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ASSET MANAGEMENT

Montanaro UK Income Fund

Quarterly Commentary – Q3 2022

Market review

The dominant theme to UK markets over the quarter was political, once again. Despite coming second in the leadership ballot of Conservative MPs, Liz Truss was appointed Prime Minister as Conservative Party members elected her ahead of Rishi Sunak. She promised *"growth, growth, growth"*, but the market reaction to *"Trussonomics"* – a confused cocktail of tax cuts and unfunded borrowing – meant that she entered with a whimper, rather than the *"Big Bang 2"* that her (ex) Chancellor pledged. Sterling fell and Gilt yields substantially increased. Borrowing costs rose so rapidly following the "mini" budget that the Bank of England was forced to intervene to purchase long-dated government bonds towards the end of September. *"Dear oh dear",* as King Charles III lamented when he saw the Prime Minister for her first weekly audience. All this, as the country reeled from the death of Queen Elizabeth II.

Yet it must be noted that it is not only the UK that has had a tough time in 2022. As we show in our latest *"Outlook for Global Small & MidCap"*, all major asset classes bar oil have lost investors money so far this year (pity the Bitcoin owners down almost 60%). The S&P 500 suffered its second worst September in 30 years and incredibly is on track for one of its worst years, in real terms, since 1872. It was a better quarter for Global SmallCap, however, which outperformed LargeCap for the first time since Q1 2021, although in the UK, SmallCap continued to lag.

Portfolio

During the quarter, the NAV of the £ seed share class declined by 11%, underperforming the benchmark by 5.5%.

The strongest contribution came from **4imprint**, the supplier of promotional merchandise, which performed well as it reported strong sales growth in H1 and expansion in both its operating margin and market share in North America. **Ricardo**, an environmental and engineering consulting company, performed well after publishing a good set of results. **NCC Group**, the cyber-security specialist, also reported good results.

The weakest contribution came from **Hilton Foods**, the leading meat packer, which declined following a profit warning, a result of inflationary pressures. **XP Power**, the supplier of power solutions, fell after reporting mixed first half results in which strong order intake did not flow through into revenue due to component shortages and lockdowns in China, which had a follow-on impact on margins. Furthermore, a court ruled that the company should pay rival Comet $40 million due to an intellectual property dispute. **Jupiter**, the asset manager, traded down as confidence in the UK economy faltered as did expectations of net inflows into their funds.

Outlook

UK equities remain an unloved asset class and smaller companies have had a torrid last 12 months. Indeed, SmallCap has lagged LargeCap equities by 24% during the past year, the worst period of relative underperformance since 1998. The asset class has fallen by 25% from its peak, with SmallCap trading on its lowest P/E (of 8.6x) since 2009.

It now seems a matter of “when” not “if” developed markets enter a recession. In some respects, investors just want economies to *get on with it* so that a recovery can begin. As the economic outlook worsens, it is possible that investors will increasingly focus on the resilience of earnings; companies with strong balance sheets, market leadership positions, pricing power and limited consumer exposure – such as those that the Fund tends to invest in – may be in relative favour. After the extreme YTD market moves, it clear to us that value (especially in SmallCap) is returning to equity markets. Given we are facing a cyclical economic slowdown, not a financial meltdown as in 2008, investors may find that they start to feel a little braver in the final months of the year.

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