

Montanaro UK Smaller Companies Investment Trust**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 Trust declined by 1.3%, an underperformance of 1.6% versus the benchmark index.

The strongest contributions during the quarter came from **Ergomed**, the global CRO for clinical trials, which received and recommended to shareholders a take-private offer by Permira at a ~30% premium. **4imprint**, the supplier of promotional merchandise, rose after a full-year guidance raise on the back of strong half-year trading. **Tristel**, the leading provider of infection control solutions to the hospital sector, posted a positive trading update with revenues and profits ahead of consensus estimates.

The weakest contributions came from **DiscoverIE**, the designer and manufacturer of components for electronic applications, which underperformed on macro concerns but no specific news. **Frontier Developments**, the Cambridge-based video game developer, suffered another profit warning on account of weaker-than-expected sales from its new Formula 1 Manager game. **YouGov**, the provider of market research, declined after announcing an extended sales cycle which led to full-year sales guidance sitting at the lower end of market expectations.

Outlook

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

This challenging period for SmallCap has resulted in outflows from the sector reaching parity with the Global Financial Crisis: cumulative outflows from SmallCap of £2.1 billion from 2022-23 compares 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 SmallCap have been between 100% to 150%.

The Portfolio is home to quality companies with strong balance sheets and trades at a discount of 10% versus a premium of 2% just over a year ago. If inflation starts to recede, the potential for a re-rating is there.

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