 as price increases become effective. **Reach**, the news publisher, announced revenues were trading ahead of full year expectations in its November trading update, however, there are concerns over inflationary pressures in print production, especially for energy and newsprint.

Outlook

As we begin 2022, we feel the Fund is well balanced and in good shape. It is a collection of what we consider to be high quality businesses that have strong market positions in their chosen niches, diversified customer bases, pricing power, strong management teams, high returns on capital, good cash generation, and are benefitting from structural growth drivers. There is a fairly even balance between more economically sensitive names (such as housebuilders, industrials, and asset managers) and more stable names (such as REITs, water utilities, and healthcare), with the 15-20% in technology being somewhere in between the two buckets. The name turnover reduced in 2021 compared to previous years (we bought and sold seven companies) and we expect this to reduce even further in 2022. We will continue to look to increase the yield – both through higher yielding names, as well as through optimising dividend capture – but we will not sacrifice quality in the pursuit of yield.

We are not economists and do not spend 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 aforementioned SmallCap effect has held true throughout periods of both rising and falling interest rates and during all but galloping inflationary environments (>12%); so we think having exposure to SmallCap is a good strategy, no matter how the macro winds are blowing.

Secondly, the balance sheet strength of the companies in our portfolio – c. 50% hold net cash – significantly reduces any refinancing risk from rising interest rates. Thirdly, parts of the Fund may not be impacted by inflation or may even be beneficiaries – for example, the REITs and water utilities have inflation-linked revenues, while asset & wealth managers, healthcare and technology companies are likely to see limited impact (technology companies are used to dealing with wage inflation in any event).

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. We have seen this with the housebuilders where, despite build cost inflation, selling prices have been increasing at the fastest rate since 2003. While there is no doubt that inflation and supply chain disruptions are having some impact on operations, we feel that the companies in our portfolio are relatively well placed to deal with the challenges.