Gresham House
Specialist asset management

LF Gresham House UK Smaller Companies Fund

Factsheet commentary - February 2022

Overview

February continued recent themes, with an increasing level of market volatility-driven negative sentiment surrounding inflationary pressures, expectations of ongoing interest rate rises, and an impending cost of living squeeze in the UK. We highlighted geopolitical tensions over Ukraine in our January commentary – these tensions worsened with Russia implementing a full-scale invasion of Ukraine. Towards the end of February this resulted in a broader market correction across global equity markets, being particularly pronounced within UK and European equities. We also saw commodity prices rising sharply, notably across key Russian and Ukraine exports such as oil, natural gas and wheat as well as a rush to safe haven assets that drove the price of gold sharply higher.

We have been anticipating increasing market and stock level volatility for some time and built up a healthy cash balance in December as value became harder to find and results from our equity screens narrowed accordingly. Our process lends itself to investing in higher quality business models and backing the best executive teams so we believe our portfolio is well set up to deliver resilient relative performance due to its focus on high-quality and moderately valued stocks that are cash generative.

Near-term disruption aside, we continue to believe in the longer-term opportunity in UK smaller companies - which is underpinned by the continuing discounted valuations applied to the UK and to smaller companies in particular.

We believe current market conditions are much more supportive of finding attractive investment opportunities for investors prepared to take a longer-term view versus the end of 2021. The equity screens we deploy for the Fund have seen the number of results produced more than triple versus the same screening criteria in December last year. We remain selective and disciplined in our approach, seeking high-quality companies with attractive long-term capital growth characteristics at sensible valuations.

Performance

The Fund delivered a return of -6.5% during the month compared to the IA UK Smaller Companies sector which decreased by 5.8% and the NSCI + AIM (ex IC) index which decreased by 4.9%.

Key positive contributions came from **Clipper Logistics** (+33%), on news of a possible takeover by GXO; **Accrol** (+21%), which rallied after a pair of profits warnings – it is a small positive, however, as we exited this disappointing investment at the end of this partial recovery rather than its start; and **Mears Group** (+6%), after a strong trading update ahead of consensus and being awarded the Residential Living Accommodation contract – a material seven-year agreement to provide management-led accommodation and property services to service personnel.

The largest detractors to performance were **Halfords Group** (-18%), on no specific news; **Alpha FMC** (-15%), on no specific news; and **Medica Group** (- 16%), on no specific news, all three having being caught in the wider equity drawdown.

Portfolio activity

The fund made one full exit, from **Accrol** (-44%).The Fund also made a number of follow-on investments into existing portfolio holdings, including Clinigen Group, Next Fifteen, and Tribal Group amongst others.

Outlook

Aftershocks from the pandemic that emerged during the start of this year, such as elevated inflation across a number of areas and global and domestic supply chain disruption, have been exacerbated by the Russia / Ukraine crisis. These specific aftershocks have been superseded by a wider set of macro factors, driven by the Russian invasion of Ukraine, that caused acute dislocations in asset classes globally and deteriorating market sentiment towards the end of February.

However, we believe our portfolio of high-quality businesses with resilient fundamentals is well positioned to deliver long-term success. In this period of higher uncertainty, we continue to apply our disciplined investment process and selectively seek out structurally attractive long-term investment opportunities that we believe have the ability to outperform through different and evolving market cycles.

Our medium-term view remains that the economic recovery in the UK should continue to support earnings growth and share prices. However, we continue to expect volatility in the short term driven by an inherently uncertain environment for market estimates. We also anticipate a rising number of profit warnings in coming months. This in turn is likely to exacerbate share price volatility for individual stocks.

We believe stock-level volatility across the market, while creating some challenges, will provide an attractive environment for investors to back quality companies with attractive long-term structural capital growth at reasonable valuations across the market cap spectrum. The economic environment and market discontinuity will provide agile smaller businesses with strong management teams the opportunity to take market share and build strong, enduring franchises. A good example of this can be found with the Fund's investment in Coats group, which provided a very pleasing update in early March.

We continue to believe that over the long term our fundamentals-focused investment style has the potential to outperform. The Fund will maintain its focus on building a high-conviction portfolio of less cyclical, high-quality businesses with stable and growing earnings streams, good cash flows and dividends. We believe these businesses can deliver strong returns through the market cycle regardless of the performance of the wider economy.

Important information

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