DowgateWealth
A tailored approach

SVS Dowgate Wealth UK Small Cap Growth Fund Quarterly Commentary: 31 March 2023

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PERFORMANCE

The quarter can be characterised as a tale of two halves: a strong start in January and February, followed by a dismal March, ultimately leading to a 0.3% decline for the quarter. The turning point in March was marked by the suspension of Wandisco shares after uncovering significant and sophisticated fraudulent activities related to received purchase orders. Although our initial investment in the company was modest due to its high-risk nature, the shares had quickly grown to become our largest holding. While we had started to take a small amount of money off the table it was too little, too late. Regrettably, a senior sales employee fabricated several substantial bookings, which underpinned the current valuation. This deception will undoubtedly lead to a significant downward adjustment of the valuation. In response to this, we've fully written down the entire holding. The CEO and CFO have resigned, and Ken Lever, a turnaround specialist, has been appointed as Executive Chair. We see this change as a positive step and maintain cautious optimism about the business returning to the market, albeit at significantly reduced levels.

On a brighter note, our top performer during the quarter was FD Technologies, which we consider one of the most compelling medium-term investments in the UK equity market today. This is particularly true with the general release of their new Azure Timehouse product (supported by KX). The company projects a minimum of 35% ARR growth for this year, but we believe that the Microsoft Azure release could push this figure closer to 45% for each of the next three years, in order to achieve the management's LTIP target. If these targets are met, a Sum of the Parts valuation and reasonable EV/Sales assumptions could provide investors with a five-fold increase in value from current levels.

INVESTMENT OUTLOOK

So far this year, the primary concern of investors' has shifted from fear of inflation to concerns over financial stability. The demise of Silicon Valley Bank galvanised markets, as stress fractures emerged among US regional banks. Contracting bank balance sheets are now destabilising the US commercial real estate sector, widely tipped as the next thing to break.

However, unlike last year, the UK has not been at the centre of financial market attention. Indeed, after the rolling omnishambles of 2022, from a low point in the aftermath of the Truss Kwarteng mini-budget, the UK has reverted to its tradition of keeping calm and carrying on. UK regulators dealt with Silicon Valley Bank's UK subsidiary, the Windsor Framework agreement started to mend some EU fences, the Pacific trade deal built a bridge to growing international markets, gilt yields moderated, and the pound sterling has strengthened. Compared to the US, with its 4000 regional banks, the UK is better equipped to regulate its small number of national lenders.

Although a strong UK recovery remains unlikely, there have been upward revisions to economic forecasts. Despite market fragility, UK equities remain cheap compared to global peers. While UK equities are not immune from broader global uncertainties, we have had our crisis early and taken the opportunity to reset the sails for stormy weather. While the UK has strived to fortify things, funds still flowed out as private investors favour fixed-income and global tracker funds over homegrown equities. Despite its improving status for investment, according to Calastone, over Q1 2023, private investors pulled out an estimated £3bn from UK equity funds and a cumulative £13bn since October 2021. The data provider reported that 'the relatively strong performance of UK equities since the bear market began just over a year ago has not improved sentiment.'

As private investors take the time to readjust their portfolios, other larger investors are starting to show the colour of their money. Since the turn of the year, there has been an increasing flow of bid activity in the UK mid-market, which we have been a good recipient of. In aggregate, these deals amount to over £10bn of equity trying to buy UK companies, more than three times the retail fund outflows over the same period and not far from the cumulative private investor fund outflow over the last 22 months. Not every deal will come to fruition, but we are confident that M&A bankers have a considerable number of potential transactions on their desks. For those deals that do conclude, the cash is likely to flow back into similar UK equity mandates. As we witness headlines dismissing the UK as an investment backwater, deemed unsuitable for listing equity and attracting investment, we feel increasingly confident that this consensus view will change. As the UK's appeal becomes more evident, the flywheels of momentum and indexation will compound returns for patient, long-suffering UK investors.

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We believe the information provided here is reliable but should not be assumed to be accurate or complete.

All information accurate as at 31 March 2023

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https://dowgatewealth.co.uk/fund-management/

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