

Montanaro European Focus Fund

*(Formerly the Montanaro European MidCap Fund
change of name to be effective on or around 17 May 2023)*

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 small and mid-sized 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 and MidCap 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 share class declined by 1.2% in Euro terms, an outperformance of 0.2% versus the Stoxx Europe Mid 200 index. Since the beginning of the year, the NAV has risen by 6.8%, an outperformance of 1%.

The strongest contribution during the quarter came from **Dechra**, the UK-based provider of veterinary drugs, which was acquired by private equity firm EQT at a 44% premium. **Edenred**, the voucher payments platform, announced resilient Q1 results and reiterated its guidance for healthy growth in the years to come. **Diploma**, the specialty distributor of industrial and healthcare products, announced solid trading results and hosted a well-attended Capital Markets Day.

The weakest contribution came from **Teleperformance**, the global leader in BPO and customer contact centres, which sold-off after a poorly received acquisition and concerns about the threat of AI to its business. **Worldline**, one of Europe's leading payments processors, saw a worsening in sentiment amid poor retail spending in Europe. **RS Group**, the wholesaler of electronics and industrial components, warned on slowing growth and saw a surprise departure of its long-standing CFO.

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 active management.

While investors have shunned smaller companies, 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.

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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