MONTANARO
ASSET MANAGEMENT

Montanaro Better World Fund

Quarterly Commentary – Q4 2023

An Article 9 Fund under SFDR

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

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

Market review

SmallCap underperformed LargeCap in 2023 for the third year in succession. Such a poor run has not occurred before this millennium. The asset class now trails its LargeCap peer 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 sterling share class increased by 10.5%, an outperformance of 3% versus the MSCI World SMidCap Index and some 4% ahead of the MSCI World Index. [For returns in other currencies please see Figure 1 at the end of the commentary].

The strongest contribution during the quarter came from **Alfen**, the smart energy solutions provider, which rose as the Q3 trading update called the end of destocking within EV Charging. Full-year guidance was maintained. **Chr Hansen**, the provider of bioscience ingredients to the food, animal and pharma industries, gained after the Chinese market showed tentative signs of a recovery, and the merger with Novozymes received conditional approval from the European Union. **Masimo**, the healthcare company focused on wearable technology, surged after winning a patent battle against Apple.

The weakest contribution came from **SolarEdge**, the supplier of solar inverters, which warned of excess inventory in the European market and weak US demand due to the impact of elevated interest rates. **Veeva Systems**, the leading Clinical Research Organisation, weakened as competitive threats increased from new market entrants. **Energy Recovery**, the global leader in energy recovery devices for desalination plants, declined as the CEO announced his resignation.

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: Global SmallCap trades at 15.6x P/E, a discount to LargeCap of some 11%, a level not seen even during the Global Financial Crisis. The 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 SmallCaps in 2024.

We are certainly optimistic about the prospects for the Portfolio. While 2023 was a particularly painful year for renewable companies, the Better World Fund was underweight the "green" areas of the market. We have seen some exciting opportunities in our Environmental Protection and Green Economy themes in recent months.

Healthcare and Technology, where we have significant positions, lagged the wider market in 2023. However, they could potentially see a significant recovery once the Federal Reserve puts an end to the tightening interest rate cycle. Over the past two years these sectors have been hurt by a combination of rising interest rates and a post-COVID slump in demand. Destocking has been an issue for life sciences companies after overstocking during the pandemic; however, the industry has been working through its excess inventory, which is paving the way for a recovery in demand in 2024.

Montanaro Impact Team – January 2024

Figure 1: Fund Performance

Absolute Returns (TR)	GBP	EUR	AUD	USD	CAD
Q4 2023	10.0%	10.1%	8.5%	15.1%	12.2%
2023	7.2%	9.8%	12.9%	13.2%	10.5%
2022	-29.5%	-33.3%	-32.8%	-37.0%	-32.7%
2021	20.0%	27.9%	25.8%	19.0%	17.9%
2020	35.0%	27.8%	26.9%	39.0%	36.7%
2019	29.8%	37.5%	35.4%	35.1%	28.7%
2018 (April launch)	-3.8%	-6.6%	-5.5%	-11.8%	-6.3%

Note : GBP and EUR returns are based on the Fund's GBP and EUR Distribution classes.
AUD, USD and CAD returns are showed for reference only. They are sourced from Bloomberg, which applies the prevailing daily FX rate to the NAV of the GBP Share Class.

Returns v. Benchmark (TR)	GBP	EUR	AUD
Q4 2023	2.7%	2.7%	2.5%
2023	-1.9%	-1.9%	-2.0%
2022	-20.8%	-19.7%	-19.7%
2021	2.2%	2.3%	1.9%
2020	22.8%	21.6%	21.4%
2019	7.9%	8.3%	8.4%
2018 (April launch)	0.2%	0.2%	0.4%

Benchmark: MSCI World SMID Cap Index (TR)