Montanaro UK Income 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

The UK equity market continued to be shunned by investors in 2023. Some alarming data was released towards the end of the year by the Office for National Statistics, showing that UK pension funds and insurers own a paltry 4% of domestic quoted shares. In 1997, these institutional investors owned 46% of the market. This shift has been described as an "exodus" by one major bank.

During the year, investors preferred the glitz and glamour of the US, where the market was driven ever higher by a thin band of stocks. The Magnificent Seven technology behemoths (Apple; Microsoft; Alphabet; Amazon; Nvidia; Tesla; Meta) delivered average returns of over 100%. 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. The UK, lacking in technology stocks, lagged the technology dominated indices.

In the main, SmallCap remained unloved due to an unsettled economic backdrop dominated by high inflation and rising interest rates. The year ended, however, with a strong "Santa-Rally". 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. *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 and meant, somewhat remarkably, that SmallCap eked ahead of its LargeCap peer for the year as a whole. The "SmallCap Effect" was back.

Portfolio

During the quarter, the NAV of the Sterling seed share class rose by 8.4%, an outperformance of 3.9% ahead of the benchmark index. For the year as a whole, the NAV increased by 8.3%, marginally ahead of the benchmark.

The strongest contribution 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**. Big Yellow**, the UK's market leader in the self-storage sector, rallied as bond yields declined, supported also by solid interim results. **Sage**, the accounting software provider, gained after announcing strong full year results with a positive outlook, as well as a share buyback programme.

The weakest contribution came from **XP Power**, a leading global power supply solution provider, which weakened after challenging short-term trading conditions, combined with a step-up in capital expenditure and a lost legal case, put pressure on the company's balance sheet, resulting in a capital raise. **4imprint**, the supplier of promotional merchandise, declined after seeing a slowdown in orders in the US market. **Spirent**, the provider of automated testing and assurance solutions for networks, security and positioning, underperformed after the company issued a profit warning, noting that the telecoms market remained challenged as customers continued to delay orders.

In 2023, distributions for the GBP seed class reached 7.27p, ahead of our initial expectations for the year, with the outperformance driven primarily by special dividends.

Outlook

For years now, the outperformance of global smaller companies has been in hibernation. The conditions are ripe for a thaw in 2024. SmallCap is trading at attractive multiples – both relative to their own history and to LargeCap – across the Developed World. One region in particular stands out: the UK.

UK equities have been chronically depressed ever since the Brexit referendum of 2016, with Smaller Companies feeling the pain even more acutely. At 15x, the 8-year Shiller P/E for SmallCap is back to where it was in 2009 in the wake of the Great Financial Crisis. While the past is of course not guaranteed to repeat, history tells us that when valuations have previously reached current levels, returns over the subsequent 5 years for SmallCap were between 10% and 20% per annum.

Equity market concentration in the US is at levels not seen since 2000, increasing 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. Following the herd rarely pays off. An allocation to SmallCap looks more compelling given current valuation levels. Investors should take note.

for the use of professional and institutional investors only. It is for background purposes only, is not to be relied upon by any recipient, and is subject to material updating, revision and amendment and no representation or warranty, express or implied, is made, and no liability whatsoever is accepted in relation thereto. This memorandum does not constitute investment advice, offer, invitation, solicitation, or recommendation to issue, acquire, sell or arrange any transaction in any securities. References to the outlook for markets are intended simply to help investors with their thinking about markets and the multiple possible outcomes. Investors should always consult their advisers before investing. The information and opinions contained in this article are subject to change without notice.