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MONTANARO

ASSET MANAGEMENT

Annual Letter 2023

"Returning to Normal"

December 2023

Here we go again. Some may wonder why, after 43 years spent in the world of investing, this is only the third annual letter. Clearly a career as a writer never happened (for obvious reasons). Bizarrely, some have asked to hear my views about what is going on. As our team has grown, there is a bit more time to ponder (Mrs M. knows Mr M. will never retire).

Let's get straight down to what many of you will be most concerned about: how is Ruby?

Torrential rain and gale force winds greeted our holiday in Cornwall this year. Ruby did not care, although she is getting a little worried that her regular zoom calls are being replaced by Mr M. actually meeting people once again.

So where to begin? The first Annual Letter came out in January 2022 and jinxed markets after the banner days of 2021 (remember them?). But who could have anticipated that a madman in Russia would be crazy enough to start a war? Then again, as Rumsfeld very wisely said in 2002: "*There are known knowns - there are things we know we know. We also know there are known unknowns - that is to say, we know there are some things we do not know. But there are also unknown unknowns, the ones we don't know we don't know.*" I rest my case, could not have put it better … by definition, black swan events are impossible to predict. Never saw that one coming …

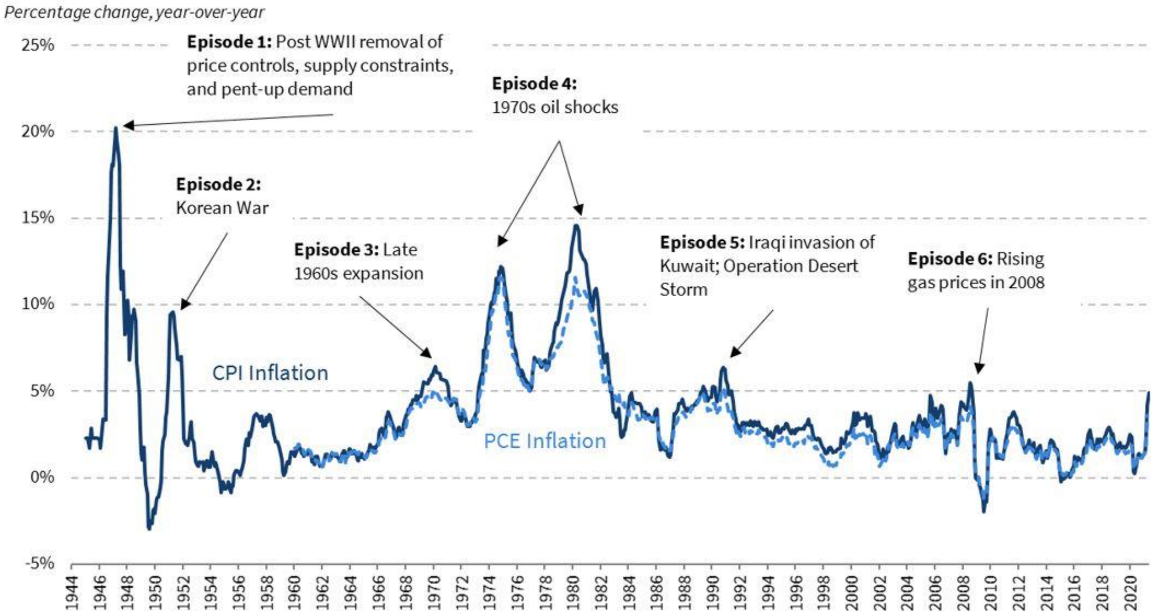
The second Annual Letter suggested that the "*current Bear Market will be over possibly by the end of the first quarter of 2023*". The S & P 500 touched a low on 13 March 2023 and at the time of writing is up 13%. What a genius some may be thinking (only those who have never met me of course). But of course, UK SmallCap continues to lag. Forecasting is a mugs game, but in for a penny…

The theme this year is "*Returning to Normal*". This letter was intended to be shorter (spoiler alert: failed) but still packed with interesting charts that have caught my eye produced by colleagues far cleverer than me (that's almost all of them – ok, all of them). If we have just lived through an "*abnormal*" period which is coming to an end, what is "*normal*" and what can we expect to happen next?

1) **What is the "*normal*" level of inflation?**

The White House published a paper "*Historical parallels to Today's inflationary Episode*" (6 July 2021) from which the following chart appeared:

Figure 1: Six episodes of post-WWII inflation



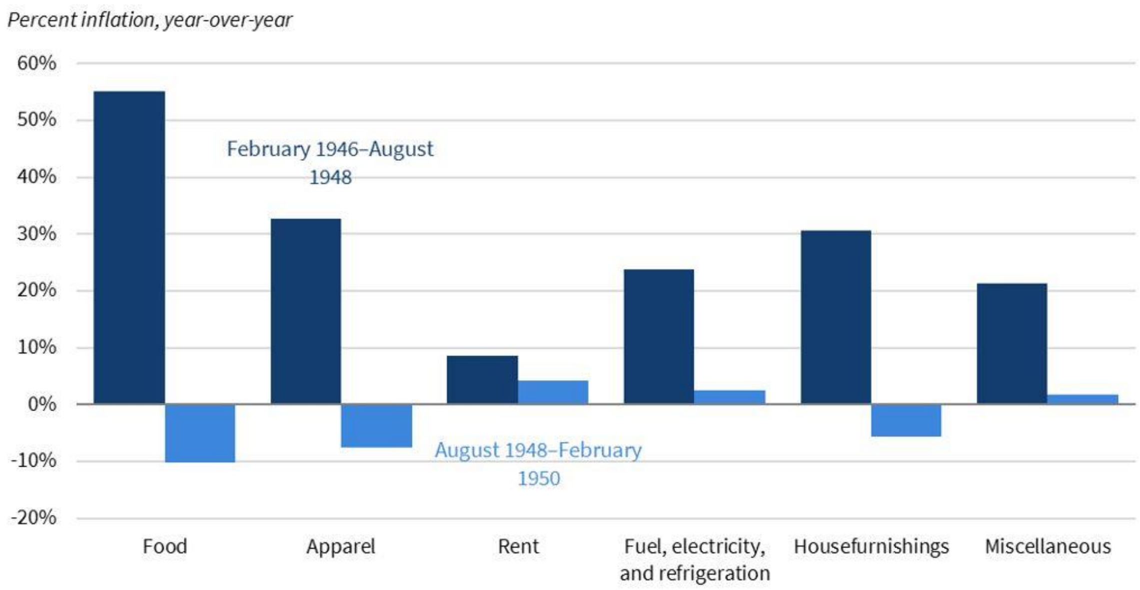
Source: Federal Reserve Economic Data (FRED), Haver Analytics, CEA Calculations.

There have been six periods after the Second World War when CPI in the United States was 5% or higher. Oil shocks caused the three most recent periods of inflation: in July 2008, the price of crude doubled to $140. However, the first (1946 - 48) was caused by the elimination of price controls after rationing (something similar was seen following the Korean War: 1950 - 51).

During the Second World War, the Government rationed consumer goods such as sugar, coffee, meat and cheese as well as durable goods like cars, tyres and shoes. All recovered strongly. Wind the clock forward, Covid saw businesses shut down and people forced to stay at home. Spending on restaurants, travel and entertainment collapsed. Unsurprisingly, pent-up demand led to a boom in retail sales as the economy opened up once again.

In the five years after the Second World war, prices then *normalised*:

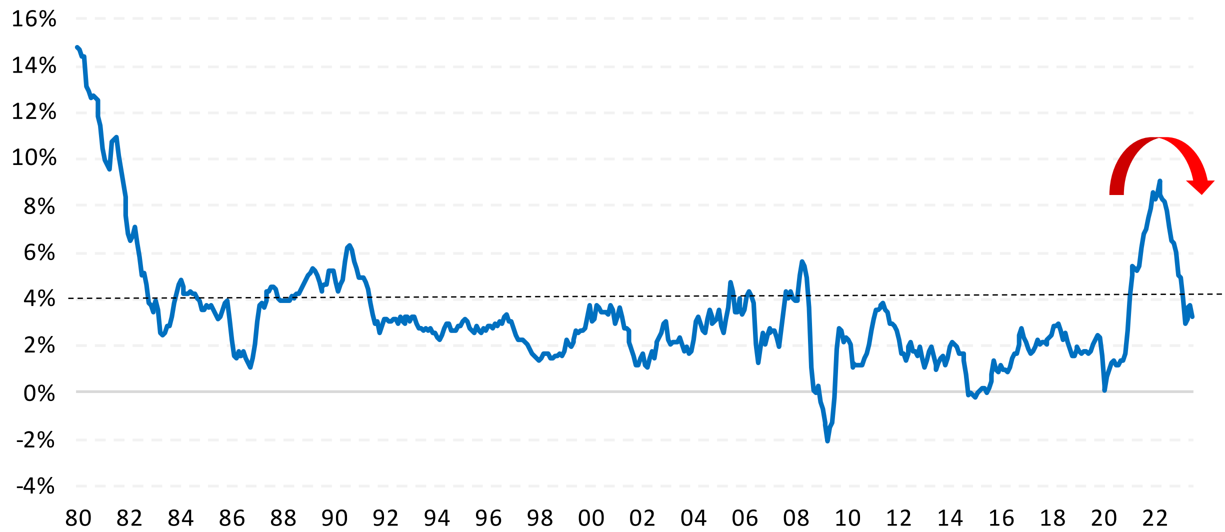
Figure 2: Immediately after WWII, inflation surged, then retreated



Source: BLS.

Although US inflation reached a 40-year high in late 2021, it has since fallen once again. The average rate of inflation over most of my career has been 3.3% which is a more "*normal*" level than the recent era of QE and free money.

US - Inflation Rate (CPI y-o-y)

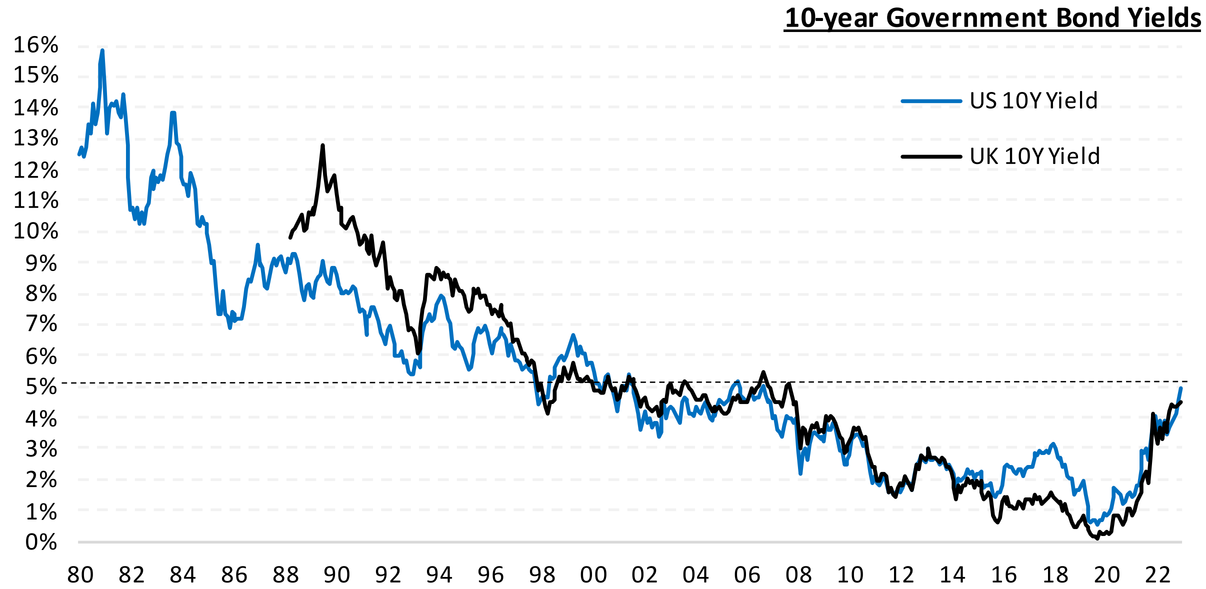


Source: Internal, Statista.

2) What are interest rates "normally"?

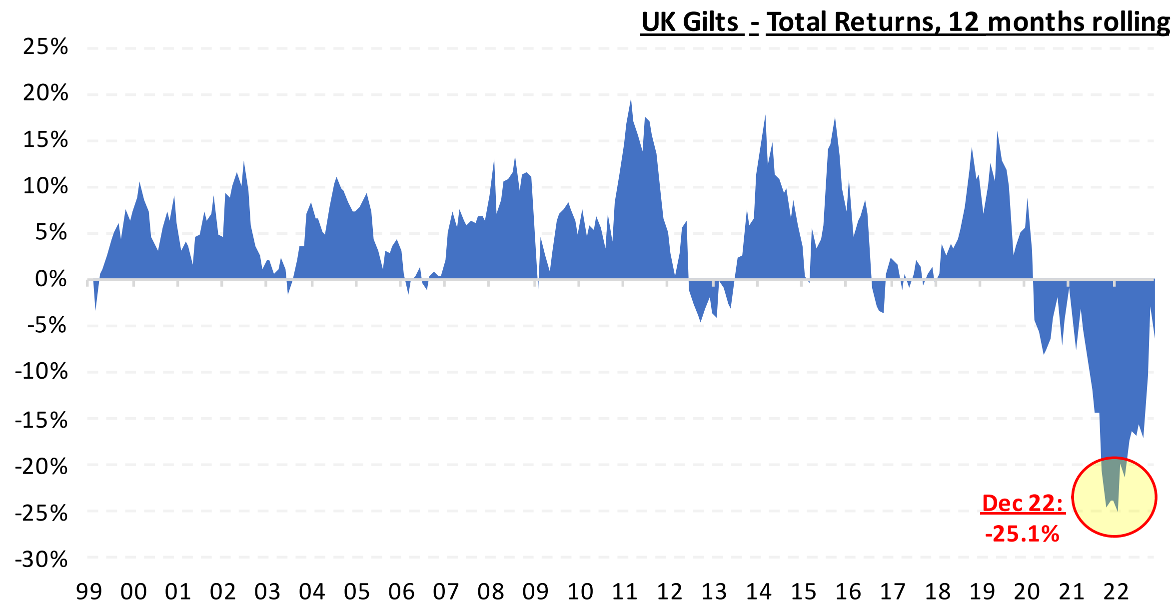
The welcome return to more *normal* has been painful over the short term. It never made sense to invest in bonds with a negative yield as we became accustomed to since 2016.

However, as we have returned to an era of positive yields, investors are likely to include fixed income in their portfolios again.



Source: Internal, Statista.

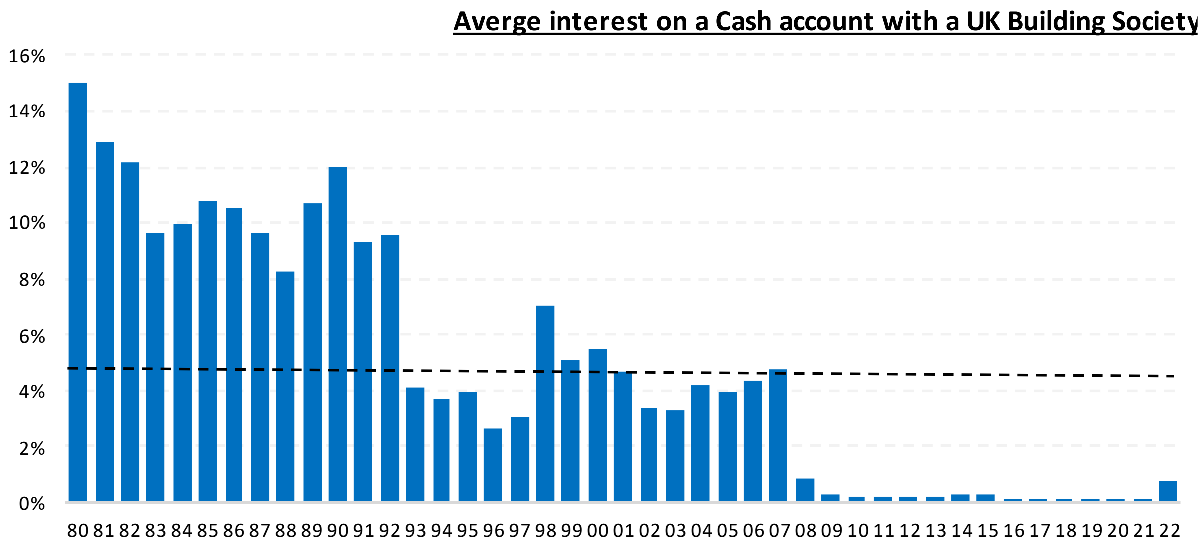
But investing in bonds is not without risk…



Source: Internal, Factset.

3) What is a "*normal*" interest rate on a Cash Deposit in the UK?

As the following chart based on data from Barclays shows, the average return on cash since 1980 has averaged 4.8%. Do you recall the days of negative returns when you paid a bank for the privilege of holding your hard-earned cash? These are unlikely to be seen again.



Source: Internal, Barclays Equity Gilt Study.

Today, the average UK bank offers a return of around 4% on cash deposits. We are pretty much back to "*normal*".

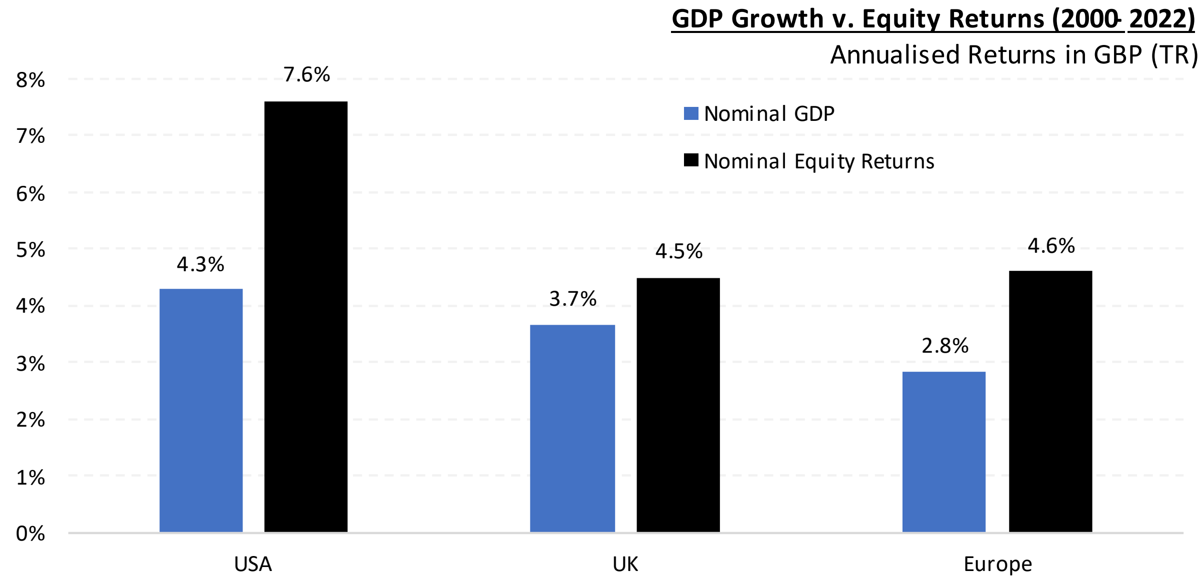
4) What is the "*normal*" level of GDP growth in the UK?

Economists agonise about the outlook for economic growth. Most are downbeat currently, citing quarterly figures that hardly set the pulse racing. The consensus view seems to be that GDP growth will remain below pre-pandemic rates in the medium term and that we face years of lost or anaemic growth.

David Smith (Economic Editor of the Sunday Times) blames four big shocks to the economy: the global financial crisis (2007/8) which ended productivity growth; Brexit which hurt trade and business investment and hurt growth; the Ukraine War which led to a cost of living crisis; and of course Covid which led to the biggest recession since the Great Frost of 1709 (had to look that one up: the coldest winter in 500 years lasted three months; flocks of birds were frozen in mid-air; the Thames was a solid block of ice; a largely agricultural economy saw crops ruined and grain prices rise six fold; the thaw led to severe flooding and GDP fell by 23%). That's a lot …

A frost fair on the river Thames.

David Smith argues that we need investment in new skills, innovation and infrastructure. However, the chart below shows that GDP growth has been anaemic for a long time. On average, "*normal*" real GDP growth in the UK since 2000 has been 1.8%; in the EU 1.3% and in the US 2.1%. So pedestrian growth is nothing new. Nonetheless, investors have enjoyed attractive nominal and real returns (see below):



Source: Internal, Factset.

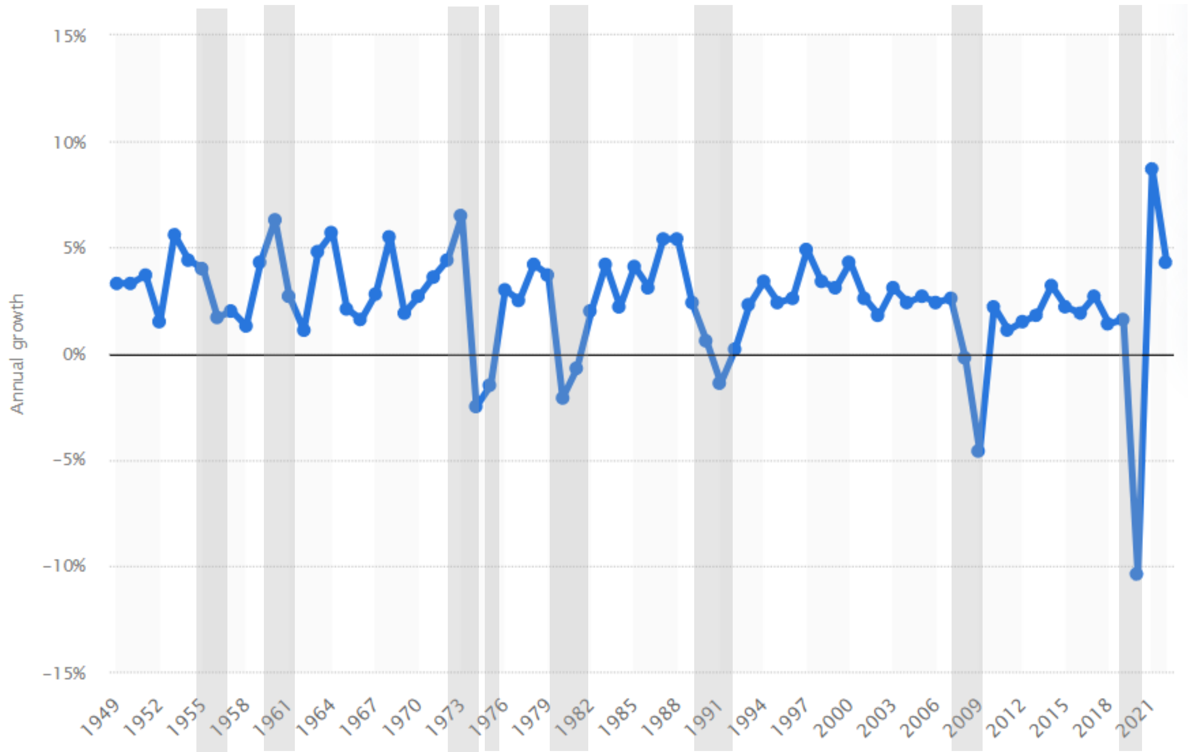
5) What is a "*normal*" economic cycle?

My uninformed impression has long been that the UK fell into recession roughly every 6 - 7 years. Common wisdom in my day was that recessions were a good thing and a necessary way of cleansing the system to eliminate excess - a healthy Darwinian survival of the fittest. No "zombie" companies saved from going bust thanks to free capital and supportive banks.

Along came Gordon Brown in 1997 who said: "*The British economy of the future must be built not on the shifting sands of boom and bust, but on the bedrock of prudent and wise economic management for the long term*". He made the Bank of England independent as part of a vision of ending economic cycles once and for all. Mr. M. was sceptical at the time…

Was Gordon Brown right and did he succeed?

UK GDP Growth from 1949 to 2022:



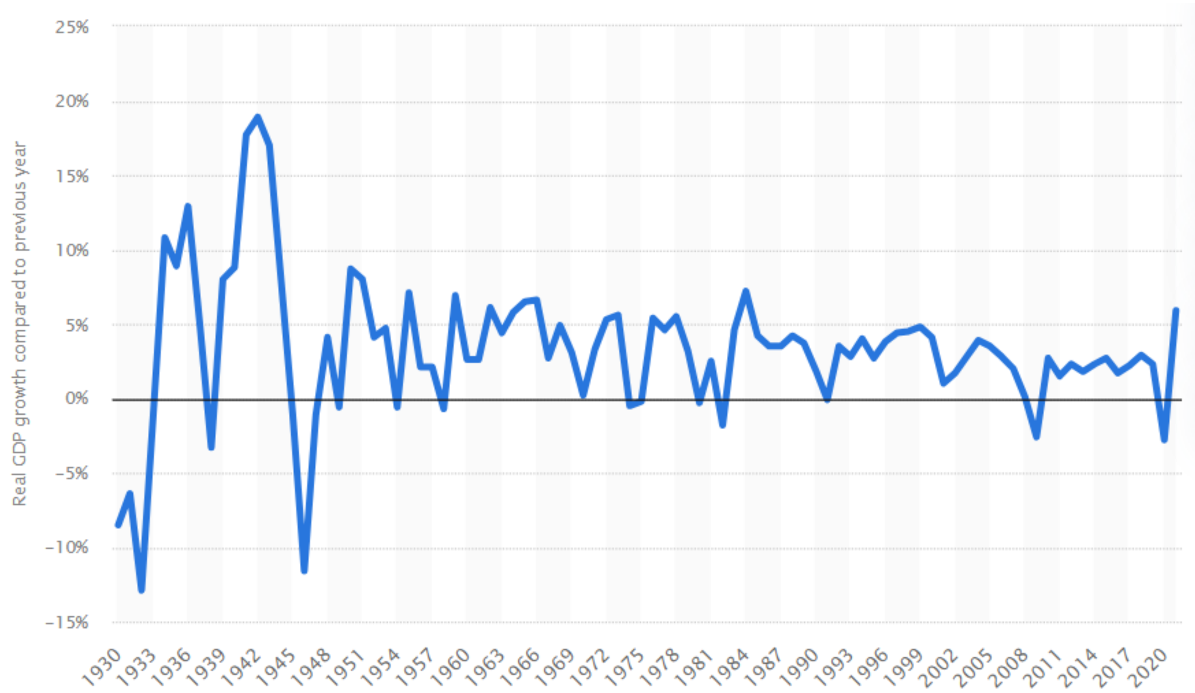
Source: Internal, Statista.

This chart shows GDP growth in the UK since the Second World War with the shaded areas showing recessions defined as negative GDP growth over at least two consecutive quarters.

Enough said…

When you look over the pond, the picture is similar:

US GDP Growth from 1930 to 2021:



Source: Internal, Statista.

People get worried about recessions due to the negative impact on company earnings and share prices. In reality, **the average "*normal*" US recession has lasted just 17 months leading to an average real fall in earnings of 28%.** Not much fun, but for long-term investors, no reason to jump out of a window. And since the Second World War, recessions have **lasted only 10 months** and have become less frequent (see following table).

	Recession		Duration	Peak-to-Trough		
	Start	Finish	(# Months)	S&P Decline	Nominal EPS Decline	Real EPS Decline
1	Oct 1873	Mar 1879	65	-47%	-39%	-36%
2	Mar 1882	May 1885	38	-33%	-41%	-31%
3	Mar 1887	Apr 1888	13	-15%	-20%	-21%
4	Jul 1890	May 1891	10	-15%	0%	-3%
5	Jan 1893	Jun 1894	17	-24%	-57%	-52%
6	Dec 1895	Jun 1897	18	-16%	-16%	-15%
7	Jun 1899	Dec 1900	18	-10%	0%	1%
8	Sep 1902	Aug 1904	23	-27%	-22%	-21%
9	May 1907	Jun 1908	13	-33%	-24%	-24%
10	Jan 1910	Jan 1912	24	-16%	-22%	-19%
11	Jan 1913	Dec 1914	23	-25%	-26%	-29%
12	Aug 1918	Mar 1919	7	-3%	-22%	-37%
13	Jan 1920	Jul 1921	18	-32%	-72%	-74%
14	May 1923	Jul 1924	14	-10%	-5%	-5%
15	Oct 1926	Nov 1927	13	0%	-11%	-10%
16	Aug 1929	Mar 1933	43	-85%	-75%	-67%
17	May 1937	Jun 1938	13	-45%	-49%	-47%
18	Feb 1945	Oct 1945	8	-13%	-16%	-19%
19	Nov 1948	Oct 1949	11	-12%	-3%	-3%
20	Jul 1953	May 1954	10	-15%	-3%	-3%
21	Aug 1957	Apr 1958	8	-15%	-17%	-19%
22	Apr 1960	Feb 1961	10	-19%	-12%	-14%
23	Dec 1969	Nov 1970	11	-27%	-13%	-19%
24	Nov 1973	Mar 1975	16	-34%	-15%	-21%
25	Jan 1980	Jul 1980	6	-13%	-4%	-14%
26	Jul 1981	Nov 1982	16	-34%	-19%	-26%
27	Jul 1990	Mar 1991	8	-19%	-28%	-33%
28	Mar 2001	Nov 2001	8	-39%	-53%	-54%
29	Dec 2007	Jun 2009	18	-51%	-92%	-92%
30	Feb 2020	Apr 2020	2	-22%	-33%	-33%
AVERAGE -1873 to 2020			**17**	**-25%**	**-27%**	**-28%**
AVERAGE - 1945 to 2020			**10**	**-25%**	**-24%**	**-28%**

Source: Internal, NBER, Robert Shiller

Boom periods have also tended to be relatively short-lived, lasting on average around three and a half years. Since the Second World War, these boom periods have become longer now lasting 5 - 6 years on average. Good news.

	Expansion		Duration
	Start	**Finish**	**(# Months)**
1	Jan 1871	Oct 1873	34
2	Apr 1879	Mar 1882	36
3	Jun 1885	Mar 1887	22
4	May 1888	Jul 1890	27
5	Jun 1891	Jan 1893	20
6	Jul 1894	Dec 1895	18
7	Jul 1897	Jun 1899	24
8	Jan 1901	Sep 1902	21
9	Sep 1904	May 1907	33
10	Jul 1908	Jan 1910	19
11	Feb 1912	Jan 1913	12
12	Jan 1915	Aug 1918	44
13	Apr 1919	Jan 1920	10
14	Aug 1921	May 1923	22
15	Aug 1924	Oct 1926	27
16	Dec 1927	Aug 1929	21
17	Apr 1933	May 1937	50
18	Jul 1938	Feb 1945	80
19	Nov 1945	Nov 1948	37
20	Nov 1949	Jul 1953	45
21	Jun 1954	Aug 1957	39
22	May 1958	Apr 1960	24
23	Mar 1961	Dec 1969	106
24	Dec 1970	Nov 1973	36
25	Apr 1975	Jan 1980	58
26	Aug 1980	Jul 1981	12
27	Dec 1982	Jul 1990	92
28	Apr 1991	Mar 2001	120
29	Dec 2001	Dec 2007	73
30	Jul 2009	Feb 2020	128
31	Mar-20	??	44
AVERAGE - 1873 - 2023			**43**
AVERAGE - 1945 - 2023			***63***

Source: Internal, NBER

6) What "*normal*" returns should investors expect from equities?

Of course, much depends on the time period chosen. In 2022, not a single stock market around the world gave a positive return. Fortunately, the Barclays Equity Gilt Survey provides plenty of good, historic data:

FIGURE 1. Real investment returns by asset class (% pa)

	2022	10 years	20 years	50 years	123 years*
Equities	-11.5	2.6	3.8	4.5	4.8
Gilts	-34.0	-3.3	0.0	2.4	0.9
Corporate Bonds	-28.8	-1.5	0.4		
Index-Linked	-34.6	-1.8	0.8		
Cash	-10.9	-3.3	-1.8	0.7	0.5

Source: Barclays Equity Gilt Study

So, the answer is: since 1899, the annual real return of UK equities after inflation has been 4.8% p.a. (9.1% p.a. nominal) with only two decades (out of eleven) showing a negative real return (five each for Bonds and Cash). ***This is higher than investing in bonds or holding cash.***

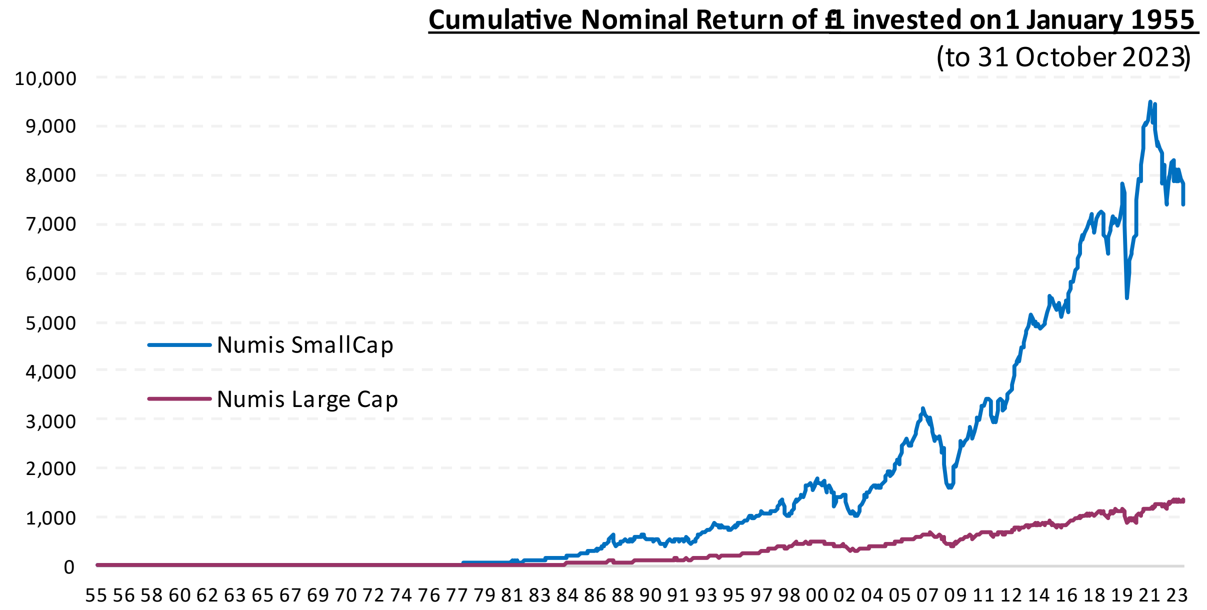
FIGURE 2. **Real investment returns (% pa)**

	Equities	Gilts	Index-linked	Cash
1912-1922	-1.9	-3.8		-1.6
1922-1932	7.5	9.9		6.1
1932-1942	4.3	0.8		-2.5
1942-1952	1.7	-3.5		-2.6
1952-1962	12.6	-0.7		1.1
1962-1972	7.7	-1.7		0.8
1972-1982	-1.2	-1.0		-1.9
1982-1992	12.7	6.1		5.8
1992-2002	3.9	7.2	5.1	3.4
2002-2012	5.0	3.4	3.5	-0.2
2012-2022	2.6	-3.3	-1.8	-3.3

Source: Barclays Equity Gilt Study

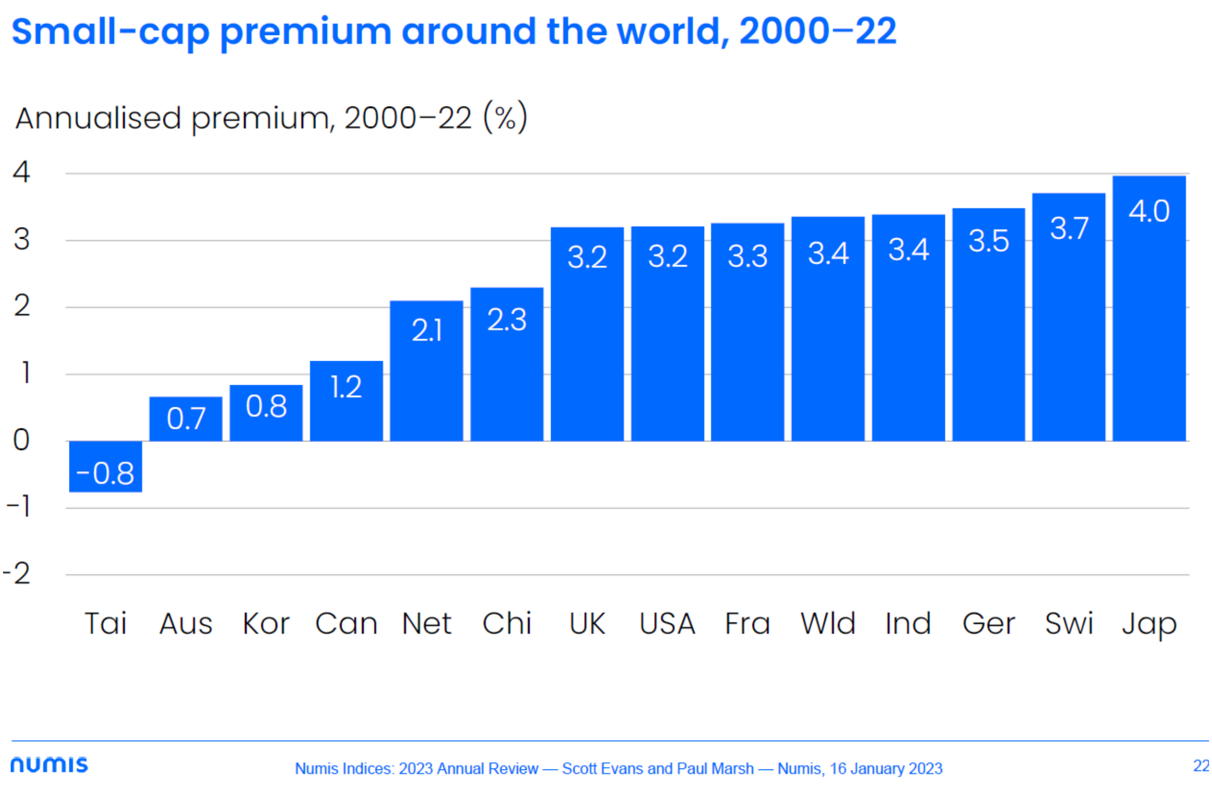
The US 10-year Treasury yield averaged 6.2% from 1950 to 2007, a period that saw the S&P 500's compounded annualised return at 11.9%, according to Keith Lerner, co-chief investment officer at Trust Advisory Services. So, the message is the same in the US.

However, UK quoted *smaller* companies have delivered higher returns over the long term, reflecting better earnings growth. The so called "SmallCap Effect", which has averaged around 3% p.a. over the past 68 years, is the reason that we established Montanaro way back in 1991:



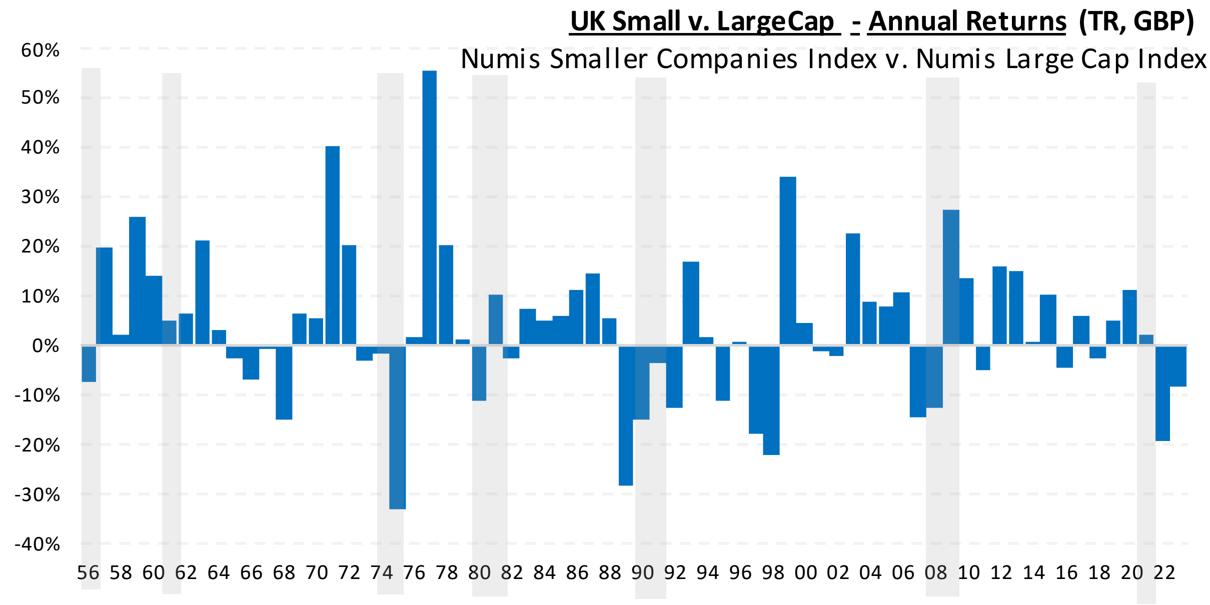
Source: Internal, Numis

The "SmallCap Effect" is also global: the following chart shows that since the turn of the century returns from quoted smaller companies have higher in almost every country:



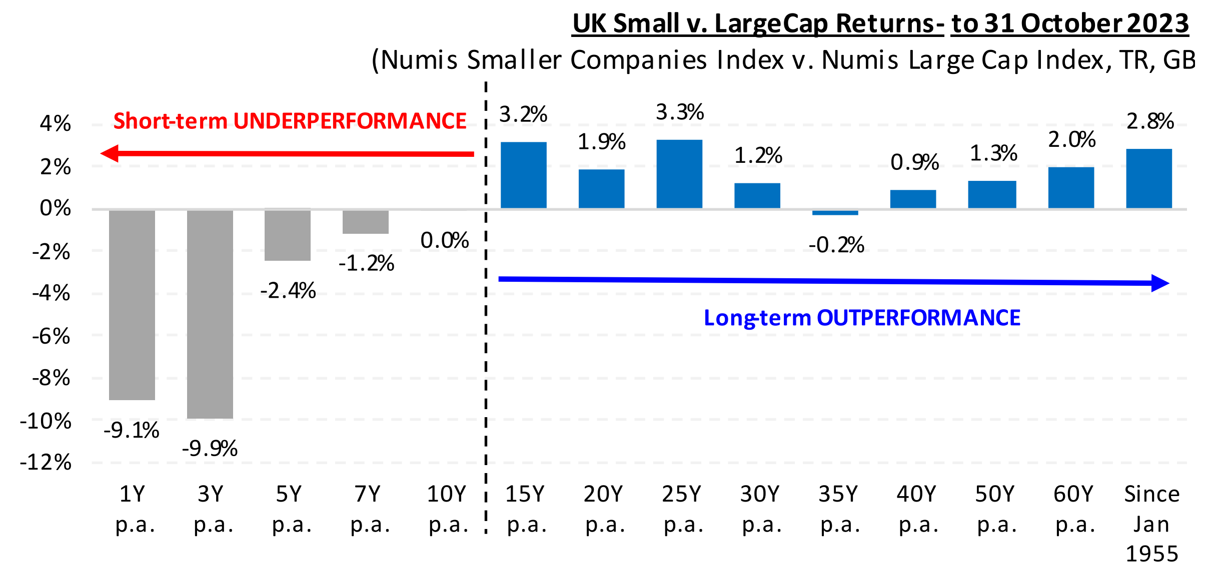
7) Is this a good time to invest in quoted SmallCap?

UK SmallCap has performed well over the long-term, delivering higher returns than LargeCap roughly two thirds of the time. Faced with a recession, it tends to do less well as there is greater exposure to more cyclical sectors (but there are times - such as Covid in 2020 - when the economy was shut yet SmallCap still outperformed).



Note: The grey areas indicate UK recessions.
Source: Internal, Numis

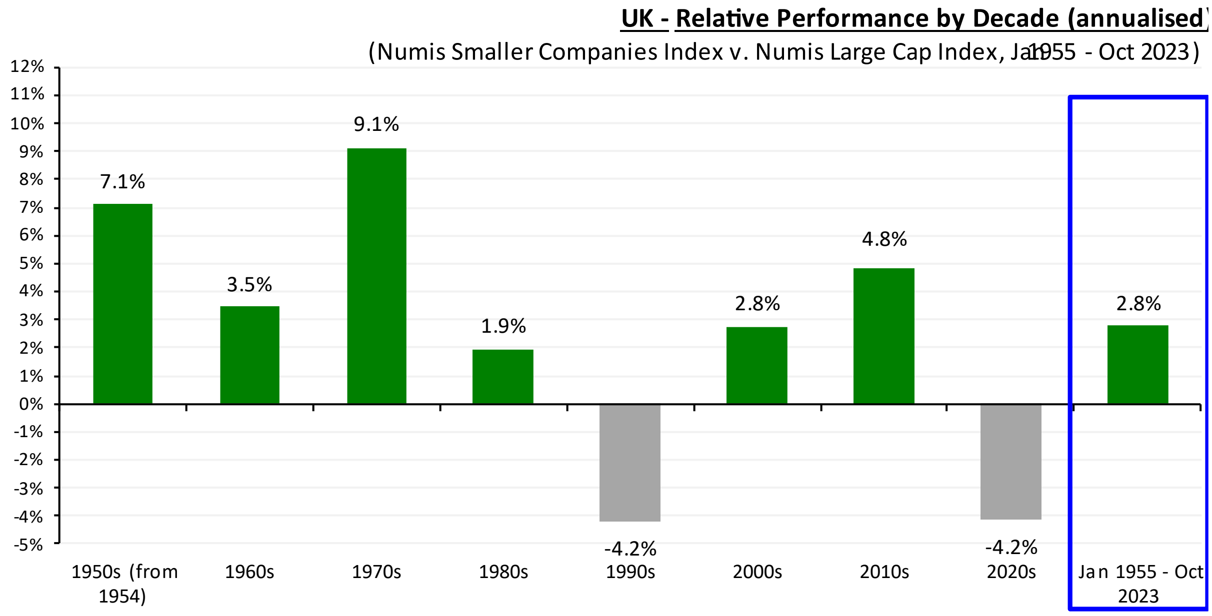
But there is no hiding the fact that we SmallCap investors have just been through an unusually challenging period. The extreme *underperformance* by SmallCap in 2022 has negated the three prior years of *outperformance* (see chart below):



Source: Internal, Numis

Why has this happened? In a nutshell, people tend to invest in quoted SmallCap if they are confident about the outlook, be it economic, political, macro-economic or whatever. In times of crisis, they often sell to hide in more liquid assets such as LargeCap or even in cash.

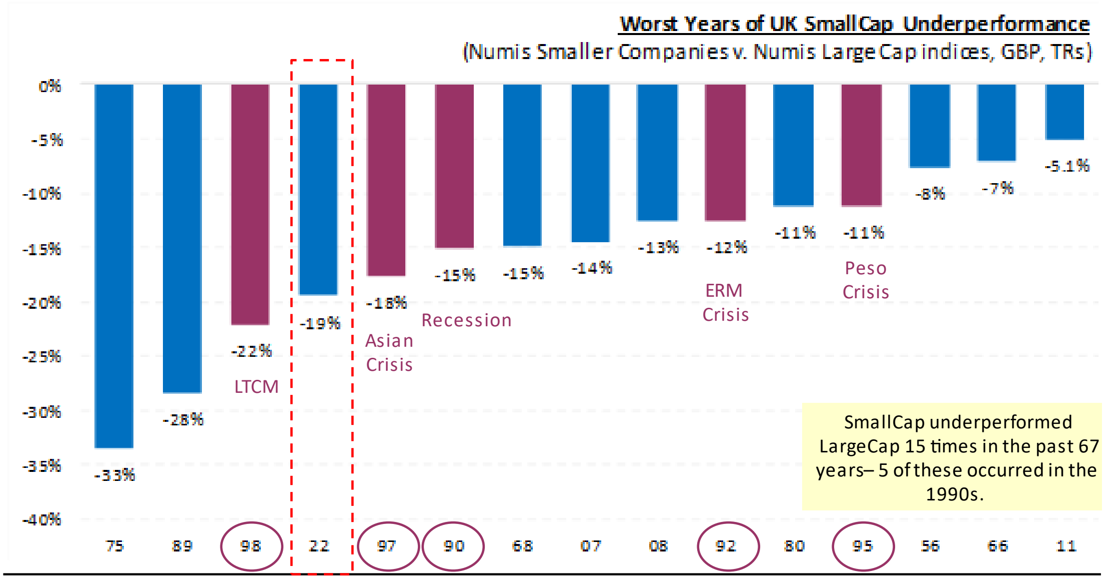
Over every decade since the Second World War, with the exceptions of the 1990s, UK SmallCap outperformed.



Source: Internal, Numis

Since 1955, UK SmallCap has underperformed by more than 5% on just 15 occasions (22% of the time) – five of which occurred in the 1990s, a decade marked by numerous crises.

The 1990s was a decade of repeated crises (bad for SmallCap)



Source: Montanaro, Bloomberg.
Based on the Numis Smaller Companies and the FTSE All -Shares indices.

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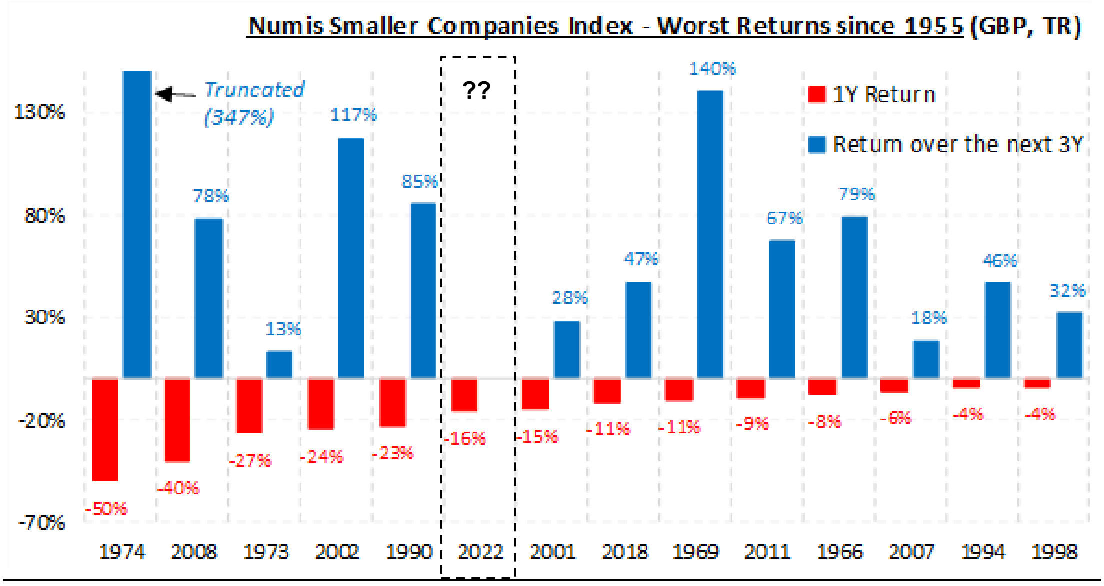
It has been a tough start to this decade. Covid saw global economies shut down, a recession and a Bear Market. No sooner had we recovered in 2021, then along comes 2022 - yet another year of crisis following the invasion of Ukraine, the impact on oil and commodity prices, supply chain disruptions, cost of living and geo-political crises. *Underperformance of 16% was the sixth largest year ever.* In the face of an extreme black swan event, this is unsurprising. So, two years of crises in three years… not much fun but a very unusual period.

The following chart ranks from left to right (in red) the worst years of absolute returns for UK SmallCap. Three of these years occurred in the decade of the 1990s.

The blue bars show the absolute return in the subsequent three years. Every year of negative return always led to positive future returns. In general, the bigger the loss the greater the future return. We will find out about the question marks in 2022 after a couple more years.

30 June 2023
unless stated otherwise

Good years have typically followed bad years for UK SmallCap



Source: Internal, Numis, Bloomberg.

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Past performance, despite what we are told, can be a guide to future performance as human behaviour rarely changes. So, this is encouraging. However, you need three key ingredients:

1) Negative sentiment:

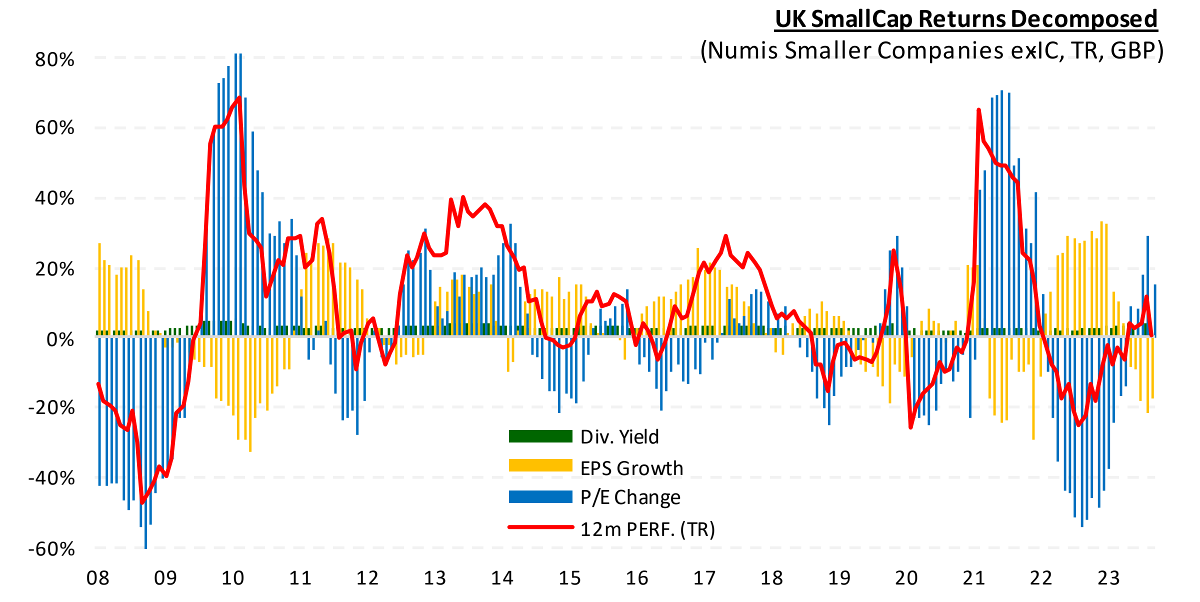
As Baron Nathan Rothschild famously (and oft quoted) said following the Battle of Waterloo against Napoleon on Sunday June 28, 1815: "*Buy when there is blood in the streets*"; he allegedly went on to add "*even if the blood is your own*". In other words, BUY when sentiment is extremely negative (like now) and you don't want to invest let alone look at your screen.

Rothschild really understood the importance of an information edge. He set up couriers of horses between Dover, Calais and Ostend with carrier pigeons waiting at a farm in Hythe which brought him the news of victory on Monday night. Wellington's official messengers sent the news that arrived a full two days later. That is some information edge!

Aware that others watched what he did (as his sources of information were better), allegedly Baron Rothschild sold on the Monday causing a crash and bought aggressively the next day. Gilts rose by over 20% on the news of the victory becoming public. It is not known how much the five Rothschild brothers made trading on inside information for two days … but it was a lot.

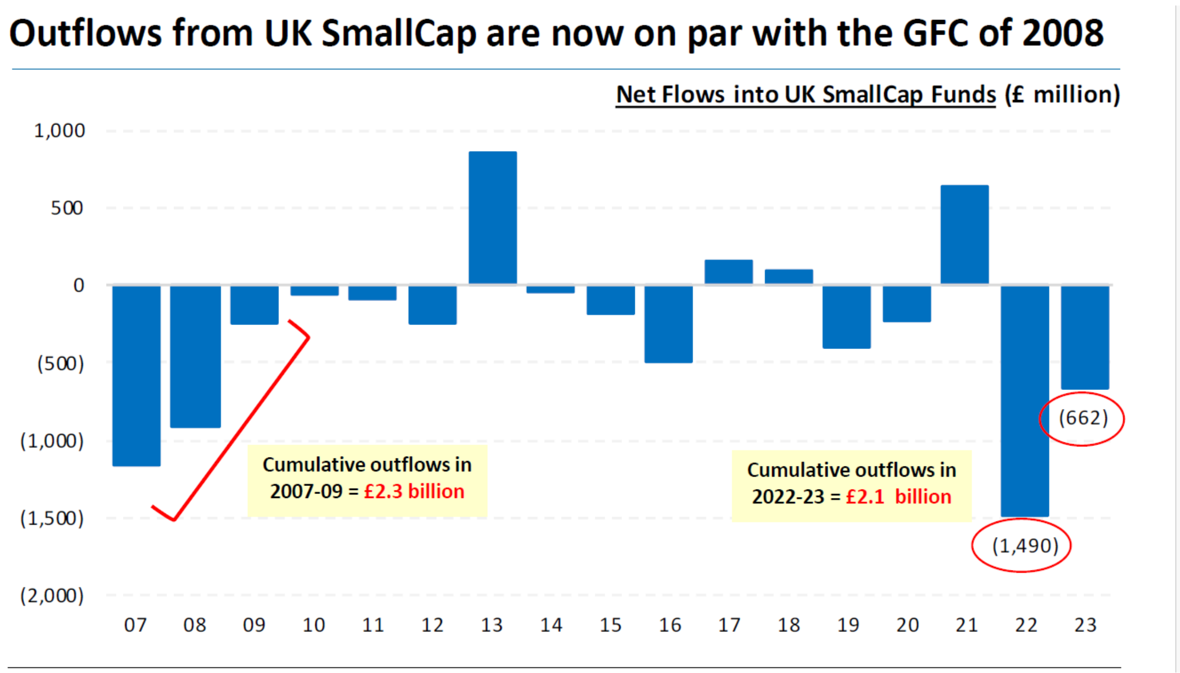
No-one knows if this story is true of course… Insider trading was legal in the UK until 1980 – when Mr M. started life in the City. For those perplexed about telling their children about the birds and the bees, I still recall discussing insider trading with my elder son Adam then aged eight (who has recently joined the team). *"Why would you not buy if you know the shares are going to go up?"* he asked. Bizarrely it was not an easy question to answer…

The following is one of my favourite charts first created back in 2008 during the global financial crisis. It breaks out the components of returns (red line) into three: dividends (green); earnings (yellow) and P/E (blue = sentiment). As the blue line rises, so sentiment is becoming more positive and vice versa. This suggest that sentiment towards UK SmallCap may have turned.



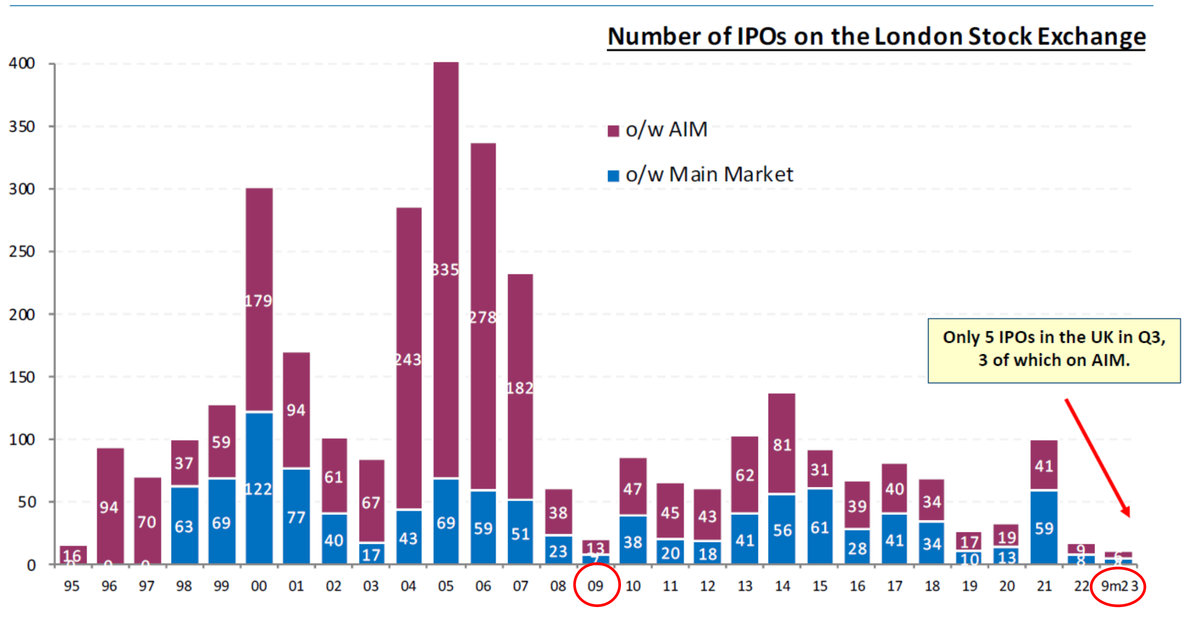
Source: Internal, Numis

Investors have sold UK SmallCap in record amounts:



Source: Internal, Investment Association.

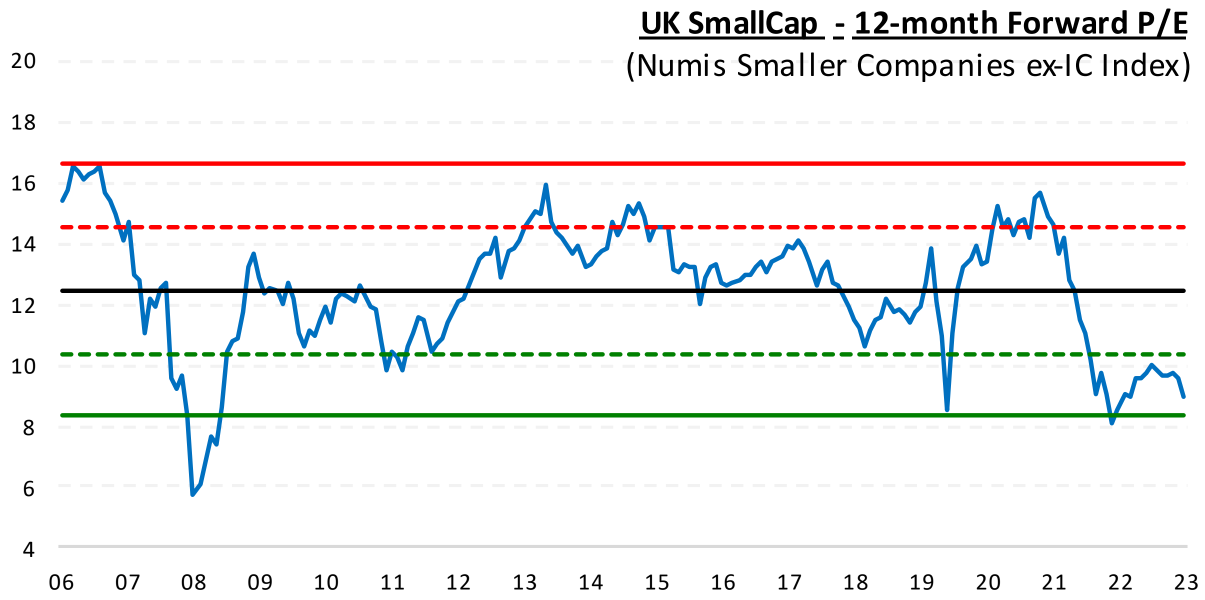
Negative sentiment towards UK equities is reflected in the collapse in IPOs (see below). This period is reminiscent of 2009 following the global financial crisis. March 2009 marked the start of a new Bull Market when sentiment turned positive almost overnight, taking most investors completely by surprise.



Source: Internal, PWC.

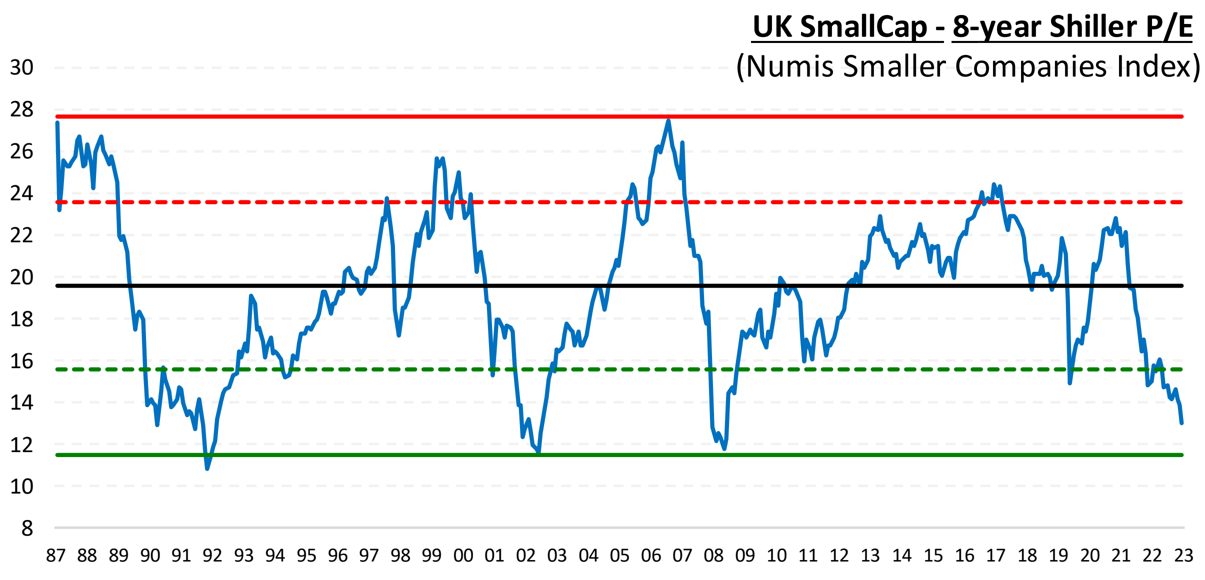
2) Valuations should be attractive:

The Price/Earnings ratio of the UK SmallCap market is now close to levels last seen in the GFC. Judging by comments from our companies, the outlook is nowhere near as dire as it was then.



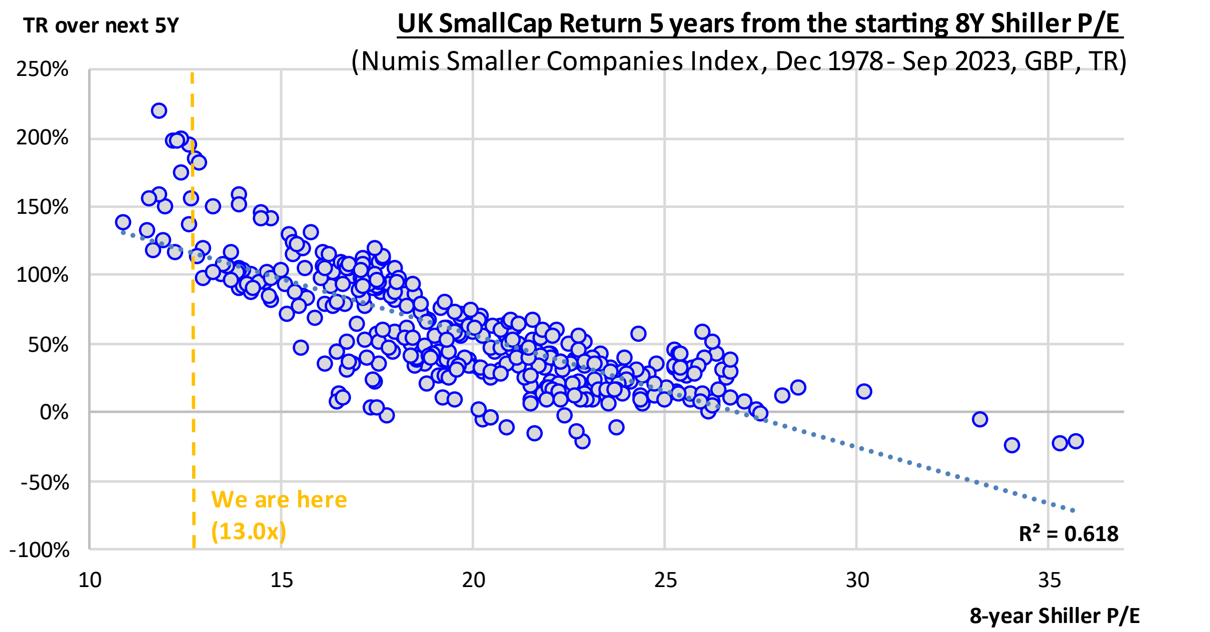
As at 31 October 2023.
Source: Internal, Numis.

Using an 8-year cycle adjusted Shiller P/E, the message is very similar. *The UK Stock Market has only been cheaper than this 6% of the time in almost forty years.* That's quite a statistic.



As at 31 October 2023.
Source: Internal, Numis.

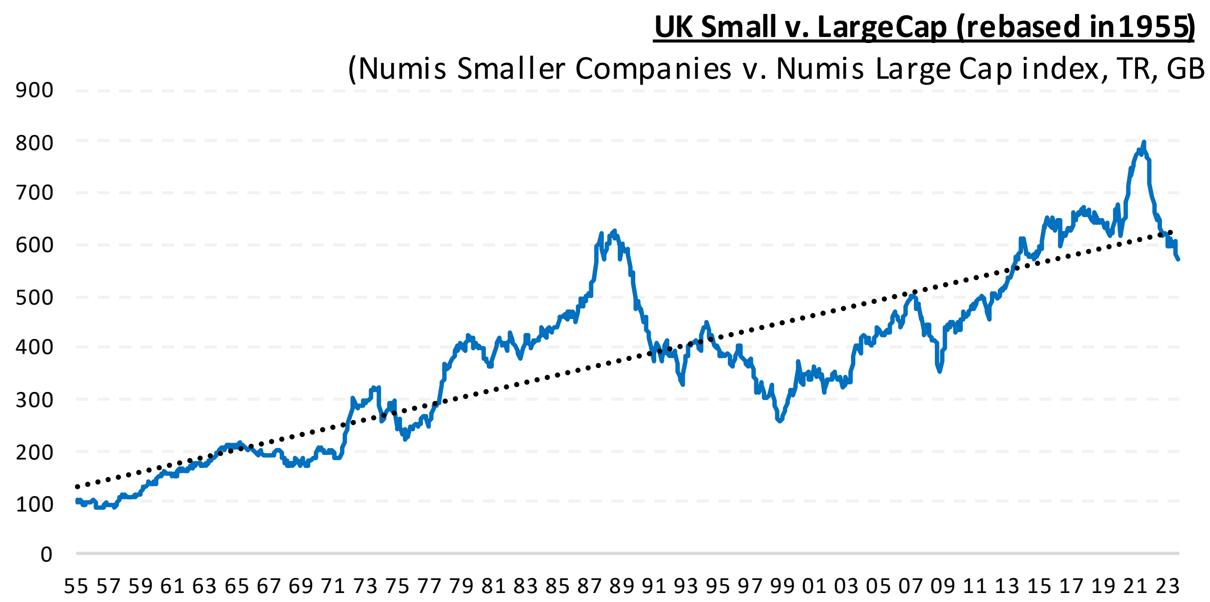
Even better, Shiller has been the best indicator of future returns that I have come across throughout my career. This would suggest that investors could enjoy 5-year returns of 100% - 150% (let's see if that gets through my compliance team).



Source: Internal, Numis.

3) Good Timing:

Trying to time markets is impossible. Anyone investing at the bottom does so by luck. There is no foolproof system. But, as markets always mean revert, it can help to see where we are in a cycle. UK SmallCap has now fallen well below its long-term trend.

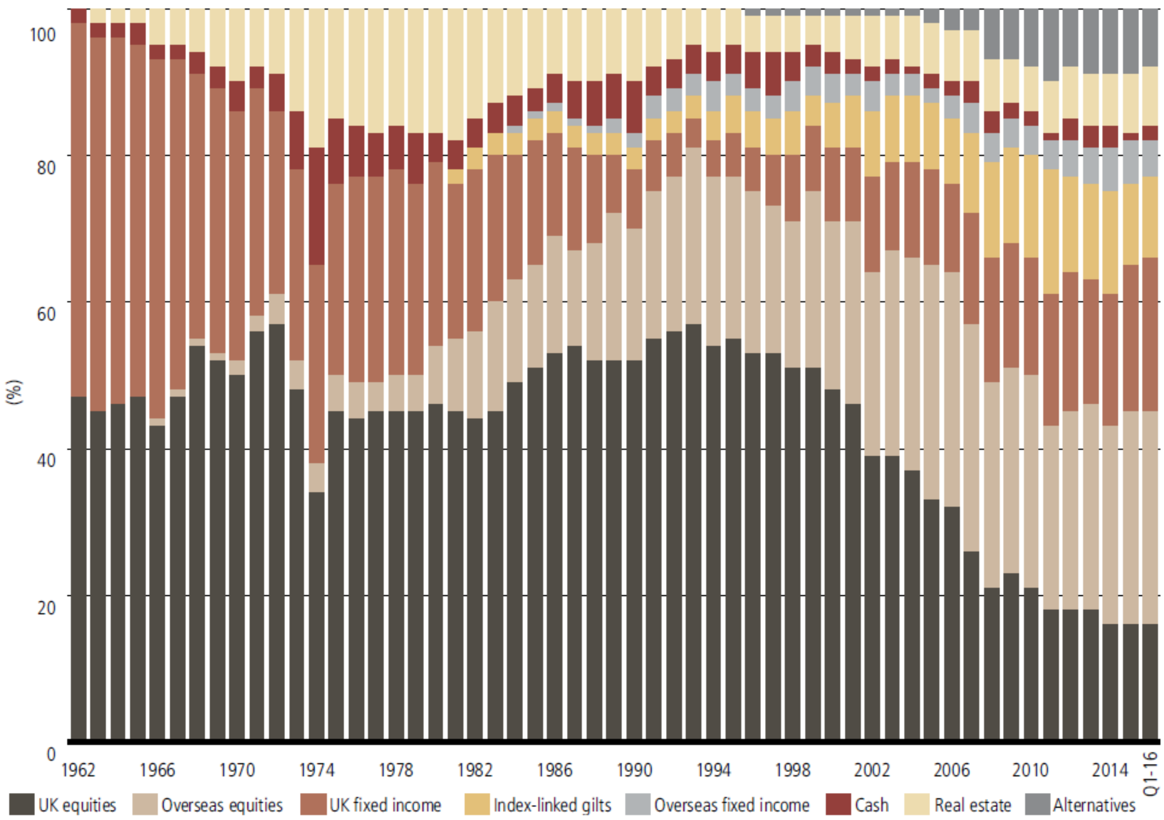


As at 31 October 2023.
Source: Internal, Numis.

8) What is a "normal" allocation to UK Equities?

The simple answer is that it has changed. Over the years, investment in U.K. equities has fallen dramatically in favour of global equities in particular as well as real estate, global fixed income and alternatives.

Figure B.1 Asset allocation – average pension fund, 1962-2016 (Q1)

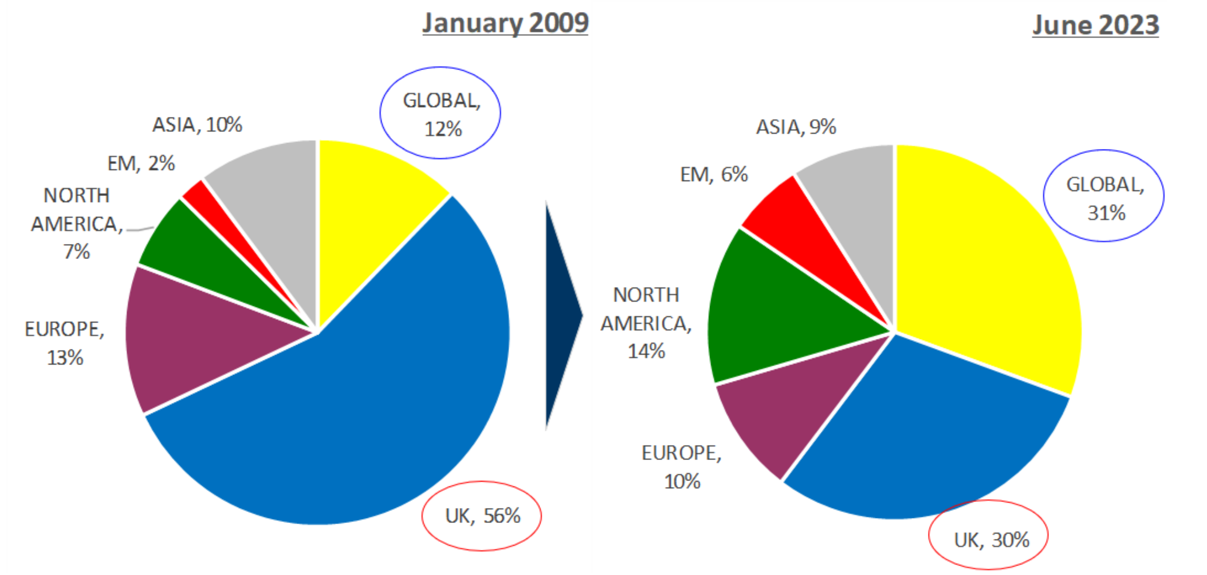


Source: Office for National Statistics (until 1995), WM (1996 onwards). Data as at 31 March 2016.

Source: UBS.

Exposure to U.K. equities is now at the lowest weighting that I can recall.

The average UK investor has halved their UK allocation since 2009



Note: Equity Funds only.
Source: Internal, Investment Association.

Just when the U.K. may be at *the most attractive* level in decades relative to other equity markets, investors have *the lowest weighting*. You couldn't make it up.

Mr. M. has long argued that the Stock Market will always prove as many people wrong as it can – the pendulum will always swing too far one way and then the other. We all buy at the top and sell at the bottom (even after 43 years) and following the crowd is comforting even if we know it is more akin to lemmings jumping off a cliff.

Why else were investors overweight Japan in 1989 right at the top? For those tracking an index, should we be surprised that banks were the largest sector of the FTSE-100 in 2007 just ahead of the Global Financial Crisis when they collapsed? Vodafone was 15% of the UK market in 1999 and hugely overpriced as institutions were forced to buy it to match the index weighting. The end of the TMT Bull Market was inevitable once the last index buyer had bought.

When pension funds followed the advice of consultants to sell all their equities and buy bonds to match their long-term liabilities to eliminate risk (so called LDI, the logic of which Mr M. never understood), the writing was on the wall - spookily reminiscent of the rush into mortgage-backed securities that led to the GFC. A bond Bear Market was on the cards. Everyone buying bonds at the same time inevitably meant they became overpriced – but no-one asked what happens if interest rates go up. Now they know. If equities deliver the highest returns over time, why were pension funds selling them all? Don't ask me…

Conclusions

It feels that we are returning to "*normal*" with cash deposits and bonds offering around 5%; inflation at 2% - 3%; GDP growth of 1% - 3% (depending on the country); LargeCap delivering real returns of 6% and SmallCap about 9%. This is how it has been "*normally*" on average throughout my career. Sentiment will turn positive when no-one expects (as in March 2003 when all the Irish banks were predicted to go bust and didn't; and in March 2009, when another Lehman Brothers bankruptcy was expected and never materialised).

The days of free money and negative interest rates are over. QE had to be reversed. The "*magic money tree*" we all loved has been chopped down. Fairy tales do not last forever. It is time to go back to the real world. I expect that long-term returns from equities will return to "*normal*" and that SmallCap will deliver higher returns once again. The SmallCap Effect remains alive and well, albeit a bit battered and bruised. Quality Growth will have its day in the sun once again. Active management is worth paying for in asset classes that are inefficient and capacity constrained.

And Mr and Mrs M. would like to close by wishing you …

Happy Christmas and the best of luck in 2024!

Ps Sorry, Mr M. has got carried away and yes, this Annual Letter is too long. Recommend you just look at the charts and the photos (Ruby loves Christmas and zoom calls). She is not so sure about the hat ...

December 2023