

# WS Gresham House UK Micro Cap Fund

## Quarterly commentary – Q1 2024

**Past performance is not necessarily a guide to future performance. Portfolio investments in smaller companies typically involve a higher degree of risk. Capital at risk. Extracted portfolio performance is not necessarily indicative of the performance of the fund. Not to be construed as investment advice or recommendation. Views expressed by the investment team are correct at the time of writing but are subject to change.**

### Overview – Q1 2024

UK equity market performance was mixed in Q1 2024. While recent inflation data beat economic expectations, investor optimism was better reflected in large-cap stocks which outperformed their smaller counterparts over the period; the FTSE 100 grew 3.0% while the FTSE AIM All Share declined 2.4%. Weaker small-cap performance was largely attributable to further outflows from UK equity funds. According to recent Calastone data, March 2024 marked the 34th consecutive month of net UK outflows and the worst month since February 2023.<sup>1</sup> Many small-cap fund managers remain 'forced sellers' of stock, driving further short-term price weakness despite strong fundamental performance in many instances. While creating short-term pressures, we believe these market dynamics present a compelling opportunity to invest in quality UK companies at attractive entry valuations.

During the quarter, the valuation gap between UK smaller companies and their larger domestic peers as well as smaller international peers widened; UK equities now trade at a record 45% discount to global counterparts.<sup>2</sup> Moreover, UK outflows into North American equity funds were greater in Q1 2024 than over the previous nine years combined.<sup>3</sup> Investors continue to exhibit a 'risk-off' attitude toward UK stocks, partly due to the attractiveness of cash investments in the current interest rate environment, which combined with high inflation and rising mortgage rates, has drawn capital away from UK equity funds over the last year. However, we saw catalysts emerge for more positive UK fund flows over the short-to-medium term. Our stock-specific research showed that the amount of cash held on UK investment platforms started to reduce during Q1 2024, while government initiatives such as the British ISA could help draw capital back into UK smaller companies and induce a broader re-rating of the space.

We recognise that macroeconomic and geopolitical uncertainty persists, but we are confident that our portfolio companies are strongly positioned to navigate external headwinds. Our consistent focus on capable management teams, clear value creation strategies with growth levers within management control, structural market tailwinds, defensible competitive positions, and attractive financial characteristics, gives us confidence that our holdings can continue to grow earnings and generate cash throughout the cycle.

Newsflow across the portfolio was largely positive in Q1 2024, as several companies delivered positive trading updates. As an indicator of portfolio quality and resilience, c.87% of company updates in the fund

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1. Calastone, "Record Inflows to Equity Funds in Q1 as 2024 starts with a bang...", April 2024.

2. Median 1-year forward P/E multiples across various international indexes, excluding investment trusts, sourced from Bloomberg data.

3. Calastone, "Record Inflows to Equity Funds in Q1 as 2024 starts with a bang...", April 2024.

have been in-line or positive relative to market expectations during 2024.

## Performance - Q1 2024<sup>4</sup>

Performance in the WS Gresham House UK Micro Cap Fund increased by 3.2% during the quarter, outperforming the IA UK Smaller Companies sector which increased by 1.4%.<sup>5</sup>

Key positive contributions came **AdvancedAdvT** (55.5%) from following an interim trading update which demonstrated strategic progress alongside its successful re-admission to AIM following its strategic acquisition of Capita's remaining software assets; **Trufin** (42.3%) following the release of strong full year results, alongside the launch of Playstack's fastest selling game to date; and **Windward** (29.3%) following full-year results comfortably ahead of market expectations.

The largest detractors to performance were **Argentex** (-37.4%) following a profit warning driven by higher than anticipated costs alongside a challenging market backdrop; **Angling Direct** (-17.4%) on the back of cautionary remarks from the CEO on the consumer backdrop into 2025 and beyond; and **Inspired Energy** (-15.0%), despite strong full year results and a positive growth outlook.

## Portfolio activity

We made no full exits, new investments, or selective follow-on investments during the period.

## Outlook – Q2 2024

We assume that elevated macroeconomic and geopolitical uncertainty will continue to drive market volatility over the coming months. Global investors remain particularly sensitive to new inflation data and interest rates, while conflicts in Europe and the Middle East threaten regional stability.

We believe that volatile conditions benefit stock-pickers focused on business fundamentals, particularly given the further profit warnings across the UK market during the quarter, which demonstrates how optically 'cheap' stocks are not so attractively priced if market earnings expectations lack a solid foundation. We are placing additional emphasis on our differentiated, network-based due diligence approach, gleaning insight and expertise from high-quality professionals and industry specialists. This allows us to build conviction in key components of investment theses and avoid 'value traps' which appear in a subdued market. However, notwithstanding an unexpected deterioration in the external environment, we are seeing green shoots of improving market sentiment and potential catalysts for a re-rating of the UK small cap space.

Importantly, a growing number of M&A deals across the UK small-cap market is providing further evidence of a disconnect between market valuations and company fundamentals. US and European private equity firms have turned their focus towards the heavily discounted smaller end of the UK market, seeking to purchase companies with high-quality fundamentals at relatively low valuations to offset higher deal funding costs. Indeed, the average one-day premium across UK public-to-private transactions grew to 52% in 2023 from a five-year average of c.40% despite the higher interest rate environment.<sup>6</sup> We expect that M&A activity will

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4. Please refer to the factsheet for full NURS-compliant performance figures.

5. The IA UK Smaller Companies sector comparator is used for illustrative purposes only.

6. Gresham House internal analysis of UK P2P data, sourced from Bloomberg.

remain an important driver of short-term returns, while over the medium term, we see the arbitrage between public-to-private transaction multiples and company trading multiples as a catalyst for a broader re-rating of the UK small-cap market.

Positively, we are also observing a meaningful increase in UK public market corporate activity so far in 2024, signalling that investors are more willing to support high quality businesses with their funding needs. The increase in activity has primarily focused on secondary sell downs and primary capital raises of meaningful size, with an average deal value of £418mn, rather than IPOs.<sup>7</sup> Helpfully, the majority of companies have seen a strengthening share price post-deal, which helps further build investor confidence. Collectively, these factors leave us cautiously optimistic on UK equity market performance during the remainder of 2024.

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7. Dealogic, 06 Apr 24.



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