MONTANARO
ASSET MANAGEMENT

Montanaro UK Smaller Companies Investment Trust

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 in the UK; 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 struggle to remember a time when the UK stock market was so out of favour. UK SmallCap remains 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 Trust was flat, marginally behind the benchmark index.

The strongest contributions during the quarter came from **Dechra**, the provider of veterinary drugs, which 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. **Cerillion**, the provider of billing, charging and customer management solutions, performed well during following strong H1 results.

The weakest contributions came from **The Watches of Switzerland**, the major distributor of luxury watches and jewellery, which declined on concerns about consumer sentiment in the UK and the US, its two key end geographic markets. **Marshalls**, the leading hard landscaping manufacturer, underperformed due to the impact of higher interest rates on the housebuilding sector. **Liontrust**, the asset manager, traded lower due to outflows and its acquisition of Swiss asset manager GAM.

Outlook

Investors have shunned UK smaller companies. Valuations are more attractive than they have been for many years. Any sign that the macro environment is stabilising could see thus change.

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".*

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 emerge even stronger as the long-term winners. Sentiment is fickle and better times are long overdue.