For investment professionals only

Premier Miton UK Smaller Companies Fund

Key Facts

Fund launch date	14 December 2012
Fund type	OEIC
Fund managers	Gervais Williams Martin Turner
Fund size	£141.0m
No of holdings	136
IA Sector	UK Smaller Companies
Base Currency	GBP
Valuation point	12:00 midday
Accounting dates	Final - 31 May Interim - 30 Nov

Ratings and Awards

defaqto EXPERT RATED

FE fundinfo Crown Fund Rating

Past performance is not a guide to future returns.

Summary

- We believe that the prospects for the Premier Miton UK Smaller Companies Fund are very strong at present.
- Now the open-ended uncertainties of Brexit are past, the UK is well-placed for a period of performance catch up.
- The upside potential is even greater amongst various small and micro-cap financial and commodity stocks.
- We believe that companies should be hesitant to accept takeover bids at present as the level of upside mentioned above could be perceived to be greater than any takeover premium.

Market Review

Global asset market returns were generally good during 2020, with earnings disappointments from the pandemic-induced recession more than offset by a rise in stock market valuations. The unprecedented scale of the monetary and fiscal stimulus over recent quarters has been the key driver of asset market trends.

Since the pandemic remained virulent during January, many investors entered 2021 anticipating further financial stimulus. Whilst asset valuations did rise further early in the month, the positive was offset by bond valuations falling back due to inflationary fears. The outcome was a month when energy and materials stocks were some of the best performers, and the FTSE All-Share Index itself fell by -0.8%.

UK small-caps have tended to outperform larger stocks over recent quarters, in part because younger businesses have a better chance of sustaining growth during a recession. The FTSE SmallCap Index (excluding Investment Companies) rose 1.6% in January and the FTSE AIM All-Share Index was up 0.4%.

Calendar year performance (%)

	YTD	2020	2019	2018	2017	2016
Fund	4.1	77.3	-14.0	-8.5	21.5	4.2
IA UK Smaller Companies	0.6	6.5	25.3	-11.7	27.2	8.1
FTSE All-Share Index	-0.8	-9.8	19.2	-9.5	13.1	16.8
FTSE AIM All-Share Index	0.4	21.8	13.2	-17.1	26.0	16.1
FTSE SmallCap (excluding Investment Companies) Index	1.6	1.7	17.7	-13.8	15.6	12.5

Source: FE Analytics. On 30 November 2020, this fund moved from a single pricing basis (mid) to a swing pricing basis, which is where the price can swing to either a bid or an offer basis depending on the investment and redemption activity in the fund. This means the investor selling or buying fund shares bears the associated [dis]investment costs and protects the continuing holders in the fund. Performance could be shown on a combination of bid, mid or offer prices, depending on the period of reporting. Performance is shown net of fees with income reinvested. The fund is classified in the IA UK Smaller Companies sector, which we believe is a meaningful comparator to help investors assess the performance of the fund. As the fund invests in UK companies, we believe the FTSE All-Share Index and FTSE AIM All-Share Index are also useful performance comparators.

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Performance

With the ongoing appreciation of stock markets over so many years, many quoted companies have been lulled into taking on more risk. Taking on greater cash burn doesn't look particularly threatening when credit is so cheap and plentiful, and super-normal growth is so well rewarded in elevated valuations. In this context, the scale of the global pandemic downside came as shock in 2020, as those with a potential corporate cash shortfall on an open-ended basis were spooked by the global share price collapse.

Whilst some small and micro-cap stocks were affected by this, there were plenty of others that were already fully funded for their investment plans. In our view, there are real advantages to picking out quoted small and micro-caps with the potential to deliver abnormal cash paybacks, providing their investment plans are fully funded. Whilst the share prices of fully-funded micro-caps might fall back with others during a market sell-off, if they are fully funded, then normally their ultimate upside potential remains unchanged. When the UK was paralysed by parliamentary gridlock and Brexit uncertainty for example, the share prices of numerous portfolio holdings did fall back quite sharply. Their share prices may not have reflected our excitement about their potential at that time, but because they were fully-funded we could remain confident that the longer-term upside remained in place.

Effectively, investing with a strong balance sheet provides an extra margin of error. Sentiment for UK quoted small and micro-caps did start to improve after the UK General Election cleared the parliamentary gridlock in December 2019. During 2020, the improving sentiment was temporarily interrupted once again by the pandemic-induced recession, but as before the ultimate upside on most of the portfolio's small and micro-caps remained in place. Indeed, after the pandemic, the prospects for many online and meditech businesses in the portfolio actually improved with the lockdowns, so their share prices had greater potential upside than before.

We believe investing in quoted micro-caps can be advantageous. If they come good, their returns have the potential to be a multiple of their initial share price. A good example is KR1, a blockchain business, which was one of seven portfolio holdings whose share prices increased by more than over 50% in January. The fund invested in KR1 in December 2018 at 5p, and its share price has subsequently risen to 46p at the end of January. This holding, and others helped the share price of the fund to rise 4.1% in January, and by 87.5% over the last twelve months.

Yet even after this very substantial return, many of the stocks in the portfolio still remain very lowly valued in our view. Another example is Jubilee Metals, which refines the remaining metal out of old mine tailings, and first brought into the portfolio in January 2018, at 3.6p. Whilst its share price did fall to just 2.0p last March, we remained confident that its upside potential remained in place. At the end of January, its share price has now risen to 12.0p, and it is now the largest holding in the fund. Yet even after its meteoric share price rise, Jubilee Metals is still standing a P/E ratio of only 5.7x for the year to June 2021.

Share prices don't just go up in a straight line of course. The share price of AO World peaked during January, and it was the greatest detractor in the month. Even so, the share price of AO World should be seen in the context of a stock that has risen by 86% over the last six months. Again, we anticipate that AO World is on the threshold of generating an abnormally large cash return, and when this comes through it will be reflected in a rising dividend that will justify a much higher share price.

In our view, a successful strategy for a small and micro-cap fund concentrates on picking out those with the prospect of abnormally substantial surplus cash, along with a safe balance sheet. Furthermore, the small and micro-cap investment universe is so broad in terms of industry sectors, that stock specific risk can be really well diversified. Overall, the share price of the Premier Miton UK Smaller Companies Fund has risen by 251.4% since the fund was first set up on 14th December 2012.

Portfolio Activity

During 2020, many of the share prices of online technology and meditech stocks performed strongly, so the information technology and pharmaceuticals sectors grew to become over half of the portfolio. Whilst many continued to report good prospects, and their valuations

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still weren't that forward looking, over the last six months we have scaled back portfolio risk and reinvested capital in other industry sectors that also appear to have substantial share price upside. Whilst many commentators have highlighted the scope for consumer stocks to recover, in general we couldn't find many that are well-positioned to generate abnormal cash surpluses. The problem is that many have major lease liabilities, and extra debt burdens taken during the recession. In general, we have found stocks in the financial and commodity sectors with much better prospects of generating abnormally sizable cash paybacks when the economic recovery arrives. Hence, a number of new stocks in the financial, materials and energy sectors have been brought into the portfolio that we believe stand on remarkably overlooked valuations. Interestingly, the prospects for these stocks would not only improve as the economic recovery comes through, but even more so were inflationary pressures were to return as well.

Interestingly, it isn't necessary to resort to micro-caps to identify financials on very overlooked valuations. Maybe that is because the financials sector is well represented in the FTSE 100 Index.

Few investors get excited about construction businesses, as they tend to operate on low margins, and intermittently announce major cost overruns on past contracts. Interestingly, we believe that the management team at Galliford Try run this business in a different way, with acute attention to avoiding taking on uncommercial risks. Perversely, the Galliford share price reflects some cost overruns on contracts taken prior to the new leadership taking the reins, so it is standing a on discount to its cash and near-cash balances. Furthermore, its valuation is approximately one tenth of its sales. The confidence in the future is demonstrated by its willingness to start paying good and growing dividends. Overall, we believe it is another example of the very overlooked nature of numerous quoted small and micro-caps, other than those with quasi-unicorn story.

Overall, the fund has an unusually broad investment universe, with plentiful opportunity at present to access stocks with substantial upside, whilst also continuing to diversify sector and stock specific risk.

Outlook

Over 2020, global stock market returns turned out to be very satisfactory, especially in the context of the global pandemic, that was still very much at large even in January 2021. Although China and some of the Asian economies have recovered well from the economic setback, a large part of the global economy is still very much mired in recession. Overall, global earnings reduced sharply over 2020, but this was offset by the valuation of stock markets rising even faster, so that global share prices appreciated over the year in aggregate.

This outcome underlines the unprecedented scale of financial and fiscal stimulus injected by central banks and governments over 2020. Whilst this stimulus may have moderated the risk of corporate insolvency, and scaled back unemployment, there are risks associated with creating so much extra cash without matching it with a similar increase in productive assets.

1. The extra cash has boosted speculative behaviour by investors. In the US for example, various unicorn stocks have been driven to much, much higher valuations. Elsewhere, numerous private investors have been banding together to drive up the share prices of hedge fund shorts, forcing them to buy back their positions because of the unlimited liability. Juicy returns like this continue to tempt fund managers to chase highly-speculative holdings.

2. Normally during recessions, companies with overstretched balance sheets are obliged to scale back their operations and sell off assets to repay debt in a process that ultimately reduces money supply. These actions are deflationary and explain why the giant stimulus after the Global Financial Crisis didn't lead to a bout of inflation. At present, with cash being so plentiful, even those with overstretched balance sheets aren't necessarily scaling back their operations. We believe there is a significant risk that inflationary pressures may become more pronounced over the coming quarters, driving up longer-dated bonds yields, which would lead to a collapse of speculative share prices.

Changeable markets like this can catch out investors. We take comfort in the fact that the UK stock exchange has largely missed out on the general rise in

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international corporate valuations over recent years, because of the open-ended uncertainties of Brexit. Quite often, UK small and micro-cap stocks stand on even lower valuations, as any hint of a domestic bias was considered particularly unappealing during the period of Brexit. Furthermore, a large part of the UK exchange comprises financials, and mining & energy stocks which have greater, recovery potential when the economic recovery arrives. The key point is that the UK stock market has few unicorns, and its returns are largely uncorrelated with those that have performed well over recent years.

Now that the nature of Brexit is largely defined, we believe that UK-quoted stocks are well-positioned for a period of performance catch-up relative to their international comparators. In particular, the recovery potential for many small and micro-caps are all the greater because so many are coming from such low valuations. The scale of the upside should be further assisted by the cyclical nature of various financial and commodity micro-caps at a time of economic recovery after the pandemic.

Furthermore, if inflationary pressures were to become more pronounced in future quarters, then the upside potential on these financials and commodity micro-caps could be even greater. They have been so out of favour for so long that it is easy to underestimate the full scale of their upside recovery potential.

Our very upbeat assessment is verified by the remarkably low valuations of so many well-financed small and micro-caps with the potential to deliver large cash surpluses. Even some of the best performers in the fund's portfolio are still standing on relatively low P/E ratios.

In short, we consider the prospects for the Premier Miton UK Smaller Companies Fund to be very strong at present. If UK mainstream stocks don't recover well in the next few months, then we believe international corporates will take advantage of the situation via numerous agreed takeovers. At present, we are currently engaging with the boards of the portfolio holdings, highlighting why we believe they shouldn't feel under heavy pressure to agree a takeover just because they are a premium to their current share prices. The key point is that the share prices of numerous portfolio holdings have so much greater recovery potential than any takeover premium.

Risks

The performance information presented in this commentary relates to the past. Past performance is not a reliable indicator of future returns.

The value of investments may fluctuate which will cause fund prices to fall as well as rise and investors may not get back the original amount invested.

This fund may experience high volatility due to the composition of the portfolio or the portfolio management techniques used.

Investment in the securities of smaller and/or medium sized companies can involve greater risk than may be associated with investment in larger, more established companies. The market for securities in smaller companies may be less liquid than securities in larger companies. This can mean that the Investment Manager may not always be able to buy and sell securities in smaller and/or medium size companies.

Forecasts are not a reliable indicator of future performance.

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Important Information

For Investment Professionals only. Not for onward distribution. No other persons should rely on any informtion contained in this document.

Source of performance data: FE as at 31.01.2021, On 30 November 2020, this fund moved from a single pricing basis (mid) to a swing pricing basis, which is where the price can swing to either a bid or an offer basis depending on the investment and redemption activity in the fund. This means the investor selling or buying fund shares bears the associated [dis]investment costs and protects the continuing holders in the fund. Performance could be shown on a combination of bid, mid or offer prices, depending on the period of reporting. Performance is shown net of fees with income reinvested. Source for all other data: Premier Miton Investors as at 31.01.2021.

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For your protection, calls may be monitored and recorded for training and quality assurance purposes.

A free, English language copy of the fund’s full prospectus, the Key Investor Information Document and Supplementary Information Document are available on the Premier Miton website, or you can request copies by calling us on 01483 306090.

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