MONTANARO

ASSET MANAGEMENT

Montanaro UK Income 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. To make matters worse, there has been no hiding place: government bonds and cash, usually safe havens, have been hit by higher interest rates and rising inflation. Central banks have struggled to deal with an inflationary environment, even as they have brought to an end the long era of "easy money" that has been in place since the Global Financial Crisis. It seems the adage rings true: one crisis leads to another.

For Quality Growth investors, this has resulted in an extremely tricky period, to say the least. The threat of higher interest rates has stalked markets, leading to a significant de-rating of growth stocks – businesses for whom the value of future earnings is vulnerable to higher interest rates. Consumers have faced a significant increase to the cost of living and recessionary fears have heightened.

The Fund has suffered from an exceptional triple-whammy of headwinds in H1 2022. Indeed, UK SmallCap underperformed LargeCap by 19% (the most since 1998), UK SmallCap Growth underperformed UK SmallCap Value by 9% (the most since 2013) and UK Quality has underperformed the UK Market by 13%. Although some may have anticipated a marked underperformance of SmallCap versus LargeCap (as is historically typical during periods of market stress), we believe that this year it is explained not so much by investors' aversion to smaller companies, but by the make-up of index constituents. In the UK, the best performing sector has been Energy, an area of the market dominated by LargeCap names.

Portfolio

During the quarter, the NAV of the £ seed share class declined by 15%, underperforming the benchmark by 6.7%.

The strongest contribution came from **Biffa**, the leading waste management company, which rose after receiving a takeover offer of 445 pence per share. **XPS Pensions**, the pensions consulting and administration business, and **Spirent Communications**, a leading global provider of automated test and assurance solutions for telecom networks and equipment, both benefited from their defensive business models.

The weakest contribution came from **Marshalls**, the UK's leading hard landscaping manufacturer, which came under pressure due to investor concerns around slowing demand across the construction sector. Management reiterated their 2022 expectations and the company's ability to pass through inflationary cost increases. **DiscoverIE,** the designer and manufacturer of components for electronic applications, experienced a significant derating in its earnings multiple, despite strong trading and upgraded guidance, as it was caught up in the sell-off high growth rated stocks. **St James's Place**, the British wealth manager, performed weakly given the correlation between its assets under management and market valuations.

Outlook

The significant decline in equity valuations, particularly for Quality Growth companies, has shifted the risk reward balance. In our view, this is especially true for the majority of the companies in our fund, given the underlying trading performance continues to be strong in general. The Fund is trading below its long-term average PE (despite the quality of companies being higher than history), while its dividend yield is now >4%. The valuation opportunity is potentially also highlighted by the resurgence of takeovers (Brewin Dolphin and Biffa in our Fund). There are also signs that inflation is potentially peaking, which may enable equity markets to re-rate in due course.

On a global basis, US Treasury Bonds recorded their 2nd worst start to a financial year since at least 1872. The Nasdaq recorded its worst H1 since its inception in 1971. In the UK, Technology and Industrials were the two worst performing sectors in H1; our Fund has meaningful exposure to both, with Technology suffering its greatest 12-month underperformance since 2005. In contrast, Energy and Healthcare were the best performing sectors; the Fund has no exposure to Energy on quality grounds, and very limited exposure to Healthcare given our smallcap focus and yield requirement.

We have no crystal ball to tell 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. In any event, we believe that our approach of assembling a well-balanced portfolio comprised of resilient, high-quality companies with good 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.

Finally, on dividends, we are pleased to increase our guidance for 2022. We now expect the Fund's distribution to be broadly flat against 2021 (which was boosted by the extraordinarily large special dividend from Pennon). Excluding Pennon's large special dividend last year, we expect the underlying dividend growth in 2022 to be c. 15%.

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