Gresham House
Specialist asset management

LF Gresham House UK Micro Cap 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 believe our portfolio is set up to deliver long-term resilient growth opportunities. This is due to our rigorous investment process focusing on high quality fundamentals-based businesses that are largely insulated from wider macro factors and are trading at reasonable valuations.

Despite the increased volatility and weaker sentiment, we continue to believe that the longer-term opportunity across the market cap spectrum of UK equities - which is underpinned by the continuing discounted valuations applied both to the UK and to the smaller companies segment - remains material, providing some downside protection in more challenging market conditions.

Notwithstanding the fast-moving geopolitical situation, we believe market conditions are increasingly supportive of finding attractive investment opportunities for those prepared to take a longer-term view. We remain selective and disciplined in our approach, seeking high-quality companies with attractive long-term sustainable income and capital growth characteristics at sensible valuations.

Performance

The LF Gresham House UK Micro Cap Fund (the "Fund") performance decreased by 9.1% 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 contributions came from **Filta Group** (+15%), after it announced a recommended all share takeover offer from Franchise Brands, another Gresham House fund portfolio company; **Accrol Group** (+22%), which rallied after a pair of profits warnings – it is a small positive, as we exited this disappointing investment at the end of this partial recovery rather than its start; and **Tasty** (+10%), on improving sentiment about the trading environment for the restaurant sector.

The largest detractors to performance were **Seraphine** (-74%), after a shock second profit downgrade as the company warned of a number of cost pressures as well as weaker customer acquisition performance leading to reduced revenue expectations, we are currently undertaking a detailed review of this position; **Alpha FMC** (-15%), which de-rated on no specific news following a very strong run in the shares previously; and **Windward** (-24%), after announcing accelerated investment costs associated with future growth opportunities as well as a broader de-rating of the technology sector.

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Portfolio activity

The Fund made one follow-on investment into **Diaceutics**, a core long-term holding, taking advantage of weaker market conditions to top up our position. The Fund made one full exit, **Accrol Group** (realising a negative return of -48.3%), due to a fundamental change in investment view following an in-depth review conducted in light of its recent profit warning.

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 heightened 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 long-term 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 long-term franchises.

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.

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