

The European Smaller Companies Trust

June 2022

Marketing Communication

Fund Manager Name

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Macro backdrop

June saw further poor returns for risk assets, completing one of the worst first-halves of a year that we have witnessed for global stock markets in over 50 years. Investors have moved from pricing a market for higher inflation and weak growth to one facing a severe recession.

Trust performance and activity

June proved to be a punishing market for those stocks perceived to have a high degree of embedded cyclicality, with economic fears trumping any perceived 'margin of safety' achieved by owning more attractively priced shares. This was evident among the fund's weakest performers, namely TKH (industrial/technology conglomerate) and DFDS (passenger and freight ferries), as well as AMG and Befesa which have seen the price of their speciality metal products fall on the latest growth fears. As we have stated in recent reports, we believe the earnings of certain 'cyclicals' will prove more resilient through the next downturn as either structural tailwinds (Green CAPEX for example) or the restructuring programmes of management teams have improved earnings volatility. Also among the main detractors was EDreams, which is an outlier in the portfolio with regards to having a stretched balance sheet. Stresses around liquidity in credit markets has in general seen companies with weaker balance sheets punished. However, we remain holders as we expect travel demand to remain high despite the journey disruptions many are facing. Positive contributors were more stock specific. FLEX LNG announced extensions to customer contracts with regards to its liquefied natural gas (LNG) vessels and the market gained more confidence in the company's mid-term prospects as a result. U-BLOX has been seeing strong demand for its products in the internet-of-things (IoT), and Renewi (waste management) continued to respond well to the results it announced in late May. Activity over the month was limited and we made no outright purchases. We decided to top up the holding in Inficon, which manufactures vacuum instruments used in the production of semiconductors. The near-term direction of the semiconductor cycle remains a highly contentious topic but we believe the company looks well placed on a medium-term view.

Outlook/strategy

We expect the rate of inflation in Western economies to start to subside through the middle of 2022, as supply-chain shortages begin to clear and as we begin to lap the comparison period of energy price rises. However, our core thesis since the extreme monetary and fiscal policy responses of 2020 was that inflation would settle at a level above that of the last ten years, and that the period of deflation/disinflation we have seen since the Global Financial Crisis is over as a significant capital expenditure cycle in the Green Transition and Digitalisation occurs. For this reason we believe our valuation-aware, blended-style approach will be better suited to the next market cycle versus the last. In the near term, economic momentum is deteriorating and many valuations now imply a severe recession. We think this presents a great opportunity for a bottom up stock-picker taking a longer-term view.

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Glossary

Balance sheet - A financial statement that summarises a company's assets, liabilities and shareholders' equity at a particular point in time. Each segment gives investors an idea as to what the company owns and owes, as well as the amount invested by shareholders. It is called a balance sheet because of the accounting equation: $\text{assets} = \text{liabilities} + \text{shareholders' equity}$.

Bottom-up - Bottom-up fund managers build portfolios by focusing on the analysis of individual securities, in order to identify the best opportunities in their industry or country/region. The opposite of top-down investing.

Capital expenditure (CAPEX) - Spending on fixed assets such as buildings, machinery, equipment and vehicles in order to increase the capacity or efficiency of a company.

Credit markets - A marketplace for investment in corporate bonds and associated derivatives.

Cyclical stocks - Growth investing Companies that sell discretionary consumer items, such as cars, or industries highly sensitive to changes in the economy, such as miners. The prices of equities and bonds issued by cyclical companies tend to be strongly affected by ups and downs in the overall economy, when compared to non-cyclical companies.

Growth investing - Growth investors search for companies they believe have strong growth potential. Their earnings are expected to grow at an above-average rate compared to the rest of the market, and therefore there is an expectation that their share prices will increase in value.

Inflation - The rate at which the prices of goods and services are rising in an economy. The CPI and RPI are two common measures.

Fiscal policy - Connected with government taxes, debts and spending. Government policy relating to setting tax rates and spending levels. It is separate from monetary policy, which is typically set by a central bank. Fiscal austerity refers to raising taxes and/or cutting spending in an attempt to reduce government debt. Fiscal expansion (or 'stimulus') refers to an increase in government spending and/or a reduction in taxes.

Liquidity - The ability to buy or sell a particular security or asset in the market. Assets that can be easily traded in the market (without causing a major price move) are referred to as 'liquid'.

Monetary policy - The policies of a central bank, aimed at influencing the level of inflation and growth in an economy. It includes controlling interest rates and the supply of money. Monetary stimulus refers to a central bank increasing the supply of money and lowering borrowing costs. Monetary tightening refers to central bank activity aimed at curbing inflation and slowing down growth in the economy by raising interest rates and reducing the supply of money.

Valuation metrics - Metrics used to gauge a company's performance, financial health and expectations for future earnings e.g. price to earnings (P/E) ratio and return on equity (ROE).

Volatility - The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. Higher volatility means the higher the risk of the investment.

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