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Economic Advantage

May 2024 review

Liontrust Special Situations Fund

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The Liontrust Special Situations Fund returned 5.5%*in May. The FTSE All-Share Index comparator benchmark returned 2.4% and the average return in the IA UK All Companies sector, also a comparator benchmark, was 3.2%.

Neither higher-than-expected UK inflation nor the potential uncertainty from an early-July election could derail UK shares this month, as buoyant investor sentiment pushed global stock markets higher.

UK consumer price inflation dropped to 2.3% in April – down from 3.2% in March but still higher than the 2.1% expected, pushing back the market's assessment of when the first Bank of England rate cut will arrive. Although expectations for interest rate cuts in 2024 continued to moderate on both sides of the Atlantic in May, investors took heart from a building picture of economic and corporate resilience.

Encouragingly, sentiment towards UK equities appears to be on an improving trajectory. Economic growth, while muted, has turned positive, with the 0.6% expansion registered during the first quarter of 2024 the fastest growth in two years. The UK is heading for a general election on July 4 and, if the polls are to be believed, a stable majority government will likely be formed which should provide a supportive market backdrop. When combined with inflation which – while decelerating slower than expected – is heading towards target, this has paved the way for a more constructive outlook for UK equities.

While this renewed enthusiasm has, to date, predominantly been of benefit to larger companies within the FTSE 100, May saw encouraging signs of a pickup in appetite for smaller companies. While the FTSE 100 rose 2.1%, the FTSE 250 mid-cap index gained 4.2% and the FTSE Small Cap (ex-investment trusts) Index rose 6.7%. The FTSE AIM All Share Index has been particularly weak during the bout of small-cap underperformance in recent years, but it gained 6.1% in May. The Fund has a strong tilt towards the small and mid cap size segments, targeting holding 20-30% of NAV in smaller companies and typically holding a further c.30% in mid cap. While this has been an inescapable headwind to performance since the start of 2022, it proved to have the opposite effect in May as sentiment towards small and mid caps rebounded.

Despite this incremental improvement in the sentiment towards UK equities, valuations of UK listed companies – and in particular small caps - remain substantially lower than their long run average and their global peers.

As the fund managers have highlighted on several occasions in recent months, these low valuations mean many UK companies have proven susceptible to takeover approaches from private equity or corporate acquirers keen to exploit the opportunity.

May was a particularly busy month in terms of Fund holdings being targeted by potential acquirers. The Fund's largest riser was Keywords Studios (+94%), a support services provider to the video gaming industry. Its shares almost doubled after confirming it was in discussions with Swedish private equity group EQT regarding a possible 2550p cash offer, having rejected four lower offers in recent months.

Perhaps the highest profile takeover approach on the UK market in May was for Hargreaves Lansdown (+30%). It announced it had rejected two takeover proposals from a private equity consortium, most recently at 985p a share. The shares promptly soared in excess of the mooted takeover price, and Hargreaves Lansdown has subsequently re-entered the FTSE100 index.

The third confirmed takeover target in the portfolio was engineer Wood Group (+19%). It disclosed that it had rejected three successive takeover proposals from Dubai-based group Sidara at 205p, 212p and 220p a share. In 2023, Wood Group received five takeover proposals from private equity group Apollo, rejecting the first four but agreeing to enter discussions following the final cash proposal of 240p before Apollo dropped its interest.

While Hargreaves Lansdown grabbed the headlines in the UK investment platform space, two of its peers are also held within the portfolio and both notched up strong gains after reporting results. UK investment platform provider AJ Bell (+19%) reported 27% growth in revenue to £131 million in the six months to 31 March, while profit before tax margins rose six percentage points to 46.8%. The company added 27,000 customers to take the total to over half a million. Assets on its platform rose to over £80 billion following net inflows of £2.9 billion during the six months and favourable market movements of £6.5 billion. The results were stronger than expected – partly due to a delay in introducing a new set of lower client charges – so AJ Bell has raised its full-year guidance.

Fellow platform operator IntegraFin Holdings (+17%) also recorded good growth in assets. Funds under direction on its Transact platform rose 13% year-on-year to £61 billion by 31 March 2024 following £1.1 billion of net inflows and a £5.0 billion positive market movement. Client numbers rose 1% to 228,000 while the adviser base increased 4% to 7,849. IntegraFin has maintained its financial guidance for the year to 30 September 2024.

Lastly in terms of the Fund's major risers in May, specialist media group Future (+60%) saw its shares rebound following the release of interim results. Future shares had previously sold off heavily over the course of 2022 and 2023, hit by broader weakness in the advertising market, the announcement of increased investment costs to stimulate medium-term growth and also lingering concerns over the potential impact of generative AI on its business model. While reporting a 2% organic revenue decline to £391 million in the six months to 31 March, Future noted that Q2 saw a return to organic growth, with revenues rising 3%. This stabilisation in revenues gives Future confidence in maintaining its prior full-year guidance. Longer term, the group expects its recent investments to accelerate organic revenue growth into the mid-single digit range.

The largest Fund detractor for the month was enterprise software provider Sage Group (-12%) which dropped as investors adjusted to a small downgrade in revenue growth guidance for the year to 30 September. Sage generated 9% organic growth in revenues in the first half of the year, a rate it expects to deliver for the full year – down marginally on the prior 10% growth guidance. Underlying operating profit rose 18% in the interim period as operational gearing led to a 1.6 percentage point expansion in margins. Despite what was a resilient performance from the business, the share price reaction reflected the extent to which Sage's valuation has re-rated upwards over the past year. Having risen over 60% in 2023, the correction represented a retracement of a small proportion of those gains.

Midwich Group (-10%) is a specialist on-trade audio-visual equipment distributor. Its shares slid on signs that last year's tough trading conditions have extended into 2024. In an AGM statement, Midwich described a mid-single digit decline in organic revenue this year, in line with last year but below its prior expectations for growth. The company believes that the delay in cuts to central bank interest rates has deferred a recovery in its markets. It now expects 2024 full-year adjusted operating profit to be similar to last year's level.

Engineering group Renishaw (-3.6%), a specialist in high-tech precision measuring and calibration equipment, described mixed conditions across its markets in a Q3 update (for the three months to 31 March) which resulted in a 4% year-on-year drop in revenues. While metrology sensor demand from the consumer electronics sector was weak, there were some signs of recovery in the semiconductor industry. Shares in Renishaw softened during the month of May, although the move came after a strong run for the shares in the earlier months of the year.

BP (-5.1%) also slid as its Q2 underlying profit of $2.7 billion fell short of analyst consensus of $2.9 billion, while sentiment towards spirits giant Diageo (-5.2%) remains weak due to concerns over the resilience of demand in its key US market.

Over recent years, the Fund has been keen to take advantage of the long-time horizon of the Economic Advantage process by deploying excess capital in investments where the fund managers strongly believe that the short term depressed valuations on the market do not reflect the longer term calibre of businesses. Primarily this activity has taken the form of topping up existing holdings, although the fund managers have also been on the lookout for new ideas where the companies in question exhibit the potential to compound growth strongly over future years.

At the end of May, the Fund initiated a new position in Alfa Financial Software. Alfa is a provider of software to automate the core workflow and processes of organisations providing lease financing solutions. The company was selected for inclusion in the portfolio on the strength of the intellectual property in its software, and its strength in embedded distribution. The software – which is described as the "heart and lungs" of a customer's business – has significant functional breadth and depth. Founder Andrew Page, now the group's executive chairman, still owns over half of the equity.

Positive contributors included:

Keywords Studios (+94%), Future (+60%), Hargreaves Lansdown (+30%), Wood Group (+19%) and Integrafin Holdings.

Negative contributors included:

Sage Group (-12%), Midwich Group (-10%), Diageo (-5.2%), BP (-5.1%) and Renishaw (-3.6%).

Discrete years' performance** (%) to previous quarter-end:

	Mar-24	Mar-23	Mar-22	Mar-21	Mar-20
Liontrust Special Situations I Inc	4.3%	0.1%	5.1%	31.1%	-11.0%
FTSE All Share	8.4%	2.9%	13.0%	26.7%	-18.5%
IA UK All Companies	7.6%	-1.9%	5.4%	38.0%	-19.2%
Quartile	4	3	3	3	1

*Source: Financial Express, as at 31.05.24, total return (net of fees and income reinvested), bid-to-bid, institutional class. **Source: Financial Express, as at 31.03.24, total return (net of fees and income reinvested), bid-to-bid, primary class.

For a comprehensive list of common financial words and terms, see our glossary at: https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

This Fund may have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the Fund's value than if it held a larger number of investments.

The Fund may encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.

The Fund may invest in companies listed on the Alternative Investment Market (AIM) which is primarily for emerging or smaller companies. The rules are less demanding than those of the official List of the London Stock Exchange and therefore companies listed on AIM may carry a greater risk than a company with a full listing.

The Fund will invest in smaller companies and may invest a small proportion (less than 10%) of the Fund in unlisted securities. There may be liquidity constraints in these securities from time to time, i.e. in certain circumstances, the fund may not be able to sell a position for full value or at all in the short term. This may affect performance and could cause the fund to defer or suspend redemptions of its shares.

Outside of normal conditions, the Fund may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Disclaimer