Montanaro UK Smaller Companies Investment Trust

Quarterly Commentary – Q1 2023

Market review

We never 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. The reasons bore the hallmark of why we do not invest in banks: you rarely know the problems lurking on the balance sheet until it is too late. Often poorly managed, investors will never know the nature and risk profile of a bank's loan book. Liquidity concerns can become solvency concerns very quickly.

In this instance, 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 dissemination 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 widely 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 seemed to have a *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 leaving after breaking covid-19 rules; a guilty verdict in a cocaine and money laundering trial; a fine for bribery relating to Mozambique "tuna bonds"; and a long list of dubious Russian clients. Quite some 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; and growth is often limited and unpredictable.

As these chickens came home to roost, inflationary pressures normalised and growth rates in the world's major economies remained positive, putting talk of a recession on hold, at least momentarily. This did little to help the domestic UK equity market, which has become something of an unloved animal.

Portfolio

During the quarter, the NAV of the Trust declined by 2.3%, an underperformance of 3.6% versus the benchmark index following a strong last quarter of 2022.

The strongest contribution during the quarter came from **4imprint**, the supplier of promotional merchandise, which outperformed as it posted a strong set of full-year results which confirmed previous guidance, alongside increased market share and operating profit margin expansion. **Greggs**, the food-to-go retailer, performed well during the quarter on the back of a positive Q4 trading update and strong full-year results. **Games Workshop**, the hobby miniature creature behind Warhammer, outperformed on a stable trading update and ongoing collaboration with Amazon on movies.

The weakest contribution came from **NCC Group**, the cyber security consultant, which issued a profit warning largely because of its tech-heavy US customer base reducing business activity in a weak macroeconomic environment. **Ergomed**, one of Europe's leading CROs for clinical trials, saw its shares derate from a high multiple, as concerns built around the health of the biotech funding environment. **Frontier Developments**, a leading video game developer, lowered its revenue and profit guidance, following the underperformance of its new F1 Manager game launched at the end of 2022.

Outlook

The IMF is forecasting that interest rates will return to *"rock bottom"* due to chronic low growth in the developed world, linked to low 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 dislocation 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 increasingly attractive valuations make 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 (hence the recent buzz of M&A activity). For those willing to close their ears to the noise, opportunities abound.

markets and the multiple possible outcomes. Investors should always consult their advisers before investing. The information and opinions contained in this article are subject to change without notice.