MONTANARO

ASSET MANAGEMENT

LF Montanaro Global Select Fund

Quarterly Commentary – Q2 2023

Market review

"Things are not always what they seem", said Phaedrus in discussion with Socrates. *"The first appearance deceives many; the intelligence of a few perceives what has been carefully hidden"*.

Equities delivered positive returns across most major developed markets during the first half of 2023. Yet the headline figures created something of an illusion. Not since the "Nifty Fifty" propelled the Bull Market of the early 1970s has US stock market performance been as reliant on so few names. Returns this year in the US were driven by the "Magnificent Seven", the behemoth technology stocks: Apple; Microsoft; Alphabet; Amazon; Nvidia; Tesla; and Meta (listed in order of market capitalisation).

Together, they propelled the Nasdaq to its strongest first-half performance for 40 years and staggeringly accounted for 75% of the total gains made by world equity markets during the period. The market capitalisation of Apple again breached the $3 trillion mark, more than the combined value of the entire FTSE-100 and more than the Russell 2000 of smaller US companies. Across the S&P 500, over 80% of the year's return came from just 15 companies, many of them technology stocks. By contrast, the median company was flat. Pity those LargeCap managers underweight the Tech Titans.

Elsewhere, interest rates continued their rapid ascent. In the US, rates rose at their fastest pace in almost four decades, while the trajectory of tightening in the UK and Europe was also steep. *"The times they are a-changin",* sang Bob Dylan, and it is easy to forget that just two years ago, a quarter of government debt was trading at negative yields. Investors *paid* for the privilege of lending money to governments.

While investors in smaller companies enjoyed healthy returns in the US and Europe during the last 6 months, these lagged those of the technology dominated indices. The UK remained a laggard on a global basis, the FTSE-100 index hurt by its heavy exposure to oil majors and its limited technology weighting (no *"AI hoopla"* as one Analyst pithily put it), while inflation remained stubborn and persistent.

From an asset allocation perspective, SmallCap remained unloved. Investors rarely favour smaller companies when the economic backdrop is uncertain and economists are talking about recession. Some reassurance was to be found, however, in the outperformance of Quality and Growth during the first half of the year. Investors had not entirely forgotten the importance of fundamentals despite the cacophony of market noise.

Portfolio

During the quarter, the NAV of the Sterling Accumulation Share Class increased by 4%, an outperformance of 4% versus the MSCI World SMidCap Index. Since the beginning of the year, the NAV has risen by over 8%, an outperformance of more than 6%.

The strongest contribution during the quarter came from **Bentley Systems**, the provider of design software for infrastructure assets, which rose following strong results which demonstrated that it is a beneficiary of large US government funding programmes. **Trex**, the world's largest manufacturer of composite decking made from recycled plastic, recovered as it became evident that channel destocking is now complete, leaving distributors better positioned. **Games Workshop**, the developer of tabletop wargames and fantasy miniatures, outperformed following a trading update highlighting better than expected revenues and profitability.

The weakest contribution came from **MSCI**, the global financial index provider, which had slightly weaker results as revenue linked to AUM fell in line with the weak capital markets of 2022. **Fortnox**, the Swedish provider of cloud accounting software, drifted after a very strong run possibly due to concerns around rising bankruptcy rates in Sweden. **Sartorius Stedim**, the provider of equipment and consumables used in the production of biologic drugs, underperformed after cutting full year guidance, citing customer inventory destocking.

Outlook

How will the market's concentrated performance resolve itself? There may be three possible routes from here: the Magnificent Seven continue to soar (potentially at some point approaching a level so disconnected from their fundamentals that a bubble appears); they fall back to earth; or the rest of the market catches up. Which route the market embarks on may come down to whether the US economy heads towards a recession, which depresses corporate earnings. Either that or the Federal Reserve pulls off an "immaculate disinflation" – an engineered soft economic landing where inflation falls without harming the economy.

With the diversification benefits and risk profiles of certain benchmarks highly questionable (Apple constitutes 5% of the MSCI ACWI Index), we believe one thing is clear: a greater focus on alpha rather than beta will continue to be a key theme of 2023. The environment is ripe for stock picking and investors may find it prudent to increase diversification over the remainder of the year.

While investors have shunned smaller companies, we believe this part of the market should not be ignored. Valuations are more attractive than they have been for many years – certainly compared with the big technology stocks – and any sign that the macro environment is stabilising is likely to bring this area of the market some much needed momentum.

Many investors believe SmallCap can be timed with the economic cycle. In our opinion it cannot.   Forecasting is difficult at the best of times and to some extent is pointless because the future is always so uncertain. As Kevin Keegan, the former-England football manager said when facing the sack after a bad result, *"I know what's around the corner, I just don't know where the corner is".* Amidst a turbulent backdrop, we try to provide our clients with some certainty by sticking to our guns and focusing on holding the very best companies we can find for the long-term.

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