MONTANARO

ASSET MANAGEMENT

Montanaro Better World Fund

Quarterly Commentary – Q2 2023

An Article 9 Fund under SFDR

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 share class increased by 0.6%, an outperformance of over 0.3% versus the MSCI World SMidCap Index. Since the beginning of the year the NAV has risen by 5.6%, an outperformance of 3.7%.

The strongest contribution during the quarter came from **Trex**, the world's largest manufacturer of composite decking made from recycled plastic, which recovered as it became evident that channel destocking is now complete, leaving distributors better positioned. **Entegris**, the US provider of specialty chemicals to the semiconductor industry, performed very strongly on better-than-expected results and the sale of a non-core business. **Advanced Drainage Systems**, the provider of high-performing stormwater management solutions, performed well following positive construction activity in the US.

The weakest contribution came from **IDP Education**, the provider of English qualification tests and student placement services, which lost exclusivity for its English qualifications used by the Canadian immigration service. **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. **MSCI**, the leading provider of support tools and services for the investment community, suffered from weaker results as revenue linked to AUM declined following the falls in capital markets during 2022.

Outlook

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 to the big technology stocks – and any sign that the macro environment is stabilising is likely to bring some much needed momentum.

In addition, investors wanting to achieve impact alongside strong investment returns should take note of the structural tailwinds that we believe support the Better World Fund’s six impact themes. Each theme exposes us to ground-breaking innovation and a generational reallocation of capital towards areas of the economy that should deliver a more sustainable world. Our companies are addressing global problems by providing the solutions that are required by the planet and people, be it water technology companies within our Environmental Protection theme or drug discovery companies supported by our Healthcare theme.

With many debating the so-called "ESG backlash" we reiterate our view that there remains a marked difference between the politics of ESG and investors using ESG factors as one aspect of a thorough investment process. For us, ESG helps to demonstrate the Quality of a company. Putting capital to work to improve the state of the world – or "impact investing" – is linked to growth. Our companies are continuing to deliver on their growth expectations, which is why we believe the long-term prospects of the Fund remain so exciting.

Montanaro Impact Team - July 2023