Montanaro European Income Fund

Quarterly Commentary – Q1 2023

Market review

We do not invest in bank shares. Every few years, this becomes a topic of interest to our clients as it was in March. Silicon Valley Bank ("SVB"), a bank catering to venture capitalist depositors, failed after a bank run, becoming the second-largest bank failure in US history. One of the reasons that we have always avoided banks is that you rarely know the problems that might be lurking until it is too late: liquidity concerns can become solvency concerns very quickly. So it has proved again.

In this case, the run did not occur with the pounding of feet along the pavements as with Northern Rock in the UK in 2008, but rather with the instantaneous spread of information via social media. SVB had a particularly large bond portfolio relative to its deposits, which left the bank sitting on large unrealised losses following rising interest rates. As this became known, outflows spiked, forcing the bank to sell its bonds to generate cash, realising large losses. When the run started, it took just 36 hours for the bank to fail. As Warren Buffett once observed: *"interest rates are to asset prices what gravity is to the apple".*

Drama in the banking sector was not contained to the US. Credit Suisse, a bank that had a certain *penchant* for being at the heart of almost every scandal to hit the banking sector, became embroiled too. Since 2020, it has been involved in a corporate espionage saga; Bulgarian drug trafficking; the fall of Greensill capital; the collapse of Archegos Capital Management; a CEO breaking covid-19 rules; a guilty verdict in a cocaine and money laundering trial; and a fine for bribery relating to Mozambique "tuna bonds". Quite a list!

When its largest shareholder, the Saudi National Bank, publicly ruled out further investment, shares in the Swiss bank plummeted further and its bonds fell to just 10 cents per Euro. Ultimately, government coordination led to its acquisition by UBS, putting the 167-year-old institution out of its misery after years of mismanagement.

We will continue to avoid banks. They are opaque; not in control of their own destiny; management are often incompetent and vastly overpaid; they rely on leverage to generate acceptable returns; growth is often achieved simply by taking on the most risk; and they operate in a sector with little (any) structural growth and lots of competition and disruption.

Away from the banking system, inflationary pressures continued to normalise and growth rates in the world's major economies remained positive. The euro-area composite PMI for March rose to a 10-month high, well above expectations. This strong momentum was almost entirely driven by the service sector, while the manufacturing sector continued to struggle.

Portfolio

During the quarter, the NAV of the Sterling Share class increased by 8%, a slight underperformance of 0.8% versus the composite benchmark.

The strongest contribution during the quarter came from **Loomis**, the provider of cash management services, which gained after strong results. **Moncler**, the Italian luxury group, traded higher with better-than-expected results boosted by the reopening of business in Asia. **Melexis,** the supplier of semiconductors for the automotive industry, posted good numbers driven by the trend towards electrification.

The weakest contribution came from **Tryg**, the largest non-life insurer in Scandinavia, which experienced profit-taking after a good run. **Merlin Properties**, the Spanish REIT focused on commercial assets in the Iberia Peninsula, underperformed as investors are pricing in the impact of higher interest rates, although the stock is already trading at a 40% discount to NAV. **GTT**, an engineering expert in containment systems used in vessels to transport and store LNG, saw profit taking during the quarter.

Outlook

The IMF is forecasting that interest rates will return to *"rock bottom"* due to chronic low growth in the developed world, linked to poor productivity and ageing populations. Such forecasts are interesting insofar as they highlight just how unusual 2022 was, as we noted in our end-of-year commentary. Interest rates soared as a result of the economic dislocations of covid, rather than underlying structural trends. Nevertheless, the outgoing tide is showing us who has been swimming naked.

We continue to be reassured by the fundamental performance of our companies. Many (not all) have posted good numbers in the latest reporting season, giving us the confidence that in our hunt for good companies, we are finding those that are not only growing, but are doing so from a position of fundamental "Quality" strength. Although SmallCap remains out of favour and has underperformed its LargeCap peer in the UK, Europe and the World equity markets so far this year, the increasing attractiveness of valuations makes this a rich hunting ground for long-term investors. We would go so far as to say that the pickings are as attractive as they have been for several years.

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