MONTANARO
ASSET MANAGEMENT

Montanaro European Focus Fund
(Formerly the Montanaro European MidCap Fund)

Quarterly Commentary – Q4 2023

"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 MidCap underperformed LargeCap in 2023 for the third year in succession. Smaller companies 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.

Portfolio

During the quarter, the NAV of the share class increased by 4.8% in Euro terms, an underperformance of 4.7% versus the Stoxx Europe Mid 200 index.

The strongest contribution during the quarter came from **Reply**, the technology consultant and systems integrator, which saw its share price rally strongly in Q4 as fears abated about the risk of AI to its business model. **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. **Diploma**, the specialty distributor of industrial and healthcare products, reported resilient preliminary results and gave a bullish outlook.

The weakest contribution came from **Worldline**, the French payments processor, which suffered from setbacks in its German business, as well as general weakness across its various businesses, leading the market to downgrade its long-term growth outlook. **Rentokil**, the global pest control business, posted disappointing growth in its US business which raised speculation about its merger with Terminix and share loss to Rollins. **Edenred**, the specialist payment and voucher platform, came under pressure after a French minister proposed capping food voucher fees in France.

Outlook

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.

Smaller companies offers an attractive way to diversify equity exposure and avoid such mistakes. Valuations are at historically attractive levels: European ex-UK SMIDCap trades at just 12.5x 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 8% is wider than almost at any point in the past 20 years. A discount has not been seen since our records began in 2006.

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 the asset class – and the companies in which we invest – in 2024.