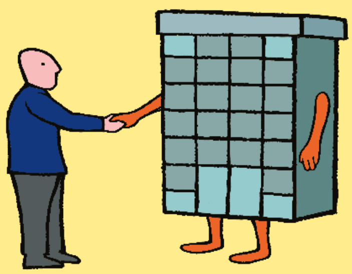
MONTANARO
ASSET MANAGEMENT

UK INCOME FUND

Investment Commentary

Q4 2024



Market review

The Montanaro UK Income Fund ("UKIF" or the "Fund") GBP Seed Class delivered a total return of +2.4% in 2024 compared to +7.9% for the IA All Companies Sector (the Fund's official benchmark). While the headline numbers provide a snapshot, they mask the underlying dynamics of an eventful year.

Casting our minds all the way back to October 2023, sentiment towards UK SMIDCaps was particularly pessimistic: the FTSE-250 fell >10% in a month from mid-September to late-October 2023 as investors all but threw in the towel on our domestic mid-market. However, as confidence in 2024 rate cuts grew, the final weeks of 2023 saw a strong rally. While the anticipated pace of rate reductions moderated during Q1, the prevailing market sentiment remained upbeat, extending the momentum throughout H1 2024.

A UK general election was called in mid-May and, with a decisive Labour majority anticipated, markets took comfort in the prospect of reduced political uncertainty. These factors therefore combined to create a favourable backdrop for UK SMID-caps in H1 2024. The Fund performed well ahead of the market in this environment, outperforming the Benchmark by 2.5% by the end of July.

However, cracks in this narrative began to appear in early August. Weak US labour market data raised concerns that the Federal Reserve might have over-tightened monetary policy, leading to a global sell-off in industrial cyclicals as growth fears mounted. Domestically, as we progressed through September and October, the Government's rhetoric around the upcoming Budget began to increase consumer unease. Although the national living wage increases and tax hikes contained in the Budget of 30 October were largely as expected and less severe than some feared, they nonetheless triggered worries of renewed inflation (as companies are likely to pass on increased costs to consumers), increased unemployment and slower growth – the dreaded stagflation. This, combined with the Government's increased investment plans, requiring additional borrowing, led to a surge in bond yields and a weakened GBP. Spiking bond yields through Q4 2024 was not a phenomenon contained just to the UK: across the Atlantic Ocean, robust economic data and sticky inflation led investors to reduce their expectations for interest rate cuts, while incoming president Donald Trump's policies (tariffs and tax cuts) are also seen as inflationary.

The rapid rise in bond yields during Q4 weighed on interest-rate sensitive sectors like REITs, while the weakened UK consumer confidence pressured UK domestic cyclical names such as consumer discretionary and housing-related businesses. Staffing and IT services companies also suffered, especially those exposed to UK Government spending. Indeed, between the end of August and the end of the year, nine of the Fund's bottom ten contributors (and 16 of the bottom 18) were in these sectors.

It is also worth noting that the recent weakness in GBP and strength of the USD has benefited UK exporters. This dynamic has driven a material outperformance of the FTSE-100 (dominated by international dollar-earners) compared to UK SMIDCap stocks since the start of Q4 2024.

Overall, although some of our holdings faced challenging market conditions, several delivered outstanding returns. Pleasingly, the Fund's distributions exceeded our initial expectations and are poised for robust growth in 2025.

Portfolio

During the quarter, the NAV of the Sterling seed share class declined by 5.9%, an underperformance of 4.5% versus the composite benchmark on a total return basis (returns in £)[1].

The strongest contribution during the quarter came from **Games Workshop**, the creator of the

[1] Please note that the Montanaro UK Income Fund is domiciled in Ireland. The UK domiciled WS Montanaro UK Income Fund is similar but not identical to Irish Fund. Both Funds have multiple share classes and the factsheets should be consulted for specific return information: https://montanaro.co.uk/our-funds/

Warhammer fantasy miniatures and tabletop games, which increased following a strong trading update and the agreement of creative guidelines with Amazon for the creation of a TV series. It also entered the FTSE 100 during the quarter. **Sage**, the provider of accounting and business management software, rose as it posted excellent full-year results ahead of expectations, as well as a strong outlook. **DiscoverIE**, the designer and manufacturer of customised electronics for industrial applications, outperformed following the release of their half year results showing record operating margins and an improvement in order intake.

The weakest contribution came from **Vistry**, the housebuilding and construction company, which issued a profit warning in October due to cost overruns at nine sites in the South division. The position was halved at this juncture to manage risk-reward, as at that stage it was not clear whether the issues were isolated to one division or indicative of broader structural issues. Following a second profit warning in November, and the firing of the COO, the holding was fully exited. A third profit warning followed on Christmas Eve. **Big Yellow**, the leading self-storage solutions provider, underperformed as its half year results showed slightly softer occupancy levels and as higher bond yields weighed on its valuation. **Taylor Wimpey**, the housebuilding company, also suffered in line with the broader housebuilding industry, as investors remained concerned that high interest rates could impact housing demand in 2025.

Outlook

Sentiment around UK Small & MidCap equities is at rock bottom. Both equity and bond markets are concerned about weak consumer confidence; the resurgence of inflation; and poor government fiscal discipline. Catalysts for a near-term recovery are not obvious, but 'twas always thus. Indeed, what is around the corner, especially from a macroeconomic perspective, is extremely hard to predict.

Is it likely that the Government will act soon to assuage the bond market and restore its credibility? Could elevated consumer savings start flowing back into the economy, resulting in a rosier picture than otherwise foreseen? Might the strong USD / weak GBP dynamic drive a further flurry of UK mid-market listed takeovers? Could another "unknown unknown" lead to a shift in macro-economic perspective? Of course – but none of us knows.

What we do, however, have confidence in is that the companies in the Fund have good returns on capital, strong balance sheets, market leading positions, diversified customers and that they are exposed to long-term growth drivers. They are expected to deliver a 2-year EPS CAGR of 12%; offer a 2025 dividend yield of almost 4%; and are trading at just 14.5x P/E. The average sell-side analyst target price upside for the Fund is +35%. As prices have declined in recent weeks reflecting the near-term challenges in certain sectors alluded to above, valuations have rarely been so compelling for the long-term investor. Indeed, several companies are priced as if they will never grow sales or margins again.

In closing, it is worth remembering how quickly the macroeconomic environment and investor sentiment can change. As an example, by the end of October 2023, investors had thrown in the towel on UK SmallCap, yet over the subsequent nine months the market rallied almost 30%. Now, extreme pessimism has taken hold again. Through these mood swings, we stick to our process. This approach has worked for UKIF over the long term.

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