Liontrust UK Smaller Companies Fund

August 2023 review

Fund managers: Matthew Tonge, Anthony Cross, Julian Fosh, Victoria Stevens and Alex Wedge

The Liontrust UK Smaller Companies Fund returned -3.4%* in August. The FTSE Small Cap (excluding investment trusts) Index comparator benchmark returned -2.4% and the average return of funds in the IA UK Smaller Companies sector, also a comparator benchmark, was -2.2%.

The Bank of England implemented its 14th successive hike in this tightening cycle, taking interest rates to 5.25%. Wage and inflation data released later in the month confirmed the view that one or two more increases are likely to be needed before rates top out.

During August, investors were also paying close attention to trends in China, where interest rates are moving in the other direction. Having gradually disappointed this year against expectations of a post-Covid lockdown bounce in activity, China's economic woes weighed on investor sentiment during the month. China's central bank responded by lowering its one-year loan rate – the 'medium-term lending facility' – by 15 basis points, in a move that surprised markets and economists alike..

The UK market experienced broad-based declines with some pockets of deeper weakness in areas with greater exposure to Chinese demand – such as basic materials (-5.9%) and consumer discretionary (-3.3%).

Overall, the Fund's August performance was adversely affected by a couple of stock setbacks. **LSL Property Services** (-12%) was one of these. Its share price took a hit in September last year as investors priced in the impact on the housing market of the disastrous and short-lived UK mini-budget which triggered a spike in mortgage rates. Revenues fell around 20% in the first half of 2023, which it compares to a 27% reduction in mortgage market activity and 18% drop in housing transactions. While LSL had previously expected conditions to recover in the second half of the year, the Bank of England's faster-than-expected pace of rate hikes means that it now expects the mortgage market to remain depressed, with full-year earnings likely to fall short of its prior forecasts.

Frontier Developments (-43%) was another detractor in the month. Despite a lack of company news flow the shares have moved down due to increasing worry over the sales performance of the F1 Manager 23 game. Consensus forecasts moved down with some brokers proactively downgrading ahead of the full year results in September.

In better news, video game developer **Team 17 Group** (+6.3%) issued a reassuring, if very brief, half-year trading update that commented it had performed well against a backdrop of a particularly competitive retail market.

Tribal Group (+14%), the software provider to the education sector, also made positive comments on current trading. its underlying progress has been overshadowed recently by issues around its contract with Nanyang Technology University, which triggered a profit warning last December. The contract was terminated in March but still has the potential to rumble on as a distraction, with negotiations over settlement costs ongoing. Nevertheless, June's interim results served as a reminder of the solid growth of the business. The software provider to the education sector grew revenues 1.5% to £43.4m in the first half of the year, with operating profit rising by a more impressive 21% to £8.1m.

Within the Fund, **Instem** (+35%) jumped on news that the software and services provider to the life sciences industry had agreed to be bought by Archimed, a European investment firm specialising in healthcare, with over €8bn in assets under management. Archimed's 833p offer represents a 41% premium to Instem's prior share price. The Economic Advantage team has held shares in Instem since the IPO in October 2010.

It has been a busy summer of corporate activity around the Fund's holdings; Swedish private equity investor EQT approached **Alfa Financial Software** in June before walking away from a potential deal in July and – also in July – **Gresham House** agreed to be taken over by private equity group Searchlight Capital Partners.

Economic Advantage fund holdings – and the intangible barriers to competition the investment process seeks out – have frequently proven attractive to acquirers in the past, and it appears that the trend is persisting in 2023. While each individual potential takeover is considered on its own merits, the team are acutely aware of the importance of taking a long-term view, particularly given the extent of the de-rating of so many UK-listed smaller companies over the past 18 months. With the UK market as a whole, and smaller companies in particular, trading at record discounts to global peers and significant discounts to their own long run averages, we fear that too many holdings are 'sitting ducks', susceptible to private equity or corporate acquirers swooping in and taking them over at prices which do not reflect the intrinsic value of these businesses.

Instem, in particular, is an example of where the team feel strongly that the takeover price offered does not reflect the long term value of the business. The company has been on a determined path to improve the quality of earnings in recent years by growing recurring software income; furthermore, in May 2023, Instem announced that it had been selected to assume the management of ToxHub, a clinical and non-clinical data sharing platform incorporating data from 13 of the largest pharmaceutical companies in the world. Although it will absorb some investment in the short term, this was a fantastic endorsement of the high regard in which Instem is held by its clients and the wider industry, not to mention the longer term potential to earn significant subscription revenues from commercialising the platform.

Canaccord Genuity Quest, which is used explicitly within the Economic Advantage process to analyse companies' cash flow returns on capital, commented in a note shortly after the bid was announced: "[The bid] assumes the company is no better, in terms of cash flow generation, than two years ago... [Our model] forecasts a material ramp up in free cash flow generation over the next five years and we would argue that is not reflected in the recommended offer..."

Positive contributors included:
Instem (+35%), Tribal Group (+14%), On The Beach Group (+8.5%), Team 17 Group (+6.3%) and Tatton Asset Management (+5.9%).

Negative contributors included:
Frontier Developments (-43%), Netcall (-16%), Bango (-14%), LSL Property Services (-12%) and AJ Bell (-11%).

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

	Jun-23	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust UK Smaller Companies I Inc	-5.3%	-18.4%	46.7%	1.9%	2.3%
FTSE Small Cap ex ITs	-0.3%	-14.6%	65.2%	-12.3%	-8.6%
IA UK Smaller Companies	-5.5%	-22.1%	53.1%	-6.5%	-6.2%
Quartile	2	2	3	1	1

*Source: Financial Express, as at 31.08.23, total return (net of fees and income reinvested), bid-to-bid, institutional class.
**Source: Financial Express, as at 30.06.23, 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

This document is issued by Liontrust Fund Partners LLP (2 Savoy Court, London WC2R 0EZ), authorised and regulated in the UK by the Financial Conduct Authority (FRN 518165) to undertake regulated investment business. **This is a marketing communication**. It should not be construed as advice for investment in any product or security mentioned, an offer to buy or sell units/shares of Funds mentioned, or a solicitation to purchase securities in any company or investment product. Examples of stocks are provided for general information only to demonstrate our investment philosophy. The investment being promoted is for units in a fund, not directly in the underlying assets. It contains information and analysis that is believed to be accurate at the time of publication but is subject to change without notice. Whilst care has been taken in compiling the content of this document, no representation or warranty, express or implied, is made by Liontrust as to its accuracy or completeness, including for external sources (which may have been used) which have not been verified. It should not be copied, forwarded, reproduced, divulged or otherwise distributed in any form whether by way of fax, email, oral or otherwise, in whole or in part without the express and prior written consent of Liontrust. Always research your own investments and if you are not a professional investor please consult a regulated financial adviser regarding the suitability of such an investment for you and your personal circumstances.