MUSCIT

Investment Commentary
Quarterly review - Q1 2025

Q1 Returns – UK outperforms Global equities but Small lagged LargeCap:

- FTSE All-Share +4.5%: 12% outperformance v. S&P 500 is largest in c.30 years
- Numis Smaller Companies (ex-IC) Index: -6.3%
- Numis Small lagged Numis Large by 12.5%: Worst quarter v. Large since 4Q08 (2nd worst since 1992)

SmallCap return drivers:

- Strongest sectors: Banks +23%, Telecoms +11%, Energy +4%, Aero. & Defence +4%
- Weakest sectors: Tech Hardware -15%, Healthcare -14%, Consumer Disc. -11%
- Small Growth lagged Small Value by 5.4% (worst quarter since 1Q22)

Earnings / Valuations:

- UK Small on a 13% P/E discount v. LargeCap – highest in 5 years *

** Based on Numis Smaller Companies ex-IC Index v. MSCI UK Large Cap Index. The MSCI UK Large Cap index is used in the absence of P/E metrics for the Numis Large Cap Index. The sector returns are based on the Numis Smaller Companies (ex-IC) Index.*

During the quarter, the NAV of the Montanaro UK Smaller Companies Trust ("MUSCIT") fell by 9% compared with the benchmark which fell by 6%. For the financial year ended 31 March 2025, the NAV fell by 7%, versus the benchmark return of 2% (inc. dividends reinvested). The index including AIM was flat over the period.

In the final days of the quarter, markets were buffeted by the turmoil caused by President Trump's announcements on tariffs resulting in a flight to quality. Typically, investors turn to cash, bonds and liquidity. This time was no exception: UK SmallCap underperformed LargeCap by 12.5%, the worst quarter since 4Q 2008 and the second worst since 1992. There was a major “dash for trash” as Value outperformed Growth by 9.2%, the third worst since 2007 (only beaten by 1Q 2022 - the Ukraine War - and 3Q 2009). For Quality Growth SmallCap investors there was nowhere to hide.

Prior to this, it had been a quiet and uneventful quarter with companies generally reporting a decent earnings season with few disappointments.

The **strongest contributors** during the quarter were:

- **XPS Pensions** – the pensions consultancy and administration provider, rose on the back of a positive profit upgrade following disciplined cost management and efficiency gains in project work and good client wins.

- **Bytes Technology** – the IT and software solutions provider, gained after delivering a record financial year ending February 2025, with double-digit growth across all metrics. The results reflected strong demand for software, AI and IT services from both corporate and public sector clients. Analyst upgrades, including a “Buy” rating from Berenberg Bank and a price target increase, further boosted investor confidence.

- **Games Workshop** – the creator of tabletop miniature games and fantasy products, announced a slightly higher-than-expected dividend.

The **weakest contributors** during the quarter were:

- **XP Power** – the manufacturer of power converters for electronics, continued to suffer from customer destocking and undertook a rights issue to shore up its balance sheet amid ongoing macroeconomic risks.

- **DiscoverIE** – the designer and manufacturer of customised electronics for industrial applications, saw its shares lose recent momentum amid ongoing customer de-stocking and weak confidence, particularly in Europe. Given the company's exposure to customer capex cycles, recent tariff-related news also weighed on sentiment, although direct US exposure appears limited.

- **Greggs** – the bakery chain known for pastries, sandwiches, sausage rolls of course and coffee, fell as like-for-like volumes turned negative in the early weeks of 2025.

Manager comments

There were two sales during the quarter. Firstly, we finally exited the small investment in **Big Technologies**, the AIM traded company best known for "Buddi" smart ankle tags that monitor the whereabouts of offenders on leaving prison. Although successful in winning large contracts in Australia, New Zealand and elsewhere, their foray into the United States has proven less successful leading to growth expectations being cut. Sometimes in investing you are lucky: shortly after the sale, the company sacked the founder and CEO and announced legal action. The shares have since more than halved.

The second exit was **Breedon**, a leading UK construction building materials group (think asphalt, potholes, and road surfacing). They reported record sales thanks largely to strength in America and made a large acquisition of Lionmark in the MidWest for $238 million. Highly acquisitive companies make us nervous – many deals do not work out – and our Analyst estimated a return on investment of less than 7%. Markets took a more positive view, allowing us to sell at close to an all-time high. It has been a good investment.

The only new investment was **Chemring**, a company we have held before. A UK defence company with a 65% global market share of countermeasures (flares) and energetics (Chemring Nobel is the largest producer of high melting explosive), they have dominant positions in NATO with its air and naval applications. Its subsidiary Roke (one third of sales) specialises in electronic warfare, intelligence data analytics and active cyber defence. Products include sensors for chemical and biological threat detection (they manufacture the only product of its kind in the market) as well as IED detection.

At a meeting with management, they said that their order book gives them "excellent" visibility: *"we're playing a really important role in the world today … to have such a high hazard capability is unique … it's a really exciting time for us… NATO has realised that they need to replenish supply. The point is there is no capacity in Europe for energetics. It takes a* *minimum of 2 years to ramp up capacity."* We were impressed by management and consider Chemring to be a core, long-term investment.

Outlook

Under normal circumstances, investors can look at valuation metrics to determine if an asset class is cheap and also to forecasts from companies as a guide to future growth. On both counts, the conclusion today would be that UK SmallCap is attractive.

However, these are not "normal circumstances". In all my 45 year career, I have never witnessed such an act of self-harm as the actions of President Trump's on tariffs. Unless he completely backtracks, it is impossible to predict the repercussions. As things stand today with China and America at war over tariffs, the consequences are dire.

We are neither strategists nor economists, but it seems likely that prices and inflation will rise in the US along with interest rates and there will be widespread job losses; the consumer will retrench and preserve precious cash; companies will be unable to make forecasts as the extent of the disruption to supply chains is hard to quantify; capex plans will be put on hold (if you are an international CEO looking to build a new factory, which country do you choose while tariffs are unpredictable); the US will move from "excellence" to "pariahs". Already we read of Canadians and Danes boycotting all US goods and tourism to the US will probably collapse.

It is possible that we are witnessing a complete breakdown of the world order as we have known it for the past century and more. If the US becomes viewed as an "unreliable trade partner" and an "enemy of free trade" (protectionist), they will become isolated on the world stage. International investors will move investments out of Wall Street to Europe and the Far East; the US Dollar will no longer be perceived as the reserve currency of choice and will fall; and the US bond market will be shunned. What a mess…

To invest in UK SmallCap, valuations should be cheap – and they are. However, you also need confidence in the future which is clearly lacking. This is the time for dynamic management teams in growth markets with pricing power, high margins and cash on the balance sheet to prove themselves once again. This is your portfolio. There will be opportunities and few of our companies seem overly concerned about tariffs.

This is also the time to hold your nerve and to trust in your investments. Rarely does it pay to panic and overly heed the doom and gloom of news headlines. Best to ignore the noise. Markets go up and they go down. No one predicted that equity markets would hit all-time highs so soon after Covid in March 2020. Although it is likely that volatility will remain high for now and markets could of course fall further, there will come a time when sanity returns and confidence will recover. We will be waiting patiently for that day.

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