MONTANARO
ASSET MANAGEMENT

Montanaro UK Smaller Companies Investment Trust

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 Trust has suffered from an exceptional triple-whammy of headwinds. SmallCap underperformed LargeCap by 19% (the most since 1998), SmallCap Growth underperformed SmallCap Value by 9% (the most since 2013) and Quality has underperformed the wider market by 13%. Although some may have anticipated a marked underperformance of SmallCap versus LargeCap (as is historically typical during periods of uncertainty), we believe that this year's underperformance is explained less by investors' aversion to smaller companies but more 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 Trust declined by 15%, an underperformance of 3% versus the benchmark index. However, as recessionary fears increased in June, there were signs that Quality was returning to favour with the NAV finally outperforming on a relative basis.

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. **Biffa**, the leading waste management company offering collection, treatment, and recycling services, gained after also receiving a takeover offer. **Cerillion**, the provider of billing, charging and

CRM solutions, announced a positive set of interim results with record-high sales alongside margin expansion.

The weakest contribution came from **Marshalls**, the UK's leading hard landscaping manufacturer, which came under pressure due to worries about possible slowing demand across the construction sector. Management reiterated their 2022 expectations and their ability to pass on higher input cost through the supply chain. **Treatt**, the supplier of citrus oils and botanical ingredients, declined after reporting higher than expected costs during the first half of the year. **Integrafin**, well known for the Transact platform widely used by IFAs, saw a share price de-rating reflecting increased costs.

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 the Trust, given the underlying trading performance continues to be strong in general. The valuation opportunity is also highlighted by the resurgence of takeovers (Ideagen and Biffa). There are also early signs that inflation may be peaking, which would enable equity markets to re-rate in due course.

We have no crystal ball to tell us when market sentiment will turn, nor any prescience on future economic conditions. Nonetheless, given the once-in-a-generation nature of some of the extreme market moves and headwinds to our investment style so far this year, it seems reasonable to anticipate a mean-reversion of these in due course. In any event, we believe that our approach of carefully curating a well-balanced portfolio of resilient, high-quality companies with good future growth opportunities and strong balance sheets is an attractive one for long term investors. Our focus on quality should also fare well (at least on a relative basis) if economic conditions were to worsen.

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