Montanaro European Companies Trust

Quarterly Commentary – Q4 2023

Market review

"Gettin' up there doesn't worry me. Stayin' up there is what I mind."

Vin Tanner (Steve McQueen), *The Magnificent Seven,* 1960

Market review

European SmallCap underperformed LargeCap in 2023 for the third year in succession. Such a poor run has not occurred since before this millennium. The asset class now trails LargeCap across the key benchmark periods of 1, 3 and 5 years. This is almost unprecedented.

SmallCap remained unloved due to an unsettled economic backdrop dominated by high inflation, rising interest rates and talk of a recession. This heady mix had quite an impact on the trajectory of share prices over the year.

In the first quarter, Warren Buffett's axiom about interest rates and gravity hit home as weak assets in the banking sector were pulled down to earth. A crisis that began in the US, with the rapid failure of Silicon Valley Bank, soon spread to Europe. After years of mismanagement and scandal, Credit Suisse was acquired by UBS in a government backed deal, ending 167 years of independence. There is a reason we do not invest in banks. Away from this drama, inflationary pressures began to normalise towards the end of March and growth rates remained positive in many of the world's major economies.

As a result, at the midway point in the year, equities had delivered positive returns across most major developed markets. Yet headline figures created something of an illusion. Not since the "Nifty Fifty" propelled the Bull Market of the early 1970s had US stock market performance been as reliant on so few names. Returns were driven by the Magnificent Seven technology behemoths: Apple; Microsoft; Alphabet; Amazon; Nvidia; Tesla; and Meta. Returns from SmallCap, while positive, lagged those of the technology dominated indices.

Although Central Banks continued raising rates during the summer, expectations rose that the tightening cycle was coming to an end. Yet this proved a false dawn: a strong US labour market pointed to rates remaining *"higher for longer"*. Halloween brought with it a return of the style headwinds experienced in 2022: rising bond yields; Growth underperforming Value; LargeCap outperforming SmallCap.

The year ended with a welcome Christmas present for investors, however. Falling inflation across almost every major economy in the world (China being the exception, which continued to experience deflation) benefited even the famous toymaker at the North Pole. A "Santa-Rally" was boosted by expectations that interest rates would decline earlier than initially expected in 2024. *Hallelujah!* Here at last was the outperformance of SmallCap and our "Quality Growth" investment style. It was a reminder of how quickly market sentiment can change.

Portfolio

During the quarter, the NAV of the Trust increased by 13.8%, an outperformance of 3.9% relative to the MSCI Europe SmallCap (ex UK) Index.

The strongest contribution during the quarter came from **NCAB**, the supplier of PCB boards, which rose after reporting order stabilisation in Q3 and being added to the OMX Stockholm Benchmark Index. **IMCD**, the leading global specialty chemicals distributor, rallied on expectations that the customer inventory stocking glut was over. **Reply**, the technology consultant and systems integrator, saw its share price rally strongly in Q4 as fears abated about the risk of AI to its business model.

The weakest contribution came from **Kitron**, the leading Scandinavian electronics manufacturing services company, which declined following lacklustre guidance for the first half of 2024 due to weakness in Europe and China. **Brembo**, the Italian brake specialist, weakened on concerns about the 2024 global vehicle production volume. **Viscofan**, the leading supplier of artificial sausage casings, traded lower ahead of its Q3 results over fears of weaker demand. Following the results, it rose, despite a cut in guidance, as the company reduced its debt.

Outlook

A question we (and many of our clients) are pondering is: *"when will the SmallCap Effect return?"* We believe that the outperformance of smaller companies has been in hibernation. The conditions are ripe for a thaw in 2024.

With the seven technology giants now accounting for a combined 30% of the S&P 500 by market capitalisation, market concentration is at levels in the US not seen since 2000. Narrow market leadership increases the risk of what the late, great Charlie Munger called the *"lollapalooza effect"*: the tendency for emotions and cognitive biases to reinforce each other and drive herd mentality.

SmallCap offers an attractive way to diversify equity exposure and avoid such mistakes. Valuations are at historically attractive levels: European SmallCap trades at just 11.9x P/E, on par with the levels of 2011, in the depths of the EMU crisis. When compared to LargeCap, the situation is even more striking: the current P/E discount of 7% is wider than almost at any point in the past 20 years. For instance, after the failure of Lehman Brothers in late 2008, SmallCap reached a record discount of 9%, a level that has remained unmatched until the last few months. This remarkable discount achieved during the GFC unleashed a huge bull run for SmallCap in the following decade.

Extreme valuations rarely remain at extreme levels – as always with financial markets, mean-reversion kicks in. This is the reason we feel positive if not outright excited about the prospects for European SmallCaps – and the companies in which we invest – in 2024.

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