WS AMATI UK LISTED SMALLER COMPANIES FUND

Thoughts on UK Smallcap

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Amati Global Investors

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The UK equity market has been unloved for many years now and 2024 so far has seen a continuation of this trend, with equity fund outflows being an ongoing feature and UK market returns continuing to lag the main global indices.

The relative decline of the UK market in recent years has been well documented, driven by a combination of political, economic and index construction factors.

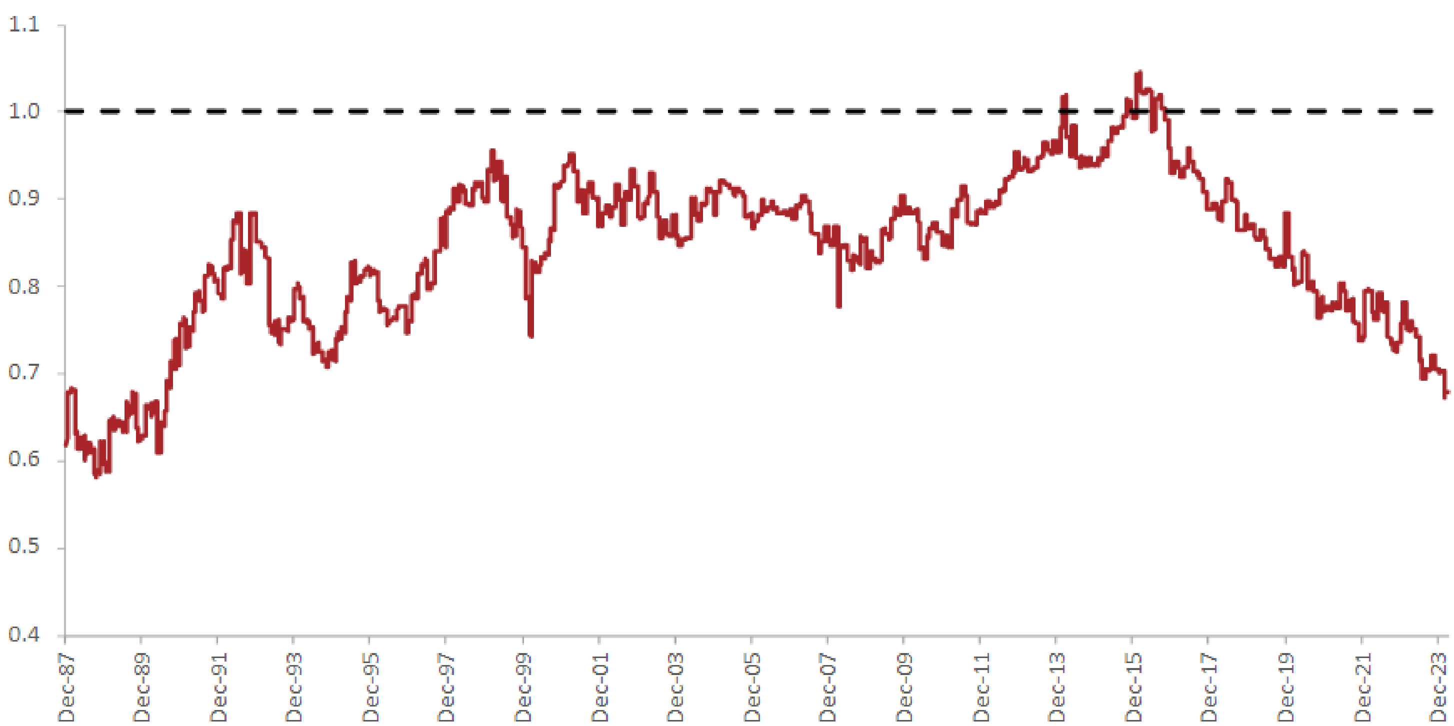
Politics – Brexit has significantly undermined confidence in the UK which has been exacerbated by weak government post COVID and no less than three prime ministers in the past eighteen months, with another likely before the end of 2024.

Economics – the above factors have led to weakness in sterling, falling productivity, low levels of GDP growth and stubbornly high inflation. As a result interest rates and bond yields have risen faster in the UK than elsewhere.

Index – the UK market (dominated by the FTSE100) has a far less dynamic composition than the US with very low exposure to tech and high exposure to mature sectors such as banks, oils and mining. The attractions of London as a listing venue have diminished post Brexit and low valuations have encouraged growing companies to list elsewhere or remain private.

This has led to UK equities trading on a significant valuation discount to global markets. As the chart below shows we can track this trend back to the Brexit vote in 2016.

UK vs Global Equities (12m fwd P/E relative)

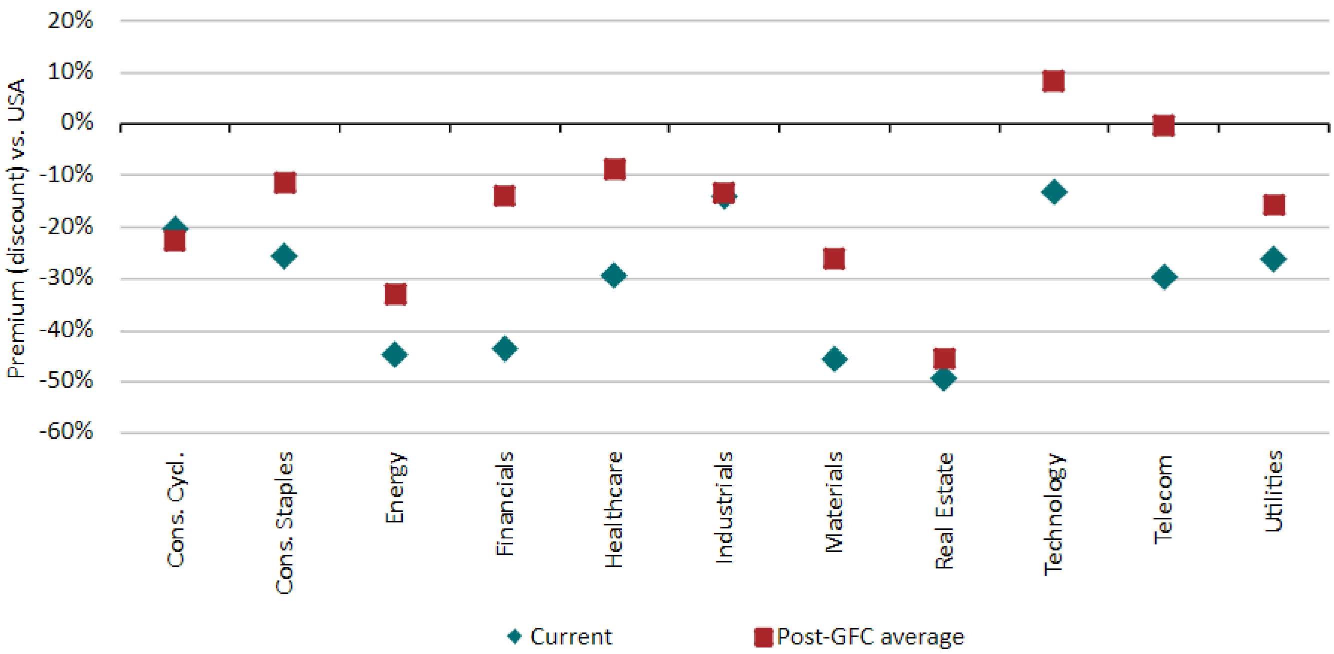


Source: Berenberg, 12/03/2024

Many observers would argue that this is justified and well deserved, reflecting the numerous structural barriers the UK faces. However, this low valuation is not merely a function of sector composition but a market wide one, affecting UK-listed companies across sectors.

The chart on the next page highlights how omnipresent the UK discount has become no matter which sector you apply it to.

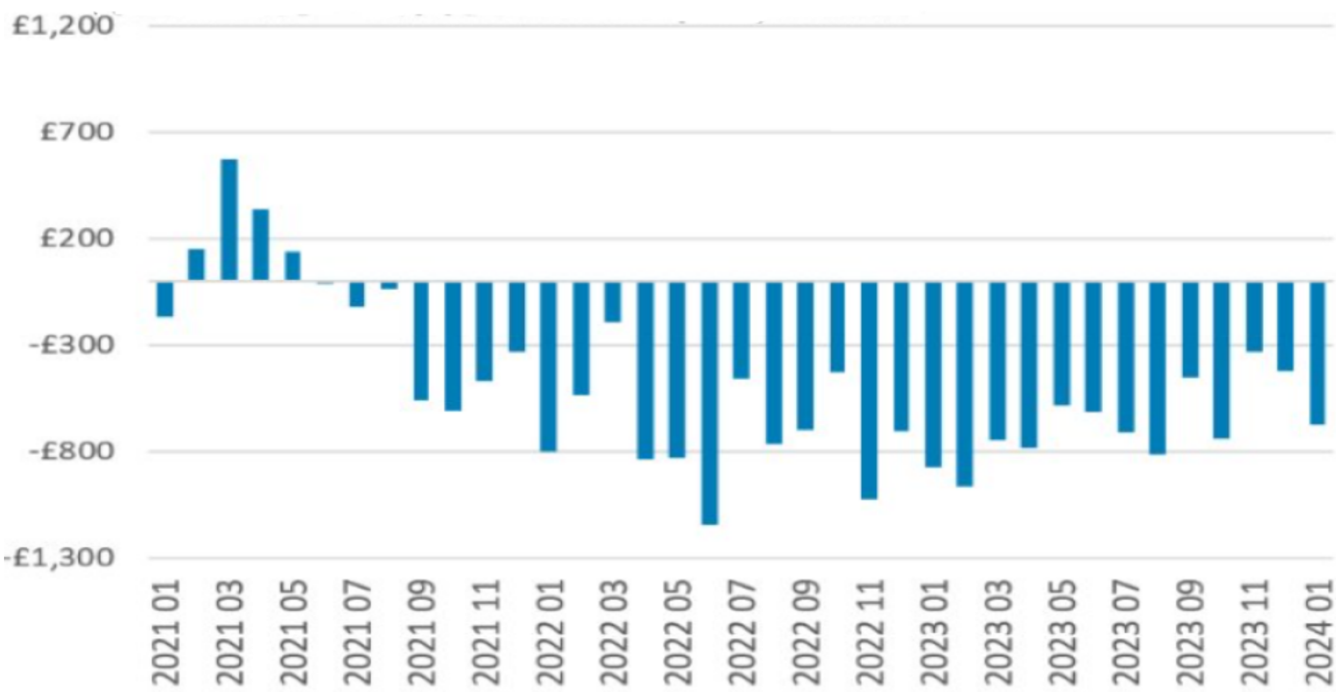
UK Sector Valuations vs US



Source: Liberum, as at 29/02/2024

All of the above factors have led to significant redemptions in UK equity funds both at a retail and pension fund level, such that the UK is now less than 5% of the MSCI World index having been more than 20% at its peak. The chart below confirms the consistent drawdowns we have seen from UK equity retail funds over the past three years alone.

Net Flows - UK Focused Equity Funds



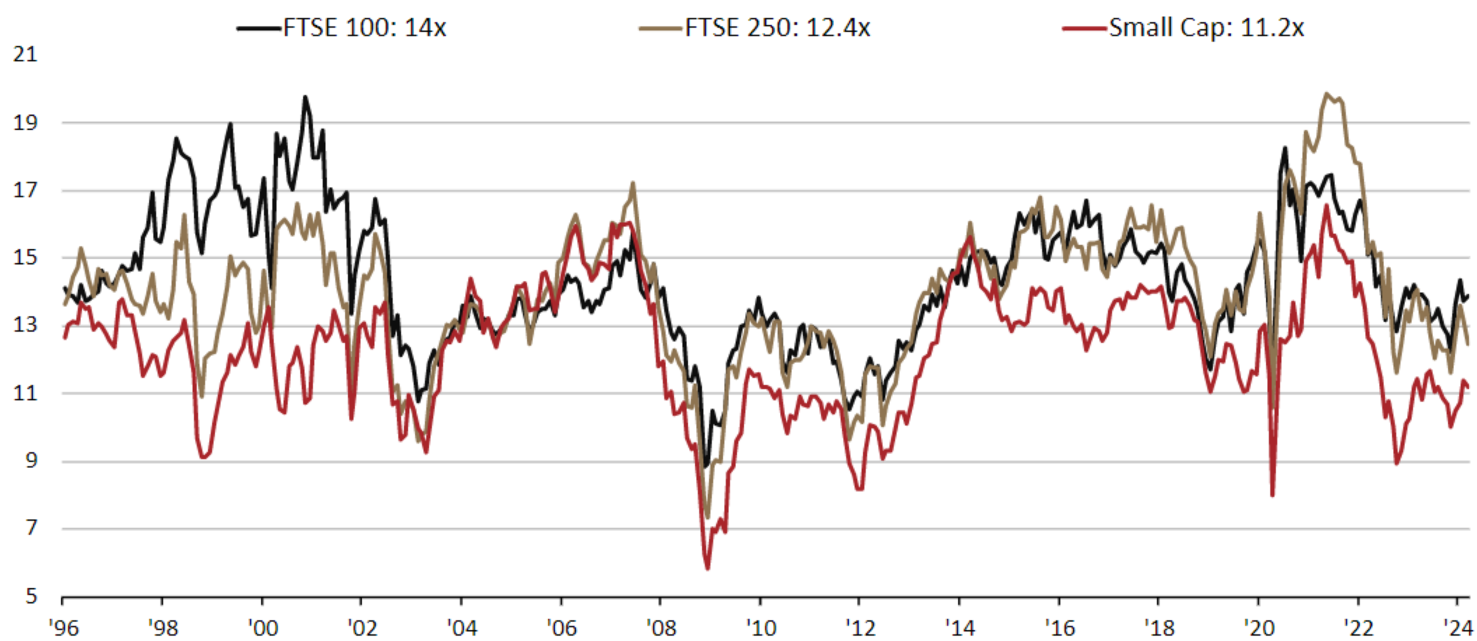
Source: Calastone, as at 29/02/2024

This pressure on liquidity has been most acutely felt the further down the market capitalisation scale you go. Returns from UK mid and smallcap have been flat over the past three years whilst AIM has endured a particularly torrid time.

Deutsche Numis UK Indices 1 Year and 3 Years Total Return

Source: Deustche Numis, as at 29/02/2024

Such poor returns and weak liquidity have meant that smaller companies have borne the brunt of the derating of UK companies. The chart below shows the PE ratios of UK equity indices by size. The further down the cap scale we go the lower the valuation. This has left UK smaller companies (especially those below £250m) friendless, with limited new investor appetite.



Source: Liberum, Datastream, as at 01/03/2024

Most market analysts would acknowledge that UK smaller companies are now an exceptionally cheap if unloved asset class. It is crucial that action is taken to re-establish the UK as an attractive place for companies to list and raise capital, leading to improved liquidity at the lower end of the UK stock market. There is now a far broader acknowledgement of the issues which have been holding back UK capital markets , with a wide range of possible solutions emerging to incentivise increased investment and listings in UK growth businesses. These initiatives are broadly supported across the political spectrum.

From a macro perspective a clear peak in UK interest rates and gilt yields as well as moderating inflation could all have a strongly positive impact on current valuations and the upturn when it comes could be rapid. The chart below highlights some dramatic periods of recovery seen for the IA Smaller Companies sector since the GFC in 2009. Quite often the darkest hour can be before the dawn.

Period	IA UK Smaller Companies Return
March 2009 - March 2011	+104.5%
Nov 2011 – 2013	+63.1%
Feb 2016 - 2018	+43.7%
March 2020 - 2022	+62.9%

Source: FE Analytics

We believe that the biggest challenge for UK small and midcap markets is not one of valuation but one of liquidity, and the need to attract a broader investor base to the asset class. At Amati we continue to focus on businesses with conservative balance sheets, sustainable margins and strong cash generation and currently there are plenty of these companies available at attractive prices. If investors don't take the opportunities now available in the UK markets, then corporate buyers will continue to do so instead and listed UK businesses will be acquired on the cheap. The recent surge in M&A activity and share buybacks impacting UK quoted companies tells us that this process is well and truly underway already, highlighting the compelling value on offer in UK markets right now.

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