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ASSET MANAGEMENT

Montanaro Global Innovation Fund

Quarterly Commentary – Q2 2022

Market review

This has been the worst first half of a year for developed market equities in over 50 years. There have been few hiding places: government bonds and real estate, usually safe havens, have been hit by the prospect of Quantitative Tightening and higher borrowing costs, respectively. Indeed, US Treasury Bonds recorded their second worst 12-month period since at least 1872.

Central Banks have struggled to tame record inflation prints, even as they begin to unwind their enormous asset purchasing programmes which led to over a decade of "easy money" since the Global Financial Crisis. Exogenous events out of the control of Central Banks, like the impact of the War in Ukraine on energy and food prices, have further heightened the macroeconomic uncertainty.

For Quality Growth investors, it has been a difficult period, to say the least. The pace and magnitude of rate hiking presented a shock to markets, and a higher cost of capital, leading to an aggressive de-rating of growth stocks. These are businesses whose earnings are longer-dated, and thus whose valuations are more sensitive to changes in the cost of capital. In addition, consumers have faced a significant increase to the cost of living and recessionary fears have heightened.

Although some may have anticipated a marked underperformance of SmallCap versus LargeCap (as is historically typical during periods of market stress), on a global basis, SmallCap has held up relatively well. On a more localised basis, however, the underperformance of the asset class has been far more pronounced: in the UK, SmallCap has underperformed LargeCap by 19% so far this year, while on the Continent it has underperformed by 11%. This, however, is explained not so much by investors' aversion to smaller companies, but by the make-up of index constituents. In both the UK and Europe, the best performing sector has been Energy, an area of the market dominated by LargeCap names, and a sector to which the Fund has no exposure on quality grounds.

It's also worth noting that in both Europe and the UK, Technology was the worst performing sector in H1 2022, while the Nasdaq recorded its worst H1 since its inception in 1971.

Portfolio

During the quarter, the NAV of the Sterling Accumulation B Share Class declined by 19%, an underperformance of 9% versus the MSCI World SMidCap Index. Reassuringly, there are signs that the "Quality Growth" stocks that we invest in are returning to favour following a torrid first half to the year. As investors worry more about economic slowdown, and less about increases to the 'cost of capital', there is cause to believe the worst of the *relative* underperformance of longer-duration equities is behind us. That two of our Portfolio companies received takeover proposals at significant premia is reassuring with respect to valuations.

The strongest contribution during the quarter came from **Ideagen**, the supplier of Governance, Risk and Compliance software for highly regulated industries, which rose after agreeing to a takeover approach by HgCapital. **TransMedics**, which sells machines for restoring and assessing human organs before transplantation, had a very strong quarter following the launch of its liver product in the US. **EcoOnline**, the provider of chemical management and safety software in the Nordics, gained following a recommended takeover approach by Apax.

The weakest contribution came from **Unity Software**, the provider of software tools for video game development, which declined following an unexpected issue in its adtech monetisation engine for video games, which caused it to reduce guidance. **Qt Group**, the leading provider of tools to help developers design and build software applications, weakened after sluggish Q1 growth, although guidance for the full year remains unchanged. **SiTime**, the supplier of timing solutions, fell after investors worried about a slowdown in consumer spending in 2H.

Outlook

The significant decline in equity prices has shifted the risk / reward balance: equities have significantly de-rated, particularly those in the Quality Growth part of the market. These are companies which historically have been able to protect their earnings more easily in weaker macroeconomic environments given their higher pricing power, higher gross margins, and structural growth tailwinds. Several companies in our Fund are going through periods of impressive operational performance, seeing revenue growth, market-share wins, and new innovative product launches. Furthermore, many of our portfolio companies focus on offering innovative technological products and services that help their customers become more cost-efficient; in an inflationary environment, these offerings may prove particularly compelling.

We have no crystal ball on if and when market sentiment will turn, nor on future economic conditions – but given the once-in-a-generation nature of some of the

market moves and headwinds to our style that we have seen so far this year, it would be natural to believe that we might see a mean-reversion of these in due course. There are also signs that inflation is potentially peaking, which may enable equity markets to re-rate in due course. In any event, we believe that our approach of assembling a portfolio comprised of high-quality, innovative companies with significant future growth opportunities and strong balance sheets is an attractive one over the long term. This focus on quality should also enable our companies to fare well on a relative basis if economic conditions were to worsen.

We thank you for your continued support during this difficult six months and look forward to meeting with you again in the coming weeks and months.

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