MONTANARO

ASSET MANAGEMENT

LF Montanaro Global Select Fund

Quarterly Commentary – Q4 2022

Market review

As the global pandemic of Covid-19 eased, some commentators suggested an economic boom was on the cards. Freed from lockdown, the world was ready to party*: "Goodbye virus…hello Roaring Twenties"* screamed one hopeful article in the *Financial Times*. You only had to look back a century to the boom that followed the 1918 pandemic (Spanish Flu) to see what would follow: a hedonistic decade of economic growth and stock market excess spurred by technological innovation (the car and the radio); *"the illicit thrill of Prohibition moonshine and the un-girdling of women"*[1]. London had its *"Bright Young Things",* New York the Jazz Age of *The Great Gatsby*.

While economic growth initially rebounded faster from the impact of Covid than many had expected, 2022 brought surprises that derailed this trajectory. The first war in Europe since the Second World War brought with it rising oil prices and inflation unseen in a generation. The era of easy money came to an abrupt halt. The mood music changed. It was as brutal a start to a year as we can remember.

Our Funds recorded one of the worst months ever in relative terms in January 2022. The reason for this was a dramatic style rotation from Growth to Value, one of the fastest that we have witnessed in over 30 years of managing Small & MidCap portfolios. The swift change in sentiment was due to a burst of global inflation, which stoked fears of interest rate rises and disproportionately hurt long duration assets, notably High Quality Growth Small & MidCap equities.

The year did not get much better for Quality Growth managers as even recessionary fears mounted. Exacerbated by the dreadful war in Ukraine, investors sought refuge in larger companies. The result was our worst year looking after investments for our clients since 2008 on an absolute basis and our worst relative year since the Eurozone crisis of 2013. Usually, our Portfolios hold up well in market downturns due to their high quality. Not so this time. The rotation out of SmallCap, Quality and Growth was a "perfect storm".

It is never nice to report such disappointing results and for this we are sorry. Yet as we note below, the final quarter of the year offered a glimmer of hope.

[1] "The need for a damned good party", *Financial Times*, 1 January 2021

Portfolio

During the quarter, the NAV of the Sterling Accumulation Share Class increased by 5.7%, an outperformance of 2.5% versus the MSCI World SMidCap Index.

The strongest contribution during the quarter came from **Games Workshop**, the developer of the Warhammer games and miniature figures, which rose after announcing an agreement in principle with Amazon for a film and TV production series. **Esker**, the French provider of cloud software solutions used to make company cash conversion cycles more efficient, rose after reporting solid Q3 numbers, including strong bookings growth. **IDEXX Laboratories**, the leading supplier of pet diagnostics, gained after reporting better than expected organic revenues driven by strong pricing power.

The weakest contribution came from **Tyler Technologies**, a leading provider of software to the US government sector, drifted after reporting in-line Q3 2022 results. **Paycom**, a payroll and HR software provider for small businesses in the US, underperformed as analysts considered the potential impact of a recession on employee numbers. **Entegris**, the advanced materials and filters supplier to the semiconductor industry, weakened as Q3 results were impacted by US semiconductor export controls to China.

Outlook

How to think about the months ahead from an investment perspective? Perhaps like the Aymara Tribe in South America, we should walk backwards into the future. In their culture, the most important feature of time is what we know: *"we can see the present and the past; they are laid out before us…anything we know or believe about the future is based on inference from what we have experienced in the present or the past…when making plans for the future, we should take much the same attitude as if we were walking backwards into unknown terrain"*[2]. As an investment house founded by an anthropologist, we find such a philosophy appealing.

With this in mind, what do we know and how can this inform our thinking? Many P/E valuations halved in 2022 and are back to 2016 levels or even 2008. Equity value is more attractive in our Quality Growth segment of the market than it has been for years. We also know that inflation dramatically rose last year but appears to have peaked last June. The US consumer price index declined in each of the last six months, while European inflation eased more than expected in November. This suggests that monetary policy may be having the desired effect. If this trend continues, central bankers may at least refrain from significant further tightening.

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[2] *What We Owe The Future*, William Macaskill

We also know that economic growth has slowed, with some regions likely entering recession. In such an environment, it is probable that corporate earnings will decline this year. And here comes the nub of our outlook: in such an environment, the well capitalised Quality companies in which we invest should deliver *better* earnings growth than the wider market. As we walk (backwards) into the future, we can have confidence in the resilience of our companies and that, after a very difficult year, they are well placed to deliver attractive returns to our investors over the long term as they have in the past.