

Montanaro UK Income Fund
Quarterly Commentary – Q3 2023**Market review**

The optimism of the summer months was dashed towards the end of the quarter. Rising bond yields were accompanied by similar style headwinds to those of 2022: SmallCap underperformed LargeCap in the UK, the sixth time it has done so in the past eight quarters, while UK SmallCap Growth underperformed UK SmallCap Value by 4%.

There was a marked difference to 2022, however. Then, equity markets sold-off because interest rates were moving rapidly higher. The decline in markets during the third quarter of 2023 was because investors now expect interest rates to remain *“higher for longer”*.

This was partly explained by surprising economic strength in the US, where the labour market remained extremely resilient. With Halloween fast approaching, the spectre of another interest rate rise spooked both equity and bond markets. The yield on certain benchmark bond indices hit levels last seen during the Global Financial Crisis. It was a painful time all-round for risk assets.

Portfolio

During the quarter, the NAV of the Sterling seed share class was flat, 1.2% behind the composite benchmark index.

The strongest contribution came from **Vistry**, the UK housebuilder, which announced a new strategy to focus exclusively on its Partnerships business, where it provides affordable mixed tenure housing. **4imprint**, the supplier of promotional merchandise, rose after a full-year guidance raise on the back of strong half-year trading. **XP Power**, the power solutions supplier, gained on the back of interim results that suggested supply chain conditions had stabilised.

The weakest contribution came from **NCAB**, the leading PCB supplier, which reported continued pressure in orders, although margins continued to expand. **DiscoverIE**, the designer and manufacturer of components for electronic applications, underperformed on macro concerns but no specific news. **St. James's Place**, the British wealth manager, reported weaker than expected AUM inflows and a fee cut for some of its clients, which impacted the shares.

Outlook

The triple-whammy of headwinds that the Fund's investment style has faced since the end of 2021 (SmallCap, Quality and Growth) have continued in 2023. Indeed, UK SmallCap Growth has now underperformed UK SmallCap Value by a whopping 57% over the last three years, while UK Quality has underperformed the market by 20% over the same period.

This challenging period for UK SmallCap has resulted in outflows from the sector now being on par with the Global Financial Crisis: cumulative outflows from UK SmallCap of £2.1 billion from 2022-23 compared to the £2.3 billion experienced in 2007-09.

This has driven valuations back to levels last seen in 2009, which marked the start of the recent Great Bull Market. While the past is of course not guaranteed to repeat, history tells us that when valuations have reached these levels, returns over the subsequent 5 years for UK SmallCap have been between 100% to 150%.

While you wait for the market to turn, you are also getting a good yield from the Montanaro UK Income Fund; the 2023 dividend forecast for the Fund was recently upgraded and represents a yield of over 4%.

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