MONTANARO
ASSET MANAGEMENT

Montanaro UK Income Fund

Quarterly Commentary – Q2 2023

Market review

Domestic equities missed out on a global stock rally in the second quarter of 2023. There were various reasons for this: persistent core inflation; rising interest rates; a fall in the price of oil (the FTSE-100 is so regularly at the mercy of commodity prices); and Sterling strength. There was also, as one Analyst pithily put it, no *"AI hoopla"* in the UK.

That excitement was left to the US and the "Magnificent Seven": 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.

Set against this backdrop, we struggled to remember a time when the UK stock market was so out of favour. SmallCap remained particularly unloved. Investors rarely favour smaller companies when the economic backdrop is uncertain and economists are talking about recession.

Portfolio

During the quarter, the NAV of the Sterling seed share class declined by 2%, marginally ahead of the composite benchmark index.

The strongest contribution came from **NCAB**, the Swedish distributor of printed circuit boards, which announced better than expected order intake. **Dechra**, the provider of veterinary drugs, agreed to be taken over by private equity firm EQT at a 44% premium. **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 **Marshalls**, the leading hard landscaping manufacturer, which underperformed due to the impacts of higher interest rates on the housebuilding sector. **FDM Group**, the provider of IT service professionals, came under pressure due to concerns demand may weaken in the short-term from financial services clients. **Liontrust**, the asset manager, underperformed due to outflows and its acquisition of Swiss asset manager GAM.

Dividends have remained resilient; following our biannual detailed forecasting exercise, we have increased our expectations for the Fund's 2023 distributions, driven by a special dividend from 4imprint.

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 and any sign that the macro environment is stabilising is likely to bring this area of the market some much needed momentum.

Despite 2022 seeing the largest underperformance of UK SmallCap versus LargeCap since 1998, we have seen no such reversal so far in 2023. Quality and Growth factors have been neutral this year, despite their significant underperformance last year. So, although these three style headwinds to the Fund have now broadly stabilised, they have not yet turned into tailwinds.

Many investors believe investing in 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 continue to focus on investing in high-quality market leading companies with diversified customers, pricing power, limited consumer exposure, high margins and strong balance sheets; we believe these companies will survive the macro-economic challenges and be long-term winners.