Liontrust UK Smaller Companies Fund

September 2022 review

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The Liontrust UK Smaller Companies Fund returned -8.5%* in September. The FTSE Small Cap (excluding investment trusts) Index comparator benchmark returned -8.5% and the average return of funds in the IA UK Smaller Companies sector, also a comparator benchmark, was -9.1%.

A higher-than-expected US inflation reading (8.3% year-on-year for August) removed any small possibility that inflation would drop out of investors' key concerns during September. The US Federal Reserve reacted by raising rates a further 75 basis points – its third consecutive hike of this size – and commenting that further economic pain was likely as more tightening is implemented

Equity markets softened and government bond yields rose, trends which were accentuated in the UK towards the end of the month by an adverse market reaction to UK Chancellor Kwasi Kwarteng's 'mini-budget'. Having already committed support worth an estimated £150bn to cap household energy bills, the Chancellor went on to announce a package of fiscal stimulus which included around £45bn of tax cuts. Additional borrowing of £72bn will be needed this year to support the plans; markets signalled strongly that they viewed the measures as damaging to the UK's credit quality. In trade-weighted terms, the pound lost almost 5% to its low on 26th September. UK Government bonds sold off extremely sharply, with, for example, the 5 year bond hitting a high of 4.7% on 27th, up nearly 200 percentage points on the month and up by around 110 points since the budget announcement a couple of days earlier. At this point, the Bank of England moved to stabilise markets – temporarily reinstating its bond-buying quantitative easing efforts – over fears of potential systemic solvency issues for some pension funds.

On the UK equity market, these events only served to deepen the year's existing trend of weakness concentrated in mid and small caps. While the large-cap FTSE 100 monthly return of -5.2% was bad enough, the mid-cap FTSE 250 returned -9.7% and the FTSE Small Cap registered -8.5%.

Earlier in the year, share weakness in these areas seemed to stem predominantly from ratings contracting – i.e. the 'p' in p/e levels falling – as investors priced in higher interest rates (and discount rates) on future expected growth. More recently, as recessionary forces have built, earnings estimates have come under pressure, prompting further share price weakness.

It is understandable that the market might be concerned that mid and small-caps in aggregate would be disproportionately affected by the problems faced by the UK's domestic economy. While we by no means claim that any of our companies will be immune from a contraction in the UK economy, we have so far been reassured by the trading resilience shown by many of them. Over time, we would expect their high-quality characteristics to allow them to outperform the average company, especially against a tough economic backdrop.

Resilient performers include **Big Technologies** (+21%), which issued full-year guidance of at least £48m in revenue with an adjusted EBITDA margin of more than 58%, ahead of market expectations. The provider of integrated hardware/software solutions for the electronic monitoring of criminal offenders reported a 27% increase in first-half revenues to £22.9m following new contract wins and more business from existing customers.

Other stocks to defy the widespread market weakness included **Quixant** (+11%), after well-received interim results and news of a mass production order for gaming cabinets, and **AB Dynamics** (+12%), which said that full-year profits for the year to 31 August would exceed market expectations after it overcame ongoing supply chain disruption to record 22% year-on-year revenue growth.

However, there were also a couple of profit warnings in the portfolio that triggered heavy share price falls. **Hilton Food Group** (-45%) is a specialist in processing and packing food for supermarkets. It now expects 2022 profitability to be below consensus analyst forecasts, citing volume pressures as consumers become more cost conscious. It also flagged that its seafood unit had been hit by "unprecedented" raw material price increases.

Mortgage Advice Bureau's (-33%) interim results showed that although average mainstream adviser numbers rose 19% year-on-year to 1,890, revenue per adviser was down 13%. The company commented that pipelines are taking longer to convert, partly due to the 2021 comparable being boosted by stamp duty holiday changes which accelerated mortgage completions. It expects the government's recent mini-budget to support the housing market via the stamp duty changes, but still forecasts a further softening of purchase activity and slow pipeline conversion, which feeds through to a small downgrade to its full-year financial guidance. The investor reaction to the budget was more unequivocal, with a slowdown in the UK residential market widely expected as a result of sharp upwards rebasing of mortgage rates and the withdrawal of swathes of products.

The drop at **Keystone Law** (-25%) was more reflective of a very tough market environment than company-specific setbacks. The platform law firm released interim results for the period to 31 July it commented that it was on track to deliver a full-year outcome "comfortably in line" with expectations.

Inevitably, markets use a very broad brush when reacting to economic developments and do not differentiate between different companies until later in the cycle when the successful ones are able to show, by their delivered results, their superiority. We believe that our funds are invested in dependable, consistent businesses in possession of barriers to competition which gives them pricing power. This pricing power is likely to prove critical in dealing with cost pressures that look set to persist for some time.

Because our investment process focuses on intangible asset strengths, it has a bias towards less (physical) asset-intensive businesses. Our smaller companies also often have a strong owner-manager culture, a consequence of a requirement for at least 3% senior management equity ownership. This tends to be accompanied by a more conservative business ethos focused on organic growth and lower balance sheet gearing. Almost 75% of the Fund's companies are in a position of net cash. While heavily indebted, capital-intensive companies are exposed to rising interest costs and inflated capex spending, our businesses should be able to prioritise capital allocation towards growth and investment. Hopefully, this should set them up to emerge from the current macroeconomic turmoil in decent shape and thrive once conditions normalise.

In the meantime, we have been trying to view the UK market sell-off as a period of disruption which should present investment opportunities, particularly lower down the size scale. We have been looking for opportunities to initiate or top-up positions in high quality, strong businesses with Economic Advantage characteristics at materially cheaper levels than we were able to at the start of the year.

As we have previously observed, market weakness may also lead to more interest from corporate acquirers. The latest holding to exit the portfolio due to takeover was **CareTech**, as its purchase by a founder-led private equity consortium completed. **Attraqt Group** (+55%) may be next; during September, its board recommended a 30p per share offer from a group led by K1 Investment Management, a private equity business which targets enterprise software. The bid level is a 50%+ premium to Attraqt's prior share price, but only takes it back to levels it traded at in May – before it warned that sales lead times were lengthening as its consumer-facing clients suffered from current economic conditions. There have now been four approaches for fund holdings this year: Clipper Logistics, CareTech, IDeagen and Attraqt.

Positive contributors included:
Attraqt Group (+55%), Craneware (+22%), Big Technologies (+21%), AB Dynamics (+12%) and Quixant (+11%).

Negative contributors included:
Hilton Food Group (-45%), Mortgage Advice Bureau (-33%), Keystone Law Group (-25%), LSL Property Services (-23%) and Integrafin Holdings (-18%).

Discrete years' performance (%), to previous quarter-end:**
Past performance does not predict future returns

	Sep-22	Sep-21	Sep-20	Sep-19	Sep-18
Liontrust UK Smaller Companies I Inc	-28.9%	46.9%	12.8%	-5.0%	19.7%
FTSE Small Cap ex ITs	-24.4%	72.4%	-12.7%	-7.8%	0.6%
IA UK Smaller Companies	-31.9%	51.1%	-0.4%	-7.1%	10.8%
Quartile	1	3	1	2	1

*Source: Financial Express, as at 30.09.22, total return (net of fees and income reinvested), bid-to-bid, institutional class.
**Source: Financial Express, as at 30.09.22, total return (net of fees and income reinvested), bid-to-bid, primary class.

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/glossary

Key Risks:

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

The portfolio is primarily invested in smaller companies and companies traded on the Alternative Investment Market. These stocks may be less liquid and the price swings greater than those in, for example, larger companies.

Disclaimer