Montanaro UK Income Fund

Quarterly Commentary – Q1 2022

Market review

After a difficult start to the year, our Funds stabilised in March, outperforming their respective benchmarks. Clearly, this was not enough to offset the underperformance experienced in January, but it was a sign that investors' enthusiasm for Low-Quality Value stocks may be waning.

It has been a painful quarter for Quality Growth managers like us. Our Funds recorded one of the worst months ever in relative terms in January. The reason for this was a dramatic style rotation from Growth to Value, one of the fastest that we have witnessed in over 30 years of managing Small & MidCap portfolios. The swift change in sentiment was due to a burst of global inflation, which stoked fears of interest rate rises and disproportionately hurt long duration assets, notably Growth Small & MidCap equities. To put things in context, the MSCI World Growth index underperformed its Value counterpart by a staggering 8.1% in January, the second largest such underperformance in almost 50 years (only topped by April 1999, when Value enjoyed a brief respite amidst the dot-com frenzy).

The outperformance of Value continued in February, albeit not with the same vigour as we had seen earlier in the year. While inflation remained a dominant theme, another far more serious moment of historical significance impacted markets on 24 February 2022. Russia launched the largest military attack in Europe since World War Two by invading Ukraine, further shaking the confidence of equity investors. None of our Funds has ever had (or will have) direct exposure to Russia or Eastern Europe.

For Q1 as a whole, the MSCI UK Smallcap Growth Index underperformed its Value equivalent by 7.9%. Even more stark has been the underperformance of Smallcap against Largecap in the UK; indeed, the Numis Smallcap Index underperformed the FTSE 100 by a full 12.6% during Q1, as the latter was bolstered by its energy and commodities constituents.

Portfolio

During the quarter, the NAV of the share class declined by 12%, underperforming the benchmark by 5%. Given the scale of the style headwinds described above, underperformance was perhaps not overly surprising. Much of this decline came in January and it was reassuring to see the NAV rise in March by 3% and outperforming by over 1%.

The strongest contribution came from **Brewin Dolphin**, a UK wealth manager, which announced an agreed bid by Royal Bank of Canada at a 62% premium. **Bloomsbury**, the UK based worldwide publisher, upgraded expectations for the year ending Feb 2022 twice during the quarter. **Hilton Food Group**, the food packaging business, released a strong set of results for FY21 with sales growth of 19% and resilient margins.

The weakest contribution came from **Kainos**, the provider of digital transformation services primarily to the UK Government, which weakened on no specific news as it was caught up in the general sell-off of high growth tech names. **XP Power**, the provider of power solutions, declined after a US court ruling awarded $40m of damages to its Swiss competitor Comet. **Taylor Wimpey**, the housebuilding company, traded lower after the UK Government announced its intention to widen the legal obligation on housebuilders to fund the remediation of buildings affected by unsafe cladding. This has put pressure on share prices despite a very positive trading fundamentals.

Outlook

In times of market turbulence, it is easy to get distracted by the noise of headlines. There have been many such distractions over the quarter, from worries about inflation to sombre updates from Ukraine. Against such a backdrop, we have been focusing as always on our companies and understanding how they are impacted by the pressures impacting the global economy. On the whole, the message has been reassuring. Many companies have posted positive trading updates and some have come in ahead of consensus expectations. The environment has allowed us to add to positions in companies whose valuations have fallen due to negative sentiment, rather than a deterioration in the underlying fundamentals.

The outlook for dividends remains positive; we are currently expecting the Fund's distributions to grow to at least 7.2p in 2022. This represents growth of at least 10% relative to 2021 (if the exceptionally large special dividend paid by Pennon last year is excluded).

Finally, it is worth noting that the entire Montanaro team invested additional capital in our Funds in Q1. We are aligned with our clients and share the ups and downs of markets with you.

As well as the investment implications of the Ukraine conflict, MAM is acutely aware of the human suffering that is occurring. In response to this, our team has collectively made a contribution to the 'Disaster Emergency Committee – Ukraine Humanitarian Appeal'. This contribution has been matched by MAM, providing a significant donation *to help people affected by this escalating conflict. More information about this appeal can be found here: https://www.dec.org.uk/appeal/ukraine-humanitarian-appeal*