

Montanaro UK Smaller Companies

Reputation restored

Over the last three and a half years, under Charles Montanaro’s direction, Montanaro UK Smaller Companies Trust (MTU) has rebuilt its long-term record of outperformance of its benchmark. A strong NAV uplift over the second half of 2019 (helped by some clarity on Brexit), where the trust ranked second of 11 funds in our peer group, has improved the trust’s standing against its competitors.

Shareholders have also been rewarded by a marked narrowing of the trust’s discount, although there may be more of this to come – MTU’s discount looks anomalously wide relative to peers (see page 17). In an uncertain economic environment, the trust’s focus on quality companies should serve it well. The manager also notes that the qualities of the portfolio are often appreciated by bidders and expects last year’s strong M&A activity to continue this year, with UK assets attractively priced.

UK small cap with a bias to quality

MTU aims to achieve capital appreciation through investing in small quoted companies listed on the London Stock Exchange or traded on AIM and to outperform its benchmark, the Numis Smaller Companies Index (excluding investment companies).

Year ended	Share price total return (%)	NAV total return (%)	Numis SC ex IC TR (%)	Peer group avg* NAV TR (%)	MSCI UK total return (%)
29/02/16	0.9	(0.5)	(1.8)	5.1	(9.2)
28/02/17	14.0	12.5	21.2	26.0	24.1
28/02/18	12.1	14.4	8.7	15.3	3.1
28/02/19	0.7	(6.8)	(2.2)	(4.5)	2.1
28/02/20	15.5	15.8	0.8	9.5	(3.5)

Source: Morningstar, Marten & Co. *Note: this is defined on page 16

Sector	UK Smaller Companies
Ticker	MTU LN
Base currency	GBP
Price	122.5p
NAV	141.8p
Premium/(discount)	(13.6%)
12m forward dividend yield	4.4%

Share price and discount

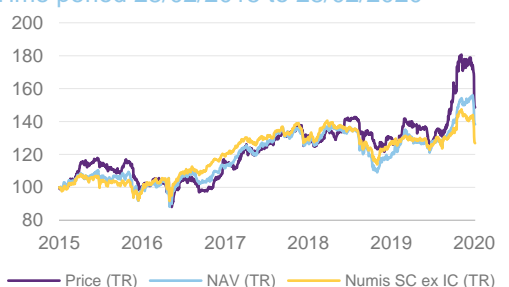
Time period 28/02/2015 to 02/03/2020



Source: Morningstar, Marten & Co

Performance over five years

Time period 28/02/2015 to 28/02/2020



Source: Morningstar, Marten & Co

Domicile	England & Wales
Inception date	16 March 1995
Manager	Charles Montanaro
Market cap	205.0m
Shares outstanding	167.4m
Daily vol. (1-yr. avg.)	170.6k shares
Net gearing	7.0%

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20	Major shareholders
20	Board
21	Arthur Copple (chairman)
21	James Robinson (senior independent director and chair of the audit and management engagement committees)
21	Catriona Hoare (independent director)

Returning to quality growth roots

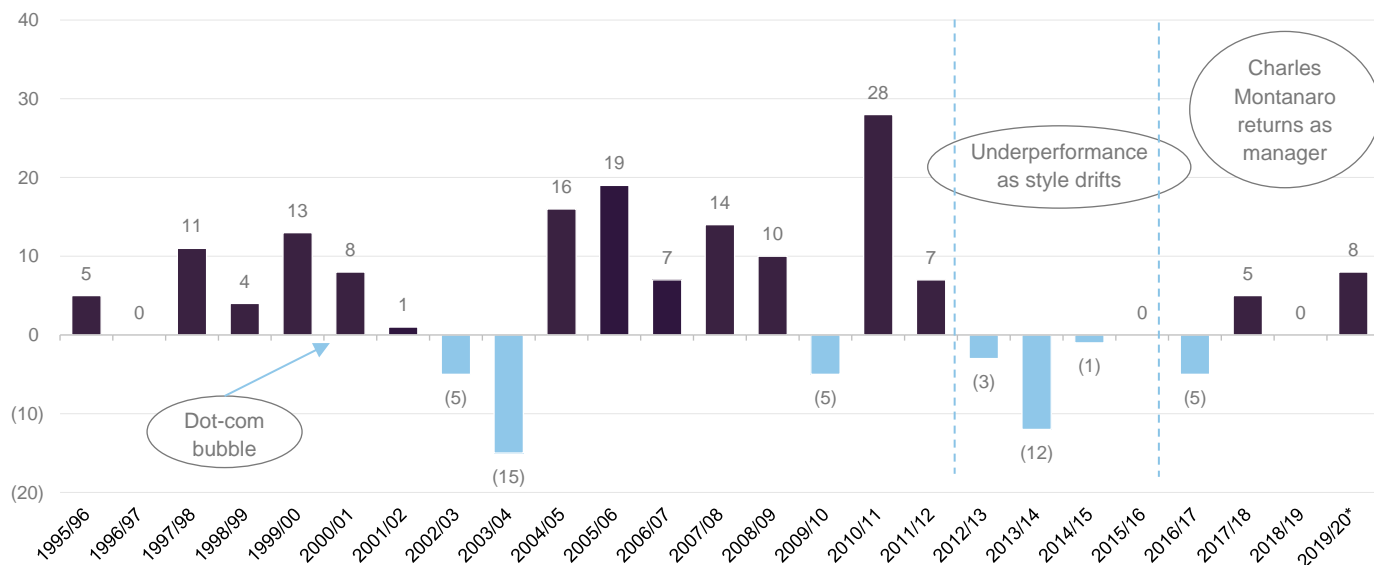
Charles Montanaro established Montanaro Asset Management Limited (MAML) in 1991, and MTU was launched in March 1995 with Charles as its lead manager. He has been the trust’s named manager for about two-thirds of its life, most recently returning in 2016. The trust raised £25m at launch and topped that up with a £30m C share issue the following year. Today the trust has a market cap of £233m.

MTU came through the dot-com crash in the early 2000s particularly well

MTU has lived through some major market events, including the dot-com crash between 2000 and 2002, and the 2008/2009 global financial crisis. The trust’s performance over its history, relative to its benchmark, is captured by Figure 1.

MTU survived its first major market test well, after Charles largely steered clear of technology companies in the late 1990s, believing they were not appropriate for the portfolio. A focus on good quality companies kept the trust away from loss-making, speculative investments. It has also shown up in the portfolio’s experience of M&A – over the trust’s lifespan, 95% of its original portfolio has been taken over.

Figure 1: MTU relative returns against benchmark, by financial year



Source: MAML. Note: MTU’s benchmark changed from the FTSE SmallCap Index (ex IC) to the Numis Smaller Companies Index (ex IC) on 1 April 2013. Note: Years 1-3 undiluted NAV, years 4-5 diluted NAV and thereafter basic NAV with warrants no longer in issue. *Note: 2019/2020 return as at 31 December 2019 – MTU’s accounting year ends on 31 March.

Charles’s return as manager in 2016 has seen performance turn around after style drift had led to a period of sustained underperformance

MTU’s most sustained period of underperformance relative to its benchmark came between 2012 and 2016, a period when Charles had stepped back from the lead management role. Performance in 2013/2014 was particularly poor as the trust drifted from its focus on quality growth. At its nadir, MTU’s discount peaked at about 23%.

Charles reassumed the reins in 2016, and a number of steps were taken to improve returns and make the trust more attractive to investors, especially retail investors. Notable moves included selling out of housebuilder stocks and increasing the allocation to technology and asset managers. The trust had no exposure to AIM under the previous lead manager, but this changed in 2016; the trust’s exposure to AIM is limited, however, as we explain later.

Management fees were cut in 2014 and again in 2017, to a competitive 0.5% of the trust’s gross assets. This shows up in the trust’s ongoing charges ratio, which was 0.80% for the year ended 31 March 2019 (details of fees are on page 19; Figure 27 on page 17 shows how MTU compares to its peers). The shares have been split (on a five

for one basis) to make them more liquid and an enhanced dividend policy was introduced, more details of which can be found on page 17. Regarding his own future, Charles says that he will stay on as manager at least until 2021 and probably beyond then.

Fund profile

More information is available at the manager's website
www.montanaro.co.uk/muscit

MTU is a UK smaller companies trust with a focus on capital growth. MAML, the trust's AIFM, has one of the largest teams in Europe focused on researching and investing in quoted small and mid-cap companies. The team is 30-strong all together, including an investment team of 12. The team is multi-lingual and multi-national (10 countries in all). All but two of the fund managers also have research responsibilities. At the end of December 2019, MAML had AUM of over £2.5bn. Charles owns 100% of the business, but staff have options over about half of that.

Day-to-day management of MTU's portfolio is Charles's specific responsibility. The trust is benchmarked against the Numis Smaller Companies Index (excluding investment companies) and we have also used the MSCI UK Index and a peer group average (defined on page 16) as performance comparators in this report. The benchmark plays no part in determining which stocks are selected for the portfolio, or how large positions are as a percentage of net assets.

Market backdrop – 2020 likely to be quieter

A central message from Charles in our meeting with him was that the portfolio is very much bottom-up-driven. MTU does not attempt to pre-empt macroeconomic shifts. He believed that a strong end to 2019 was likely based on fundamentals and the relative value opportunity that had built up in the portfolio. Net outflows from UK small cap funds in 2019 were the highest since the global financial crisis (see Figure 5). Charles positioned the portfolio to reflect this (see the asset allocation section), with turnover in the holdings and gearing increasing to high levels for the trust.

Q419 brought an end to the "buy UK exporters/sell UK domestics" trade

As Figure 2 illustrates, the "buy UK exporters/sell UK domestics" trade that pervaded from around March 2018 meant that a lot of smaller UK companies were attractively valued. With Brexit central to sentiment since 2016, the catalyst for the resurgence in UK domestics was the dodging of a disorderly exit on 31 October 2019, coupled with confidence in the Conservative government's likelihood of winning a parliamentary majority in the December election. Since the election, moves in UK smaller company stocks and sterling have been muted, with attention switching to the Government assigning a 31 December 2020 deadline to carry out a trade deal with the EU.

Figure 2: Numis Smaller Companies Index (excluding ICs) relative to MSCI UK



Source: Morningstar, Marten & Co

Growth in the UK economy has been lacklustre, with GDP growth remaining flat over the fourth quarter of 2019 according to the Office for National Statistics – annual growth was 1.4% compared to 1.3% the year before.

UK assets are attractively valued and, after considerable outflows over recent years, capital could return

Charles expects a quieter year for small caps in 2020, with less likelihood of the peaks and troughs seen last year. He expects changes to the portfolio to be kept to a minimum. Corporate takeover activity is expected to increase, underpinned by relatively attractive pricing, notwithstanding continued uncertainty over the terms of the UK’s exit, given attractive valuations in UK assets and a historically weak currency (see Figure 3).

The scale and human cost of the Coronavirus (which at the time of publication is unclear) may provide a significant caveat with respect to broader risk appetite.

Figure 3: GBP/USD monthly exchange rate, 1990-present



Source: Bloomberg, Marten & Co

Figure 4: MSCI UK relative to MSCI World

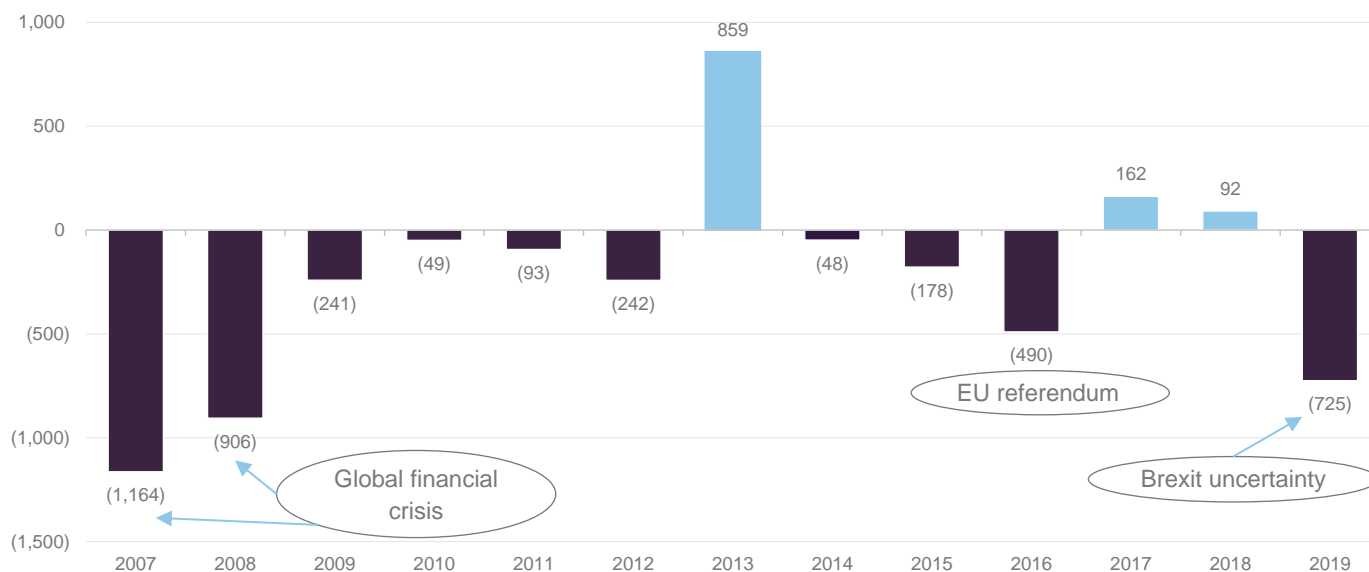


Source: Morningstar, Marten & Co

The pre-election rally staged by small caps recouped losses suffered since 2018 (as reflected by the performance of MTU’s benchmark). Charles believes there is more to come with small caps well positioned structurally to outperform most other equity asset classes globally over the next few years. Valuations are above average, but not excessively so. A return of international capital flows should allow UK assets more broadly to revert to mean, particularly as the UK equity market remains inexpensive compared to most developed markets. This should predominantly benefit domestically-

focused companies while sterling, as reflected by Figure 3, remains close to its lowest levels relative to the dollar since 1990.

Figure 5: UK small cap inflows/(outflows), £m



Source: MAML, Investment Association. Note: 2019 data as at 31 October

Investment process

MAML invests conservatively and for the long term in quality growth companies. It does not invest in derivatives or lend the stock in its portfolios. It avoids loss-making companies, highly leveraged companies and unquoted/illiquid stocks. MAML’s staff are encouraged to invest in its funds, to better align their interests with those of the underlying investors.

We believe that, post-MiFID II, less research is being produced on small and medium-sized companies, in particular, and the overall quality of that research has declined. MAML counters this with a strong emphasis on proprietary research, while actively avoiding brokers. It also encourages some theoretical research and lateral creative thought. The size of the team makes that achievable and gives MAML a competitive edge. The manager adds that, in addition to the counter provided by its own strong in-house research emphasis, he has found companies to be more receptive to meeting with MAML.

MAML is an entrepreneurial boutique with a flat structure that allows for quick decision-making and avoids the politics that bog down more bureaucratic large asset managers. MAML does not encourage the development of ‘star’ fund managers, but is focused on staff retention, including the granting of staff options over MAML equity. MAML’s ‘back office’ functions are carried out in-house rather than being outsourced (as they are in many smaller investment management boutiques).

Simple, niche, market leaders with high and sustainable returns, profitable and with good management

The underlying philosophy

MAML invests in:

- simple businesses that it can understand;
- niche businesses in growth markets (non-cyclical companies, growing organically);
- market leaders (strong, defensible market positions and pricing power);
- companies with high operating margins and high returns on capital (barriers to entry/a sustainable competitive advantage);
- profitable companies trading at sensible valuations;
- good management that it trusts (aligned to shareholders and demonstrating sound ESG practices); and
- companies that can deliver self-funded organic growth and remain focused on their core areas of expertise, rather than businesses that spend a lot of time on acquisitions.

This could be summed up as investing in high quality businesses at sensible prices. Furthermore, MAML believes it is important to:

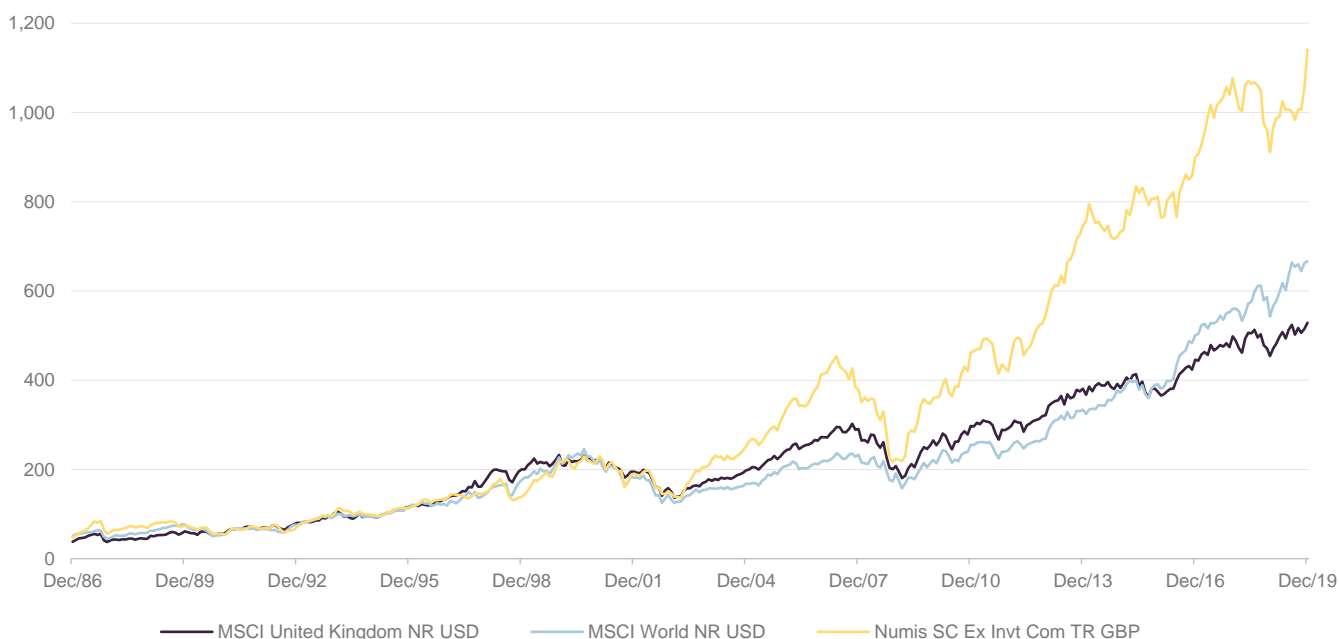
- do the work yourself (rather than relying on brokers);
- be passionate; and
- learn from mistakes (humility goes a long way).

MAML believes that is easier for small cap managers to beat indices than large cap managers

In addition, MAML believes that it is easier to add value through stock selection for a small and mid-cap portfolio, especially given the relative paucity of research available on these companies.

Small cap investing works

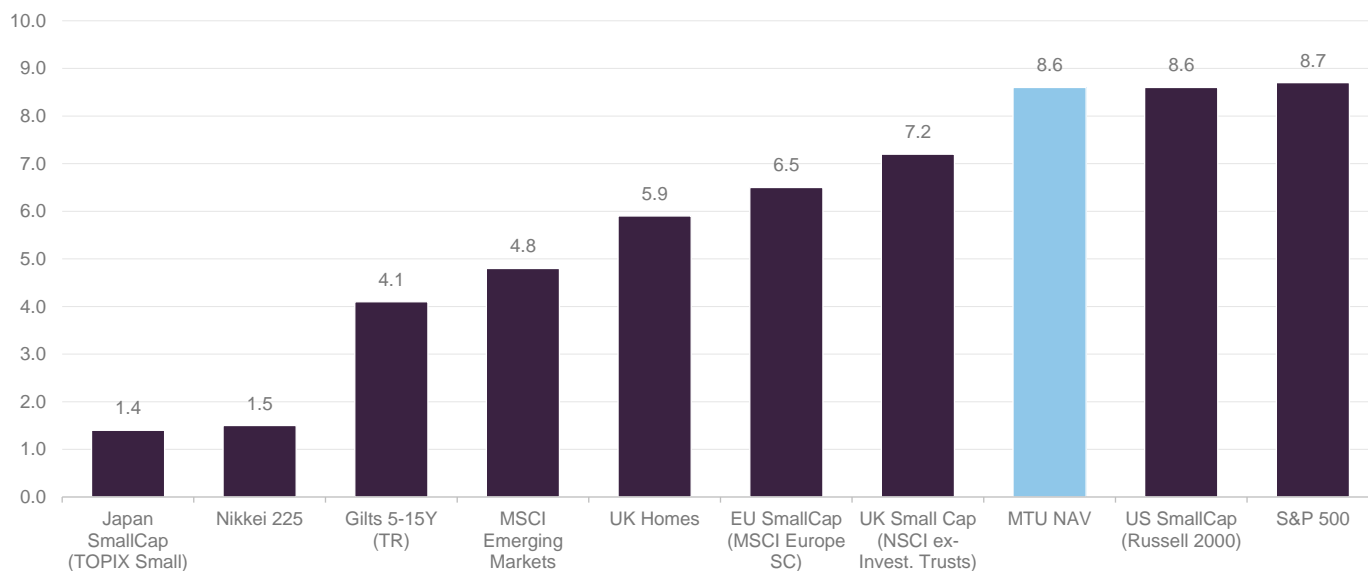
Figure 6: Numis Smaller Companies ex Investment Companies Index relative monthly performance versus MSCI UK and MSCI World - value of £100 invested 31/12/1986



Source: Morningstar, Marten & Co

Figures 6 and 7 might suggest that this approach works. Since the global financial crisis in 2008 in particular, UK smaller companies (as represented by Numis SC ex Investment Companies index) have comfortably outperformed the larger companies (as represented by the MSCI UK and World indices).

Figure 7: Absolute annual capital returns in £ since MTU's inception (%), March 1995 – December 2019



Source: MAML, Marten & Co

Selecting the underlying companies

MAML's approach is designed to select around 50 quality companies from a universe of about 2,000

An internal investment committee of six, chaired by Charles, reviews the portfolio every quarter, which reduces the dependence on any one individual – including Charles – for performance.

MAML follows a two-staged investment process, designed to identify matching *good businesses* and *good investments*. MTU's portfolio is drawn from a universe of about 2,000 companies, with a focus on those with a market cap between £100m to £1.5bn (see Figure 10). Microcap companies (<£100m) are avoided based on the liquidity risk they can pose.

The trust, by virtue of its structure, can have exposure to less liquid stocks and they have permission to hold up to 40% in AIM stocks. This is less than some of their competitors. In practice, though, it is unlikely that they would hold much more than 35%.

The depth and experience of MAML's team gives the firm a competitive edge

MAML has always generated its own investment ideas rather than relying on external analysts. A team of 10 analysts, each with their own sector expertise, continually screens the investable universe for new ideas. Research responsibilities are distributed amongst the team on a sector basis (although analysts may also compare and contrast UK companies to global peers). Emphasis is placed on being well-prepared for meetings with potential investee companies, which is possible as the research team is well-resourced. MAML's analysts can then set the agenda, challenge management and get the information that they need. Site visits are encouraged (another perk of having a large team is that it is not desk-bound).

Both management and the board of potential investee companies are closely examined, as MAML looks to predict where a company might be in 5 to 10 years:

- management's track record is analysed to understand their goals and aspirations;
- the board structure is considered, as are the corporate governance and remuneration policies; and
- the level of insider ownership is considered.

On site visits, the team will meet employees who have not met investors before, believing that doing so allows them to gain a better insight into the products and services provided and observe the culture of the company in a way that is hard to decode from reading an annual report.

The size of the team allows for some theoretical research and lateral creative thought is encouraged. On average, each analyst will seek to identify 20 stocks within their sector coverage worthy of closer scrutiny. These will form the pool from which portfolio constituents are drawn. The first part of the process is to eliminate poor-quality companies. These stocks are identified by applying a quantitative screen to the wider universe. Loss-making companies, those with poor cash-flow, and highly indebted businesses are rejected. Stocks that fit structural growth themes that the team has identified may be prioritised. Each company within the universe is assigned a quality rating (D to AAA).

Figure 8: MTU portfolio structure versus benchmark, as at 31 January 2020

	MTU	Numis Smaller Companies Index
P/E ratio, 12m forward	21.9x	12.2x
EPS growth, 12m forward	12.3%	3.9%
Dividend yield, 12m forward (NAV)	2.1%	3.4%
ROE, 12m forward	15.1%	12.0%
EBIT margin, 12m forward	20.8%	15.5%
Net debt/equity, 12m forward	7.5%	35.8%

Source: MAML, Factset, Marten & Co

All stock ideas are reviewed and approved by an investment committee

Then the detailed work starts. The analysts build a financial model and conduct a 'SWOT' analysis on each stock. They also check whether a stock meets MAML's ESG criteria (see overleaf). Then the idea is put before MAML's investment committee, who challenge assumptions and ask for more information if they feel this is warranted. Stocks that pass these quality thresholds may then go on to an Approved List of approximately 200 companies. No fund manager can buy a company that is not on the approved list.

Value is assessed on a range of measures but only after the quality evaluation is complete

Now, attention turns to valuation. Various valuation tools are considered (primarily discounted cash flows but also including P/E, free cash flow yields and dividend yields relative to peers) and the team operates with a time horizon of five to 10 years. The ideal investment should provide a margin of safety in excess of 25% over its intrinsic value.

Analysts will also look at risk factors. Analysts will then assign a recommendation to each stock. These will be presented to the whole team at weekly meetings and the fund managers will then decide which stocks make it into portfolios. Once a stock makes it into a portfolio, it will usually remain there for many years.

Portfolio construction

MTU's investment policy is more fully described in its Annual Report. It only invests in listed or quoted securities and MAML says that unquoted companies are not eligible for consideration.

Some other rules apply:

- MTU does not hedge its currency exposure;
- At the time of initial investment, a potential investee company must be profitable and no bigger than the largest constituent of the Numis Smaller Companies (ex IC index). At the start of 2020, this was any company below £1.68bn in size (£1.33bn at the start of 2019);
- For risk management purposes, the manager limits any one holding to a maximum of 4% of MTU's investments at the time of initial investment; and
- MAML will hold no more than 10% of the voting rights in any company (across all funds managed by MAML).

Position sizes determined by conviction

Typically, the target weighting for a new position will be between 1% and 3.5%, depending on both the strength of conviction that the manager has in the stock, and its liquidity. The total number of holdings is typically around 50. There is no obligation to sell a company if its market cap exceeds €5bn, but these will be gradually recycled into lower market cap companies. The manager will ensure that a single position does not exceed 7.5% of the portfolio while he also cannot increase the size of a position once its weight exceeds 4%.

The manager adds that when entering into a new position, he typically buys 50% of the target weight initially. If the investment grows to the target weight organically, it is left alone. If it declines following the investment, the manager will add to the investment to take it to its target, if it still meets the criteria.

ESG analysis

ESG principles are at the heart of MAML's stock selection decisions and a number of sectors will not be represented within the portfolio

MAML's focus on quality is supported by its commitment to ESG principles. It has an internal ESG committee that meets quarterly and oversees MAML's efforts in this area. MAML also has its own handbook, policies and checklists. It votes the shares it controls, and engages with companies. MAML expects the companies that it invests in to improve their ESG awareness and it monitors their progress.

Some sectors are excluded from portfolios on ESG grounds. MAML portfolios will not contain tobacco companies; companies manufacturing weapons, facilitating gambling or manufacturing alcohol; companies engaged in oil and coal-related E&P; companies involved with pornography; and those making high interest-rate loans. Corporate governance checks include an assessment of a company's remuneration policy.

MAML's attention to ESG issues extends to its own business. Following an extensive evaluation process, it was made a B Corp Certified company in June 2019 (more information is available at [bcorporation.net](https://www.bcorporation.net)).

Sell discipline

Stocks exit the portfolio for a variety of reasons. For example, when they become significantly overvalued, if they become too big, or due to takeovers.

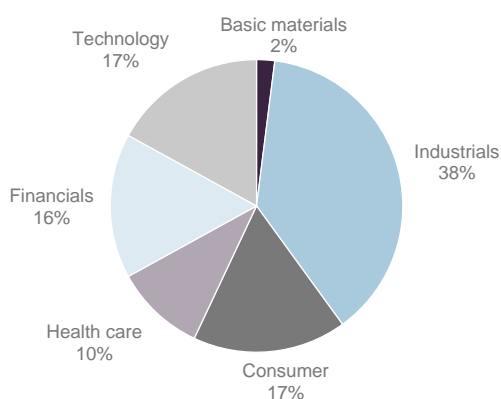
Furthermore, stocks may leave the portfolio if the analysts identify unfavourable changes in the fundamentals of the business, or an unfavourable management change.

Stocks will also be sold if they no longer pass MAML’s quality threshold, or if a new opportunity comes along that offers better prospects.

Asset allocation

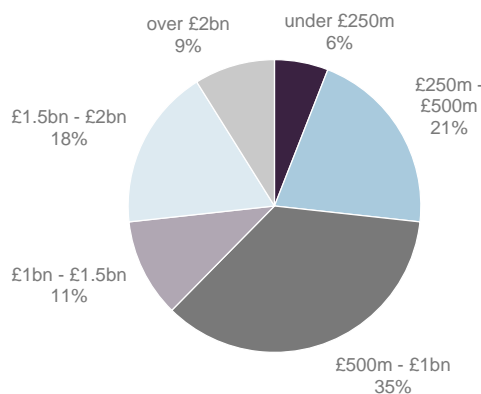
There were 51 holdings in the portfolio at the end of January 2020, including 21 allocations (32.7% of the portfolio) to AIM-listings. Figures 9 and 10 give an indication of the split of the portfolio by industry and market cap. The portfolio has a high active share relative to the Numis Smaller Companies ex Investment Companies index (89% at the end of December) and, based on Factset consensus estimates, has a bias to stocks trading on higher-valuation multiples but exhibiting higher predicted earnings growth, margins and returns on equity, and with stronger balance sheets. These factors are indicative of MTU’s bias to high-quality companies.

Figure 9: MTU sector split at 31 January 2020



Source: MAML, Marten & Co

Figure 10: MTU split by market cap at 31 January 2020



Source: MAML, Marten & Co. Note: does not sum to 100% due to rounding

In terms of sector exposure, MTU has no investments in oil and gas, commodities, banks, telecommunications and utilities. The portfolio has a deliberate overweight exposure to healthcare, industrials and technology relative to its benchmark. MAML estimates that the portfolio is about 44% exposed to overseas earnings and 56% to the domestic UK economy.

Top 10 holdings

The company's 10 largest equity holdings as at 31 January 2020 are shown in Figure 11.

Figure 11: MTU top 10 equity holdings at 31 January 2020

	Sector	% as at 31 January 2020	% as at 31 March 2019	Change (%)
IntegraFin	Financials, owner of Transact platform	4.0	2.7	+1.3
4Imprint	Media, promotional products	3.9	4.0	(0.1)
Marshalls	Construction and materials	3.6	4.6	(1.0)
XP Power	Electronic and electrical equipment	3.6	2.5	+1.1
Ideagen	Software and computer services	3.3	2.4	+0.9
Hilton Food	Food producers	3.2	3.4	(0.2)
Restore	Business services, document storage	3.0	2.0	+1.0
Discoverie	Electronic and electrical equipment	2.9	1.7	+1.2
Porvair	Industrial engineering	2.8	2.4	+0.4
Polypipe	Construction and materials	2.7	2.9	(0.2)
Total		32.9	34.1	

Source: MAML, Marten & Co

Figure 12: Top 10 holdings – size, profitability, yield and valuation

	Market cap (£m)	EBIT margin (%)	Dividend yield (%)	P/E ratio, 12m forward	PEG ratio
IntegraFin	1,740	-	2.1	31.4	2.0
4Imprint	1,170	6.0	2.0	26.4	1.8
Marshalls	2,061	13.0	1.9	28.5	3.8
XP Power	690	20.0	2.9	18.3	-
Ideagen	523	4.0	0.2	30.6	1.7
Hilton Food	1,072	2.0	2.2	22.3	2.6
Restore	809	13.0	1.4	18.7	2.3
Discoverie	592	5.0	1.9	18.4	2.5
Porvair	357	10.0	0.9	24.8	2.8
Polypipe	1,284	15.0	2.4	17.5	3.6

Source: MAML, Marten & Co. Note: data as at 2 January 2020

About 5% of the portfolio in NAV terms was the subject of buyouts, raising turnover in the portfolio and augmenting returns

Turnover of 29.2% in the portfolio over 2019 was relatively high for the trust (up from 22.6% in 2018), reflecting efforts to optimally position the portfolio in preparation for what the manager expected to be a strong end to the year. This included removing exposure to any holdings that Charles believed were not growth-oriented.

Another contributing factor was the takeover of four portfolio companies, cumulatively representing around 5% of NAV. The most notable was Entertainment One (a media rights business which owned, inter alia, the Peppa Pig franchise), making it the biggest positive stock contributor to returns in the calendar year (see the performance section). Also bought out were Charles Taylor (a management services business focused on the insurance sector), Consort Medical (drug and delivery device manufacturing for the pharmaceutical industry) and BCA (owner of the webuyanycar website).

Looking at some of the largest holdings:

Figure 13: 4Imprint



Source: Bloomberg

4Imprint

4Imprint (investors.4imprint.com/) is a direct marketing firm specialising in promotional products. It has operations in North America, the UK and Ireland. The company is operating in a very fragmented market (at the half-year stage in 2019, the company thought it had a market-leading 2.6% share of a \$28.1bn market). A TV campaign in 2019 helped drive sales as was evidenced in a trading update published in January. Group revenue for 2019 was estimated to be 17% higher than in 2018 and the company was expecting profits at the upper end of analysts' forecasts.

Figure 14: Marshalls



Source: Bloomberg

Marshalls

Marshalls (marshalls.co.uk/investor) is a manufacturer and supplier of hard landscaping products, primarily in the UK but also in continental Europe and China. The company is a beneficiary of increased pedestrianisation of cities in the UK. It has also picked up orders in connection with projects such as Crossrail. Charles says it is embracing new technology to digitalise orders and manage its inventory. A trading statement published in January said that revenue for 2019 was likely to be 10% higher than 2018, largely driven by progress in its public and commercial markets.

Figure 15: IntegraFin

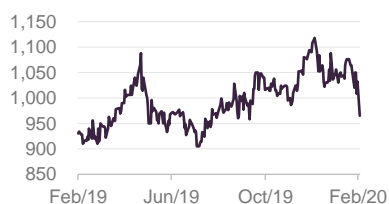


Source: Bloomberg

IntegraFin

IntegraFin (integrafin.co.uk/) is the owner of the Transact platform, which is used by UK financial advisers and their clients and provides a range of tax wrappers. It was a notable early provider of access to investment companies. Funds under direction were £39.3bn at the end of December 2019 (up from £31.6bn a year earlier).

Figure 16: Hilton Food



Source: Bloomberg

Hilton Food

Hilton Food Group (hiltonfoodgroupplc.com/) is a specialist food packing business with operations across the UK, Europe, Australia and New Zealand. The company started life packing meat for Tesco in Huntingdon. It now works on a much wider range of products for Tesco and with a range of other retailers, including Woolworths in Australia. It recently agreed a joint venture with a Dutch vegetarian product manufacturer and is seeing the benefits of its 2017 acquisition of a fish and seafood business, Seachill, which is working with Tesco and Waitrose.

Figure 17: Restore



Source: Bloomberg

Restore

Restore (restoreplc.com/) is a document storage business focused on the UK. Over the years it has expanded into office moves, secure shredding and recycling. Growth has come both organically and through bolt-on acquisitions (over 30 since its launch in 2010, including TNT Business Solutions in 2018). It has said that trading is in line with expectations with double digit growth in revenue and profits forecast for 2019. The integration of the TNT business is said to be complete.

Outside of the top 10, MAML has also been building positions in Kainos.

Kainos

Figure 18: Kainos

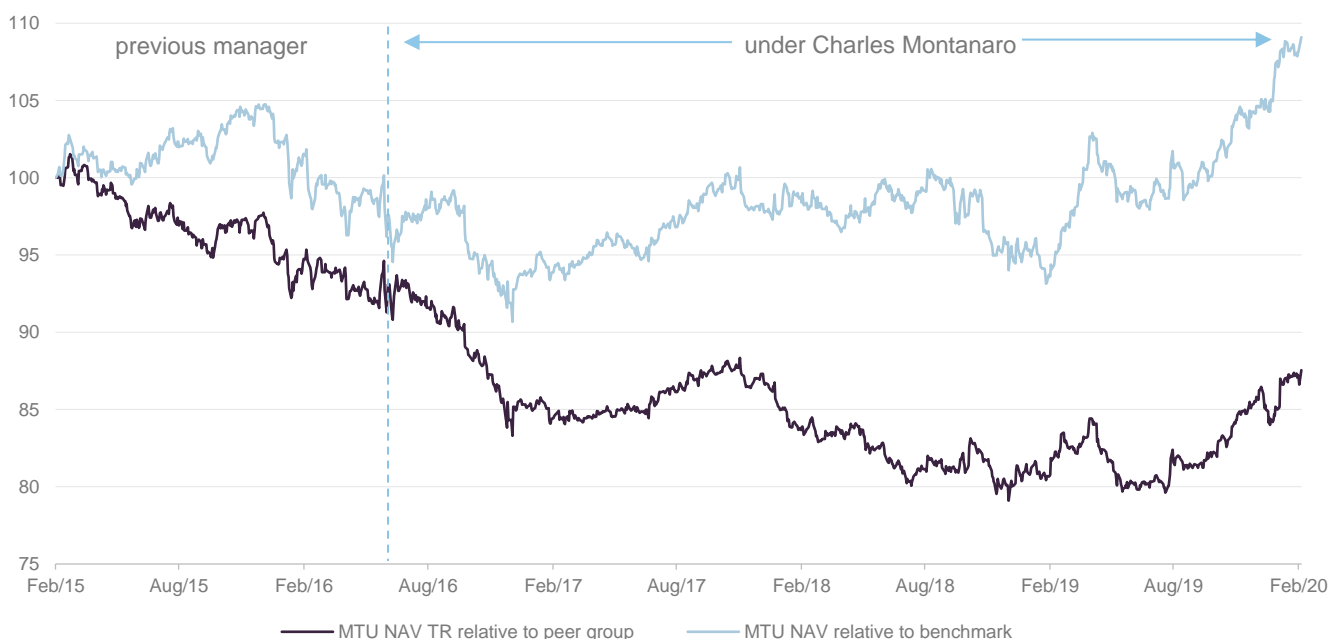


Source: Bloomberg

Kainos (kainos.com/) is a software business. It says that it leads large-scale digital transformation across the commercial, public and healthcare sectors. Charles made an investment in the company early in Q4, taking a half weighting, as is his typical approach. The shares have appreciated rapidly since then, however. Interim results, covering the six months ended 30 September 2019, released in mid-November, showed revenue growth of 29% and profit growth of 38%. Kainos is doing a lot of work with various UK government departments and thinks Brexit may stimulate more activity as systems are adapted to reflect the new reality. It is a distribution partner for Workday (an App-based ERP tool) and has been busy opening offices in Europe and North America to support this.

Performance

Figure 19: MTU relative returns over five years ended 28 February 2020



Source: Morningstar, Marten & Co

Figures 19 and 20 illustrate MTU’s relative NAV total return performance against its benchmark and peer group (defined below). The marked revival in UK small cap stocks over the fourth quarter of 2019 provided a greater catalyst for MTU’s NAV than either the benchmark or peer group. Performance was particularly good over the first and fourth quarters – December 2019 saw UK small caps have their best month in eight years, as judged by MTU’s benchmark.

Figure 20: MTU performance (%) over periods ending 28 February 2020

	1 month	3 months	6 months	1 year	3 years	5 years
MTU share price TR	(14.0)	(7.4)	16.4	15.5	30.3	49.8
MTU NAV TR	(9.2)	(1.7)	9.0	15.8	23.5	38.3
Benchmark*	(9.5)	(5.6)	1.2	0.8	7.2	27.5
Peer group** avg. NAV TR	(8.8)	(3.9)	3.0	9.5	20.6	59.7
MSCI UK TR	(9.1)	(9.8)	(7.5)	(3.5)	1.5	14.4

Source: Morningstar, Marten & Co. *Note: MTU'S benchmark is the Numis Smaller Companies Index (excluding investment companies). **Note: The peer group is defined below.

Performance attribution

MTU has a greater allocation to the industrials (including 16% in support services) and technology sectors than the benchmark and nearly all of the funds in our peer group. Several companies within these sectors performed very well over the final months of 2019. Having no exposure to the oil & gas sector has also helped.

Figures 21 and 22 show the five largest positive and negative contributions to MTU's performance over the 12 months ended 31 December 2019.

Figure 21: Positive contributions

	Contribution (%)
Entertainment One	2.1
4Imprint	1.7
Marshalls	1.6
GB Group	1.2
Diploma	1.0

Source: MAML

Figure 22: Negative contributions

	Contribution (%)
ECO Animal Health	(0.9)
Cineworld	(0.7)
Scapa Group	(0.6)
Consort Medical	(0.5)
Gear4Music	(0.5)

Source: MAML

Figure 23: GB Group



Source: Bloomberg, Marten & Co

Figure 24: Cineworld



Source: Bloomberg, Marten & Co

Entertainment One led stock-specific positive contributions to NAV, after it was bought by Hasbro at a 31% premium to its 30-day volume weighted average price. 4Imprint's shares increased by more than 65% over 2019 while GB Group, a specialist in identity data intelligence, had an even better year with its shares increasing by over 85%. The company continued its upward momentum following a positive trading update in October.

Among the detractors, it was a challenging year for Cineworld (its shares were down nearly 30%), the world's second-largest cinema-chain. It warned on profits after below-par box office performance from the likes of the *Lion King* and *Frozen 2*. Cinema sales were down year-on-year, not helped by the release of some highly-anticipated films, like *Avatar 2*, being pushed back until 2020. Sentiment towards the cinema business has not been helped by Netflix offering very short cinema release windows for potentially lucrative films, like *The Irishman* – Cineworld has been targeted by hedge fund short sellers over recent months.

In the wake of the threat posed by steaming services, the cinema industry has been consolidating – Cineworld announced in December that it had reached an agreement to acquire Canada's Cineplex for \$2.1bn – the deal would make it the largest cinema company in North American by number of screens. Charles says he will stick by Cineworld – he does not believe the company's balance sheet is as stretched as many believe. He adds that he is not overly concerned by profit warnings, so long as they are not unexpected.

Figure 25: ECO Animal Health



Source: Bloomberg, Marten & Co

Eco Animal Health, a manufacturer of non-antibiotic pharmaceutical products for pigs and poultry mainly, suffered (the shares were down around 45% at the year-end) as Chinese orders (China accounted for around 20% of sales over the most recent period) fell following an outbreak of avian flu, which has resulted in around a quarter of the world's pig population being killed. The trade war has also negatively impacted performance. Charles says the company was hit by the perfect storm and that he had not expected the impact to be as big. The shares have recovered some ground over recent weeks and – at least in terms of growth in the business – the fact that revenue has increased over three successive years offers encouragement while operations outside of North America and China have been performing well. The manager added that he saw value in the shares in December, using the sell-off to top up the trust's position.

Peer group comparison

The peer group we have used for the purposes of this note is comprised of a subset of funds in the AIC's UK smaller companies sector. We have omitted split-capital companies, trusts with a small market capitalisation, and those with an exclusive focus on micro-cap companies. A complete list of the subset is provided in Figures 26 and 27.

Figure 26: Listed UK smaller companies peer group NAV total return performance (%) over periods ending 28 February 2020

	1 month	3 months	6 months	1 year	3 years	5 years
MTU	(14.0)	(0.9)	9.2	15.2	25.0	39.8
Aberforth Smaller Companies	(13.2)	(5.4)	2.3	1.0	5.3	22.1
BlackRock Smaller Companies	(13.6)	0.0	6.3	13.9	32.7	79.1
BlackRock Throgmorton	(13.8)	(3.3)	4.1	16.5	39.2	87.8
Crystal Amber	(17.7)	(22.4)	(32.4)	(25.2)	(30.7)	13.3
Henderson Smaller Companies	(15.8)	(4.4)	7.3	8.2	25.8	56.4
Invesco Perpetual UK Smaller	(13.7)	(3.4)	4.6	14.8	31.3	75.7
JPMorgan Smaller Companies	(9.5)	0.5	16.5	27.4	47.0	71.2
Rights & Issues Investment	(13.2)	(6.2)	(2.5)	(6.3)	1.8	69.7
Standard Life UK Smaller Companies	(12.9)	(0.4)	14.4	23.7	44.9	99.6
Strategic Equity Capital	(14.7)	(2.1)	5.0	14.2	14.5	33.6
Median	(13.7)	(3.3)	5.0	14.2	25.8	69.7
Rank	8/11	4/11	3/11	4/11	7/11	8/11

Source: Morningstar, Marten & Co

MTU has been among the sector's best performers recently

MTU's relative performance has improved considerably over the past six months particularly. The manager increased gearing in the portfolio towards the end of the year anticipating a strong close to 2019. This came to fruition with MTU delivering the third-best three- and six-month returns in NAV terms. Sentiment towards the trust improved too with a price return of 27% over the three-month period from 1 November 2019 – ahead of peers including BlackRock Smaller Companies, BlackRock Throgmorton and Standard Life UK Smaller Companies.

More up-to-date information on MTU and its peer group is available on the [QuotedData website](#)

MTU's dividend yield, illustrated in Figure 27, merits highlighting. It is the sector's highest – reflecting the shift to quarterly distributions in mid-2018 (see the dividend section). We note that MTU's forward (12 months) dividend yield currently stands at 4.4%. Also worth mentioning is MTU's ongoing charges ratio, which is competitive for its size, while its discount remains higher than the sector's median, representing an opportunity if recent strong performance encourages this to narrow.

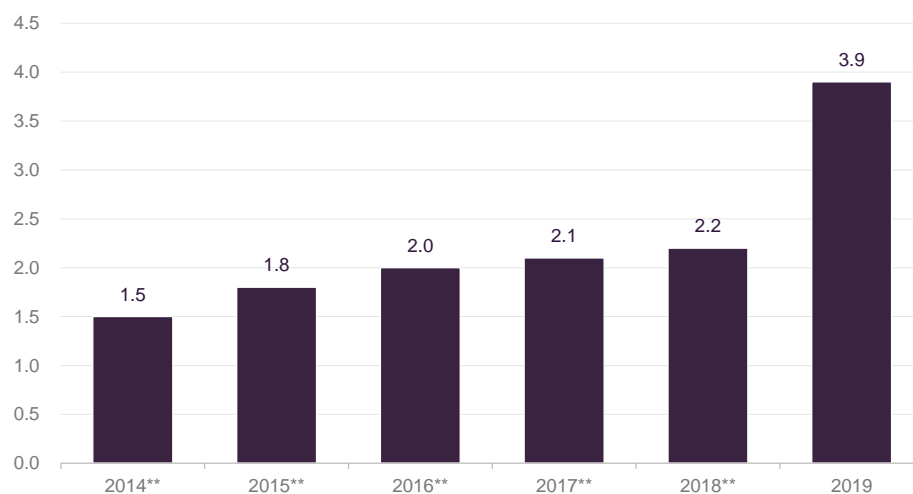
Figure 27: Listed UK smaller companies funds, comparison as at 4 March 2020

	Market cap (£m)	Discount (%)	12m trailing dividend yield (%)	Annual ongoing charge (%)
MTU	205	(11.7)	4.0	0.80
Aberforth Smaller Companies	1,110	(5.5)	2.7	0.77
BlackRock Smaller Companies	747	(1.6)	2.1	0.70
BlackRock Throgmorton	500	3.6	1.7	0.59
Crystal Amber	91	(34.1)	3.3	1.93
Henderson Smaller Companies	676	(5.3)	2.5	0.42
Invesco Perpetual UK Smaller	185	0.3	2.0	0.88
JPMorgan Smaller Companies	212	(6.6)	1.9	1.11
Rights & Issues Investment	153	(0.9)	1.6	0.48
Standard Life UK Smaller Companies	559	(0.5)	1.3	0.90
Strategic Equity Capital	142	(15.3)	0.6	1.10
Median	212	(5.3)	2.0	0.80
MTU rank	7/11	9/11	1/11	6/11

Source: Morningstar, Marten & Co

Dividend

Figure 28: MTU ordinary dividends (pence per share), 2014-2019*



Source: MAML, Marten & Co. *Note: 31 March financial year-ends. **Note: 2014-2018 figures re-stated to reflect the subsequent five for one share split.

MTU made a significant change to its dividend distribution policy in 2018

In accordance with a policy introduced in July 2018, MTU pays out 1% of its NAV each quarter as a dividend – a level it considers to be meaningful for investors. Figure 28 illustrates the difference the change in policy had on the total distribution in 2019.

The decision to switch to quarterly distributions was made to increase the relative appeal of the trust, particularly among retail investors, with interest rates around the world remaining artificially low.

Charles says that the revised dividend policy has had no impact on the way in which the fund is managed or the yield on the underlying portfolio. MTU's primary objective is to generate capital growth with the income generation of the underlying portfolio considered to be a by-product of the stock selection process.

The capital account is used to make up for any shortfalls in the revenue account. Dividends are declared in July, October, January and April and paid in August, November, February, May.

Premium/(discount)

Figure 29: MTU premium/(discount) over five years to 28 February 2020



Source: Morningstar, Marten & Co

As exhibited by Figure 29, MTU's discount had narrowed sharply from October 2019, after the threat of a hard Brexit dissipated (for the time being) and confidence increased in the likelihood the Conservative government would claim a majority in the Christmas general election.

MTU's discount narrowed in mid-2018 after it revised its dividend policy and introduced a five-for-one share split

Charles does not believe that discounts are correlated to performance and buybacks have no lasting effect, whilst amendments to dividend policy and fee structures can impact the discount. The revision in MTU's dividend policy, most notably in July 2018 (see the dividend section), provided one catalyst for the discount to narrow. Another catalyst was the five-for-one share split introduced around the same time – it helped to increase liquidity in the shares (see the capital structure and life section).

MTU does not believe buybacks have a lasting impact, believing they are best used as a liquidity tool

On buybacks, in which MTU has not engaged since 2009, the trust has taken the view that they should mainly be used to provide liquidity in the shares, which can be particularly beneficial for longstanding investors. An example used was the facilitation of Merchant Investors Ltd's exit in 2000. The company may buy back shares when it considers it to be in shareholders' best interests.

At the 2019 AGM, MTU took powers to repurchase up to 14.99% of its then-issued share capital. Shares repurchased may be held in treasury and reissued. Any shares reissued from treasury will be at a lower discount than when purchased and at a higher share price, thereby ensuring that the round trip is profitable for shareholders. If its pool of treasury shares were to be exhausted, MTU has also taken powers at the AGM to issue up to 5% of its then-issued share capital as new shares. Such shares would be issued at a premium to NAV.

MTU were an early adopter of treasury shares which is a good thing but they took the view that as long as the roundtrip made money for shareholders, it was ok to reissue at a discount – controversial in some quarters.

Fees and costs

MTU pays a management fee equivalent to 0.50% of the trust's gross assets.

As MTU's investment manager and AIFM, MAML is entitled to receive a management fee of 0.50% of the trust's gross assets (this was reduced from 0.85% with effect from 1 April 2017). Over the year to 31 March 2019, the manager received a monthly fee equivalent to 1/12 of 0.50% of MTU's gross assets valued at the end of the last business day of each month.

There is no performance fee charged (one was last charged in 2012) and with respect to MTU's allocation of the management fee, the capital/revenue account split is 75:25. The same breakdown is applied to the accounting treatment of interest accrued on MTU's borrowings.

Except in certain circumstances, the management agreement may only be terminated by the manager on giving 12 months' notice in writing to the MTU. MTU is entitled to terminate the agreement by notice in writing to the manager immediately, or at a specified date. In the event that the trust is the party terminating, the manager will be entitled to a termination fee of 1% of the gross assets of MTU at the end of business on the last day of the calendar month immediately preceding the effective date of termination of the contract.

The company's ongoing charges ratio for the year ended 31 March 2019 was 0.80% - this compared with 0.78% the year before. This is calculated as the company's annualised capital and revenue expenses (excluding finance costs and certain non-recurring line items) taken as a percentage of MTU's average monthly net assets over the course of the accounting year.

Capital structure and life

MTU has 167,379,790 ordinary shares in issue and no other classes of share capital. The shares were subdivided in July 2018 on a five-for-one basis. The objective of this exercise was to increase the liquidity of the shares and make it easier to make relatively small investments into the trust (making it better suited to monthly savings plans and the like).

MTU's passed its most recent continuation vote in 2017 with 97.4% support – the next one is expected in 2022.

MTU's financial year ends on 31 March. It tends to announce annual results in June and hold its AGMs in July.

Gearing

Gearing was unusually high over the fourth quarter of 2019, reflecting the manager's view that the trust was positioned to close the year strongly

Charles says that the first and fourth quarters often deliver the strongest returns, and has often used gearing to anticipate this market seasonality. This was especially evident over the fourth quarter of 2019, where gearing increased to around 12% - the very top end of MTU's range. Going into the period, Charles's conviction was that the trust was positioned for a strong end to the year, which he says was independent of the election outcome. He does not expect gearing to be as high going forward.

MTU has credit facilities totalling £30m with ING Bank NV, which were agreed in December 2016. This is made up of a five-year £20m fixed rate term loan and a five-year £10m floating rate revolving credit facility (RCF). As at 30 September 2019, £20m

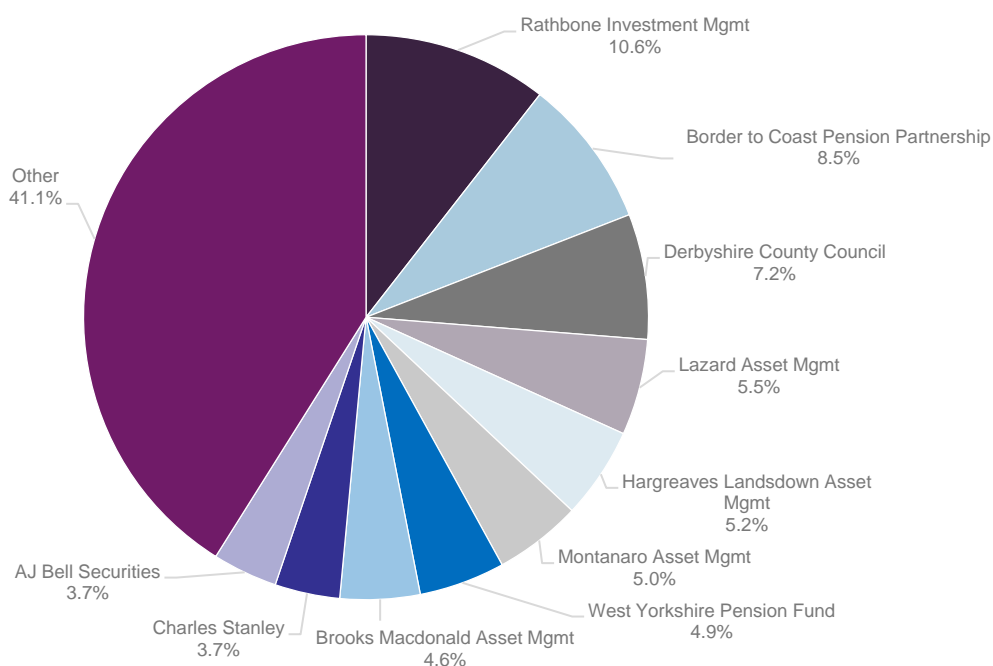
was utilised through the fixed rate term loan. Interest is payable at a fixed rate of 2.68% per annum in both the current and prior year.

The RCF had not been utilised as at 30 September 2019. When drawn down, interest is payable at LIBOR plus a margin of 1.65% per annum and mandatory costs.

Major shareholders

Figure 30 shows MTU's major shareholders, at 31 December 2019. Included here is the manager's 8.7% stake, comprising Montanaro Asset Management's 5% (Charles owns 100% of MAML) and a large proportion of AJ Bell's 3.7% stake.

Figure 30: MTU major shareholders as of 31 December 2019, % of shares held



Source: MAML, Marten & Co

Board

MTU is managed with a tight board of just three non-executive directors. Arthur Cople, the chairman, was elevated to that position in July 2019 following the retirement of Roger Cuming. The trust believes a three-person board to be appropriate for its size, allowing it to keep costs down – ongoing charges have been falling. On 19 November 2019, MTU announced the appointment of Catriona Hoare as independent director. Catriona replaced Kate Bolsover, following her resignation after over five years of service. Kate's resignation was effective the same day as Catriona's appointment.

Figure 31: Board member - length of service and shareholdings

Director	Position	Appointed	Length of service (years)	Annual director's fee (GBP)*	Shareholding*
Arthur Copple	Chairman	1 March 2017	2.9	35,000	125,000
James Robinson	Senior independent director and chair of audit and management engagement committees	30 September 2013	6.4	28,000	40,000
Catriona Hoare	Independent director	19 November 2019	0.3	-	-

Source: MAML. *Note: shareholdings and fees as per interim results period to 30 September 2019.

Arthur Copple (chairman)

Arthur Copple has specialised in the investment company sector for over 30 years. He was a partner at Kitcat & Aitken, an executive director of Smith New Court Plc, and a managing director of Merrill Lynch. He is also non-executive chairman of Temple Bar Investment Trust Plc and vice-chair of the University of Brighton Academies Trust.

James Robinson (senior independent director and chair of the audit and management engagement committees)

James Robinson recently replaced Kate Bolsover as senior independent director while retaining his role as chair of the audit and management engagement committees. James was chief investment officer (investment trusts) and director of hedge funds at Henderson Global Investors prior to his retirement in 2005. A chartered accountant, he has over 35 years' investment experience and is a director of JP Morgan Elect Plc. He is also chairman of Polar Capital Global Healthcare Trust Plc, a governor of Lord Wandsworth College and a former chairman of the investment committee of the British Heart Foundation.

Catriona Hoare (independent director)

Catriona Hoare's experience includes having been an investment partner at Veritas Investment Management in London since 2013. Before joining Veritas, Catriona held the position of fund manager at Newton Investment Management.

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