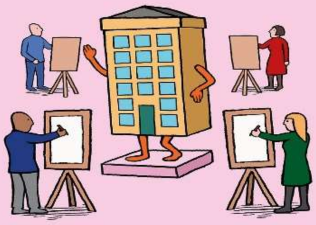
MONTANARO

ASSET MANAGEMENT

EUROPEAN SMALLER COMPANIES FUND

Investment Commentary

Q2 2024



Market review

The strongest equity returns were to be found in LargeCap during the opening half of 2024. SmallCap underperformed its larger peer by a 4% over the 6 months to 30 June, while MidCap did not fare much better. Prio to the current period, Pan-European SmallCap had never underperformed LargeCap by more than 2 consecutive years in over 25 years. The asset class is now on track for its 4th year of underperformance.

Conditions in the equity markets continued to be dominated by two main themes: stickier-than-expected inflation and the ongoing domination of the large technology stocks in the US. In both the US and parts of Europe, this continued to be a source of concern for policymakers. This had a negative impact on smaller companies which are more interest rate sensitive compared to their larger peers.

LargeCap technology stocks – and in particular anything "A.I." related – performed strongly. Nvidia, continued its heady triple-digit ascent (although the Magnificent Seven did begin to show some signs of bifurcation) while Europe's "GRANOLAS" also continued to perform strongly.

Towards the end of the second quarter, political upheaval weighed on most parts of the equity markets. The UK faced an election and a change of government, while in France a snap election was called by Emmanuel Macron, which raised market volatility. In the US, the pre-election bandwagons began to roll.

Portfolio

The NAV of the Euro distribution share class rose by 0.65% on a total return basis, an underperformance of 0.8% versus the MSCI Europe Small Cap benchmark index (in Total Return terms).

The strongest contribution during the quarter came from **AAK**, the producer of high-value added vegetable oils and fats, which rose as analysts lifted their estimates post a strong Q1 report. **Halma**, the specialist manufacturer of high-value niche products, announced surprisingly strong preliminary results as it benefitted from sales into datacentre construction. **Plejd**, the Nordic provider of smart lighting control products, benefited from a very strong first quarter with organic growth accelerating over 30% and an exciting new product pipeline.

The weakest contribution came from **Sartorius Stedim Biotech**, the provider of equipment used in the production of biologic drugs, which continued to underperform following management caution around order intake. **IMCD**, the global distributor of speciality chemicals, reported lacklustre Q1 results and also faced pressure in response to French election uncertainty. **Tecan**, the provider of robotic automation equipment for the life sciences sector, saw its share price moderate after a round of weaker-than-expected results from other companies that operate in the same end market.

Outlook

At the end of 2023 we suggested that the conditions might be ripening for the “SmallCap Effect” to emerge from its multi-year hibernation. This is yet to happen. How does this set us for the next six months?

Despite inflation remaining “higher for longer”, there were clear signs of cooling towards the end of June. Eurozone inflation slowed to 2.5% in June, allowing the European Central Bank to begin its rate cutting programme. Data in the US has also become more supportive. On a June annualised basis core CPI in the US was below 1%, while the three-month average was only a whisker above 2%. Most reassuringly for Growth investors, such as us, CPI shelter inflation (the average cost of housing in the US) plummeted to 2%. Not so long ago it was above 8%. The market reaction to this data? Futures priced in a 91% probability of a rate cut in September (up from 55%); Treasuries rallied and the yield curve steepened; and the technology behemoths fell (Nvidia by almost 6%), while SmallCap gained.

While one month of data is too little to indicate that we are in “risk on” mode to an extent that SmallCap will catch up on this year’s underperformance anytime soon, it is another indicator that market dominance comes together with concentration risk.

With macro data becoming more supportive of smaller company investing, it is worth ending with a point on valuation. SmallCap looks increasingly compelling from a valuation perspective, trading on an 11% P/E discount to LargeCap. This is higher than during the GFC of 2008! Last time SmallCap was yielding as much as LargeCap was more than 20 years ago. Some investors are sensing opportunities: there has been a notable pick-up in M&A activity in the SmallCap space. Reasons exist, therefore, to suggest that now may be as good a time as any for dipping a toe back into SmallCap waters.

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