MONTANARO
ASSET MANAGEMENT

Montanaro UK Smaller Companies Investment Trust

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 Trust declined by 8%, an underperformance of 2% versus the benchmark index.

The strongest contribution during the quarter 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. **Kainos**, the provider of digital transformation services primarily to the UK Government, rose as it gained "Phase 1 Partner" status in the US for its Workday practice, which should enhance its growth opportunities. **Ergomed**, the leading CRO for clinical trials, posted positive earnings growth and saw its shares perform well given its defensive business model and high revenue visibility.

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, declined after a court ruled that the company should pay rival Comet $40 million due to an intellectual property dispute. **Marshalls**, the UK's leading hard landscaping manufacturer, weakened on concerns that a worsening economic outlook may lead to an earnings contraction in 2023.

Outlook

UK equities remain an unloved asset class and smaller companies have had a torrid last 12 months. Indeed, SmallCap has lagged LargeCap 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. Nevertheless, it is clear to us that considerable value 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. SmallCap provides an obvious hunting ground for those looking to position themselves for a market recovery.