THE LEEDS COLLECTIVE

MARTIN CURRIE

UK EQUITIES

NOVEMBER 2022

For institutional, professional and wholesale investors only

UK SMALLER COMPANIES: A DECADE OF OUTPERFORMANCE

The FTF Martin Currie UK Smaller Companies Fund celebrated its ten-year milestone on September 1st 2022, marking a decade since the portfolio's reposition to its existing investment philosophy. Richard Bullas and Dan Green reflect on the decade's triumphs and challenges, and the outlook of UK smaller companies from here.

Richard Bullas

Portfolio Manager
& Research Analyst

Dan Green, CFA

Portfolio Manager
& Research Analyst

Executive summary

- The FTF Martin Currie UK Smaller Companies Fund was repositioned 10 years ago in alignment to the successful philosophy adopted by the existing UK mid cap fund
- Since then, UK smaller companies have outperformed all other listed UK equity asset classes. Amongst the UK smaller companies peer group, the FTF Martin Currie UK Smaller Companies Fund has generated top quartile returns
- Owning quality businesses and compounding over the long term remains an enduring and evident theme within the fund
- 75% of today's portfolio is aligned to one of four strategic investment themes where powerful, structural tailwinds are at play
- Despite a challenging outlook for the UK, valuations look compelling. We believe that the resilience inherent within 'quality' companies will enable the portfolio to emerge in a stronger competitive position once the turbulence dissipates
- The FTF Martin Currie UK Smaller Companies Fund aims to grow in value by more than the Numis Smaller Companies ex- Investment Trusts Index over a three to five-year period after all fees and costs are deducted.

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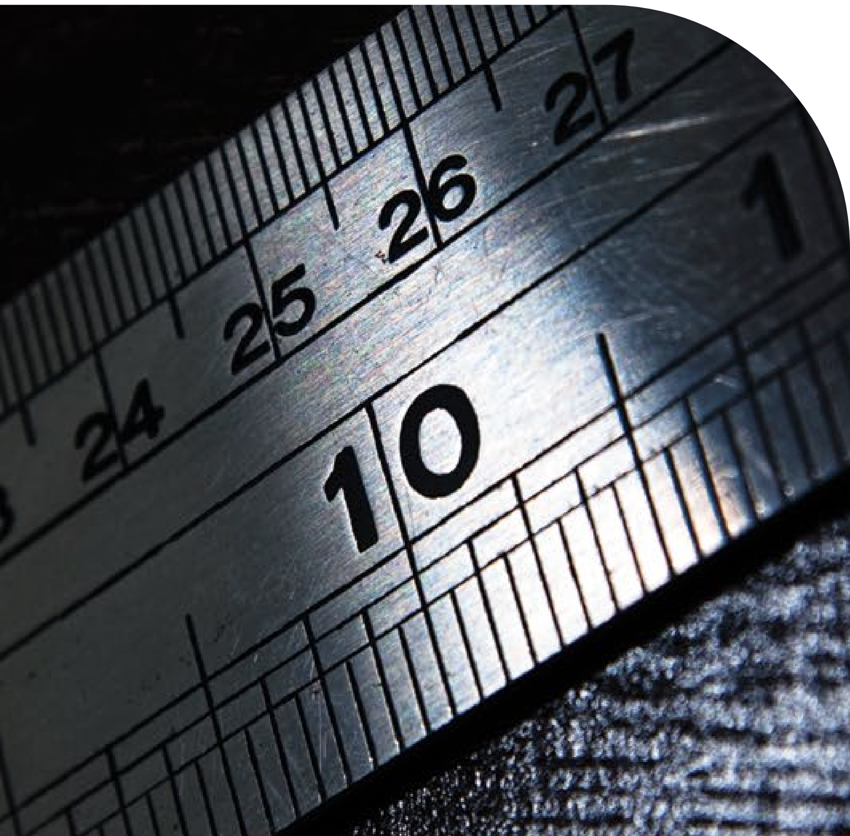
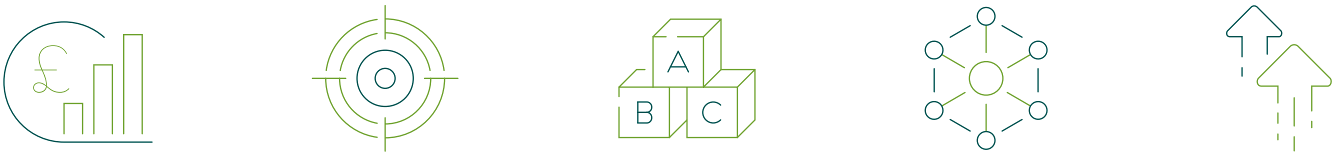


Repositioning

It has been a decade since we relaunched the UK smaller companies fund, aligning the investment strategy and process with our UK mid cap fund. We reshaped the fund investment process to one that is repeatable, pragmatic, fundamental and risk managed. The success of the UK mid cap fund since launch in 1999 provided the blueprint from which to form the future UK smaller companies portfolio, where fundamentals and valuation would be paramount.

After a detailed assessment of the inherited £18m portfolio, we identified those companies that no longer met our new investment criteria. Broadly, this resulted in the sale of resource stocks, a reduction in AIM & overseas exposure, removing less liquid micro-cap businesses and an overall reduction in the number of holdings.

The new strategy was to construct a portfolio of 40-50 high-conviction and high-quality UK smaller companies, with the core of the portfolio consisting of stocks with a market capitalisation between £100m and £1bn. This new strategy emphasized company fundamentals and valuation at the expense of high-risk/reward investments, speculative businesses, and binary outcomes.



£100m-£1bn **Concentrated** **Fundamental** **Core** **Bottom-up**

		
Business Model	Robust, scalable	Unproven, speculative
End Markets	Stable, structural growth	Structural decline, esoteric
Financials	Cash generative, profitable	Loss-making, red flag accounting
Balance Sheet	Low leverage, resourceful, appropriate capital structure	Excessive gearing, off balance sheet financing
Management	Value additive leadership, long term strategy, proven	Poor corporate governance, value destruction, controlling shareholder
Valuation	Reasonably priced, attractive total shareholder returns (TSR)	Difficult to value, blue sky valuations, distressed

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Outperformance and top quartile returns

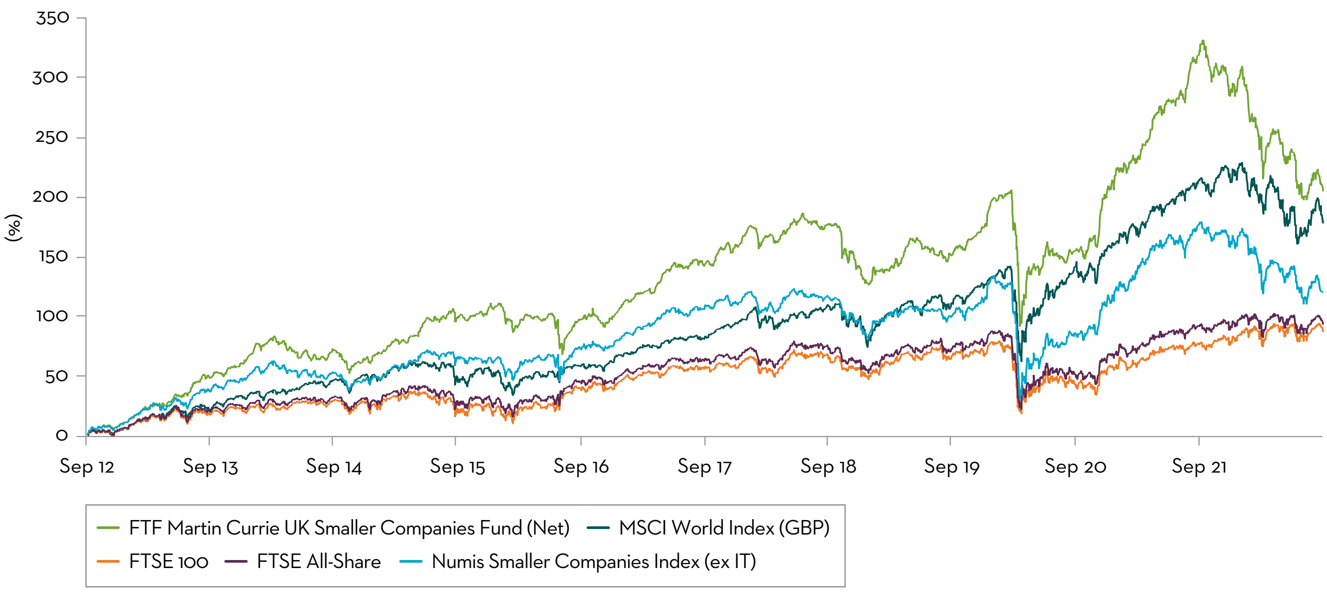
10 Year rolling perfomance

Month End As of 30/06/2022	Currency	2022 Jun/ 2021 Jun	2021 Jun/ 2020 Jun	2020 Jun/ 2019 Jun	2019 Jun/ 2018 Jun	2018 Jun/ 2017 Jun	2017 Jun/ 2016 Jun	2016 Jun/ 2015 Jun	2015 Jun/ 2014 Jun	2014 Jun/ 2013 Jun	2013 Jun/ 2012 Jun	2012 Jul – 2022 Jun
FTF Martin Currie UK Smaller Companies Fund W (Acc) (net of fees)	GBP	-21.4	52.4	-1.6	-9.2	16.5	37.4	-10.7	19.1	21.6	36.3	202.3
Numis Smaller Companies ex-Investment Trust Index (%)	GBP	-17.2	49.8	-15.0	-5.4	7.6	29.1	-6.6	10.4	20.3	31.8	126.6
IA UK Smaller Companies Sector – Quartile Ranking	GBP	2	1	3	3	2	3	4	1	3	1	1

Past performance is not an indicator of future returns.

In the past decade, UK smaller companies have outperformed the wider UK market with the fund's benchmark, the Numis Smaller Companies Index ex Investment Trusts (NSCI) delivering a return of 119.1% vs. the FTSE All Share return of 92.7%. Over this period the fund has returned 204.6%, placing it in the top quartile of UK smaller company funds over the past ten years.

Total returns: 01/09/2012 – 31/08/2022



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This demonstrates how time in the market is an important factor for investors to generate long term returns. Over the past decade there have been many periods of uncertainty that will have challenged investors willingness to invest in UK smaller companies - multiple general elections, the Brexit referendum, a global pandemic, geopolitical conflicts and rapidly changing macro-economic conditions. However, many of the businesses that we have held over the past decade have demonstrated the ability to adapt, innovate and emerge in stronger competitive positions in the face of uncertain conditions. Although the FTSE 100 is often deemed a defensive 'safe haven', this comfort for investors comes at the expense of lower long term returns relative to UK smaller companies.

Long-term supporters

We approach investment with a long-term mindset, aiming to be beneficiaries as the company compounds in value and, if needed, support the management's growth ambitions with capital when required. Nearly half of the portfolio holdings have been held for over 5 years with some of these businesses being held for the entire decade. Language services business RWS Holdings, a constant holding in the fund has grown its revenues from £65m to £750m and its profits from £15.6m to £134m in the ten years we have been invested. From being a patent translation business, RWS has evolved into the world-leading provider of technology-enabled language, content and intellectual property services, creating value for shareholders along the way. Other ever-presents include asset manager Polar Capital and aerospace and defence business Avon Protection. Both have grown and evolved over the past ten years, yet we believe their prospects remain as strong as they did when we first invested.

Other long-term holdings include professional recruitment business Robert Walters, bought for the fund in January 2013. Robert Walters has now expanded its operations into 31 countries, with profits rising from £8.5m when first bought to £54.1m in the last reported final results. We also acquired a holding in DiscoverIE (named Acal at the time) in January 2015. Since investment, profits have grown at a compound annual growth rate (CAGR) of 28.6%, with operating margins improving from 3.4% to 10.9%. The business has been repositioned into higher value design and manufacturing activities and is now listed in the FTSE250.

Some of the turnover in the portfolio has been involuntary with companies being acquired including Sumo Group, Codemasters, Urban & Civic, Lavendon and Entertainment One. While succumbing to M&A boosts short term performance, we are mindful that this can sometimes be at the expense of the long term value that we believe these companies could have created. Other businesses such as Unite or Spirent Communications have been sold as they outgrew our definition of small capitalisation.

When buying in to a business our ideal holding period would be forever. However, investing always poses risks and we have not got every investment decision correct. Investing in smaller companies will mean backing businesses that are more concentrated in a particular product, customer, service or geography relative to larger businesses. Management change can also have a profound effect on smaller businesses, and we are constantly evaluating if our investment case still holds true.

We aim to mitigate risks that would lead to a permanent loss of capital by not investing in businesses with excessive levels of debt. To demonstrate, 54% of today's portfolio is weighted to companies with net cash on their balance sheet. We also remain mindful of position size, as very large holdings can sometimes prove difficult to sell quickly if required (typically we wouldn't own more than 5% of any business). Equally, we avoid very small market capitalised and unquoted companies.

Amongst peers, there have been multiple examples in the past decade of value destruction through inappropriate balance sheets and large positions in illiquid stocks. However, since our reposition, the strategy has encountered just one instance where a portfolio holding has dropped to zero - the auditors for Patisserie Holdings were deceived by fraudulent reporting. Despite this final outcome, Patisserie Holdings did contribute positively to portfolio performance through partial sales of our holding at higher values than acquired over our four years of ownership.

"We approach investment with a long-term mindset, aiming to be beneficiaries as the company compounds in value and, if needed, support the management's growth ambitions with capital when required."

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the securities discussed here were, or will prove to be, profitable.

The portfolio today

The portfolio today has 43 companies invested in diverse end markets, with the investment process consistent with the relaunch ten years ago. Our approach results in the exclusion of some sectors from our universe such as oil & gas, mining and banks. We believe that the price you pay for a company is paramount in determining your long-term returns and this is coupled with rigorous qualitative and quantitative analysis of businesses. We do not favour an 'investing stye', but the inherent nature of smaller, faster growing, and disruptive companies in our investment universe results in a slight bias to what some observers define 'growth' businesses. The current composition of the portfolio is invested in 55% growth, 24% undervalued and 20% cyclical stocks, with 54% of company earnings being earnt in the UK.

The portfolio is constructed on a fundamental bottom-up basis, but four strategic themes are evident with over 75% of the portfolio aligned to either the digital economy, consumer brands, content and IP creation, decarbonisation.

1. **Digital economy:** The pandemic has proven to be a catalyst for technology adoption and has accelerated underlying trends. We are seeing growth in the digital economy in different end markets, such as electronic tagging for offenders, cyber security, online auction platforms, language translation, digital marketing and transportation and companies in the ecommerce logistics supply chain.
2. **Decarbonisation:** Businesses benefitting from decarbonisation efforts include those that manufacture more energy efficient ventilation products for residential homes, and electronic components for customers in renewable energy, as well as alternative asset managers that invest in sustainably led companies.
3. **Consumer brands:** Although businesses within consumer brands will likely experience short-term pressure on margins earnings due to a decline in discretionary spending, we believe brands with stronger market and competitive positions will weather the tougher economic conditions in the medium to long term and come through tougher economic conditions with enhanced market share.
4. **Content and IP creation:** Audiences are demanding more and more new content through digital channels such as video games, tv subscription services and social media. The companies in the portfolio either produce and own content or manufacturer equipment used for creating content. We believe the structural growth here will endure for the long term benefiting these businesses.

When evaluating businesses, we favour the opportunity to invest alongside company owners. We believe that mutual interest in a company enhances the probability of attractive returns. Owner-operated companies have "skin in the game" thus truly aligning the interests of company management and owners. Companies operated by managers with insignificant ownership represent an asymmetrical risk/reward payoff between directors and shareholders, and empirical data indicates that "family owned" businesses generate superior shareholder returns[1]. 45% of today's portfolio is invested in family/owner-operated companies. We are backing the entrepreneurial talent that can found in smaller companies and remain very happy to invest alongside the likes of Andrew Brode at RWS, Sara Murray at Big Technologies and Morgan Tillbrook at Alpha FX.

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[1]Source: Credit Suisse, as at 10/09/2018.

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Outlook

In October 2022, we can reflect on the fund's past decade. The current economic outlook looks as challenged as any other period in the past ten years. Our approach during environments such as these is to tune out the unnecessary noise and focus on the company operations, their end market fundamentals, and value these businesses relative to the price inferred by the market. By adopting a long term, pragmatic, and tried and tested investment approach we have assembled a portfolio of high conviction companies. We believe that this portfolio will not only survive the current economic headwinds, but will subsequently thrive once the turbulence settles. The types of companies we favour are run by experienced management teams that are both operationally competent and are also long-term strategic operators. Key attributes for this environment.

Over the long-term, UK smaller companies are the highest returning UK equity asset class producing annualised real returns (excluding inflation) of 9.7% between 1955 and 2021[2]. During times of heightened risk and a flight to safety, such as now, the opportunity to participate in these long-term returns can be forgotten or ignored. We believe that the opportunity for active management to generate returns in smaller companies is as good as ever due to the inefficiencies and mispricing that occurs at the smaller end of the market. With the declines that we have seen in 2022, valuations are looking more compelling, presenting opportunities to invest in high quality businesses.

As we look ahead, our approach is more of the same. It has served us well over the past decade and we hope to be reporting on future milestones where our returns will be generated by holding on to the market leaders, innovators and disruptors within UK smaller companies. We will continue to focus on the long term and allow the fund to benefit from the compound returns gained from holding exceptional businesses. Here's to the next ten years!

[2]Source: Numis, as at 31/12/2021.

Source: Bloomberg, as at 31/08/2022 unless otherwise stated.

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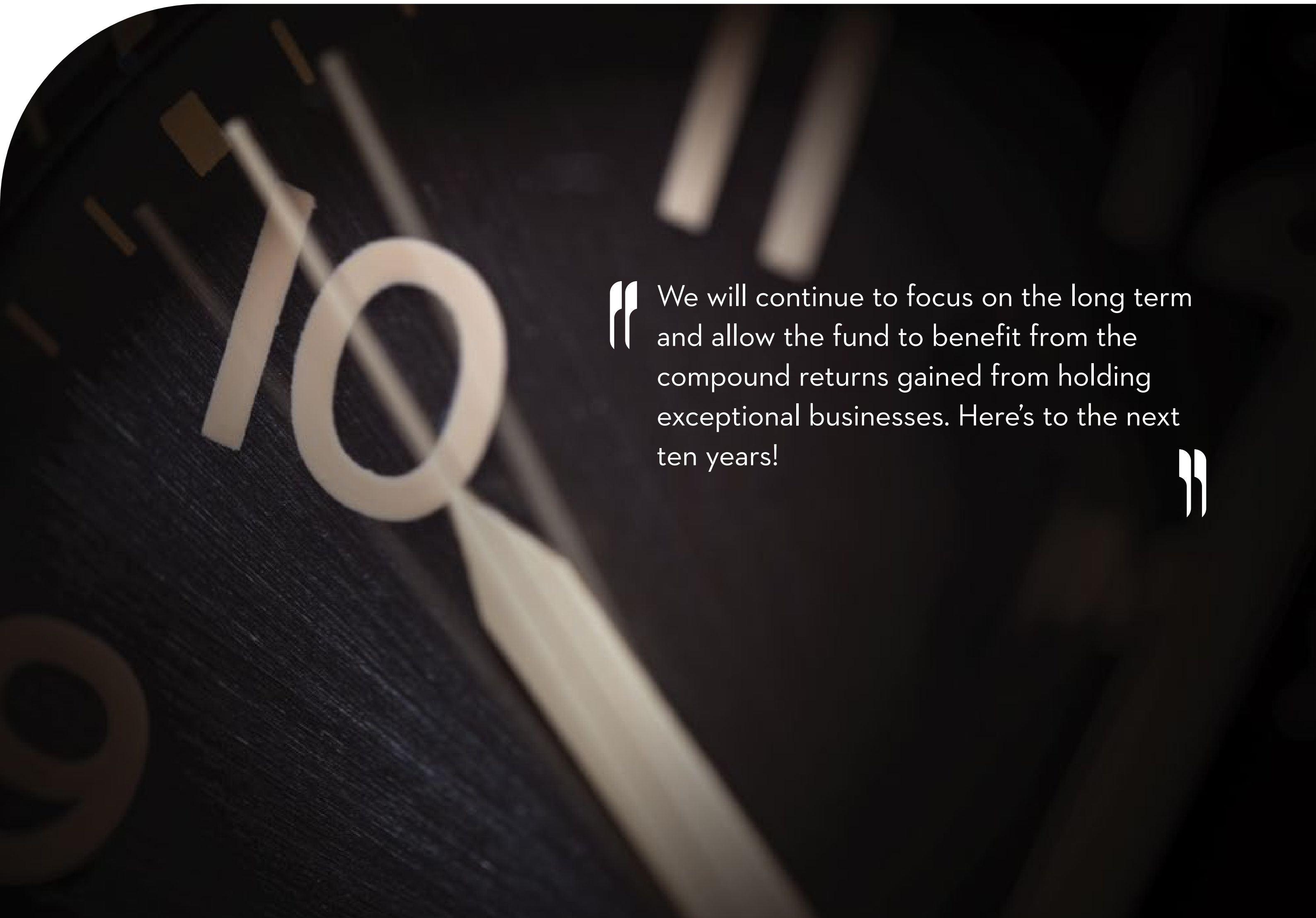

Important information

Risk Warnings – Investor's attention is drawn to the following fund risks:

Concentration risk: the risk that arises when a fund invests in relatively few holdings, few sectors or a restricted geographic area. Performance may be more volatile than a fund with a greater number of securities.

Equity risk: prices of equities may be affected by factors such as economic, political, market, and issuer-specific changes. Such changes may adversely affect the value of the equities regardless of company-specific performance.

Investment in smaller company shares: The fund buys shares in smaller companies. It may be difficult to sell these shares, in which case the fund may not be able to minimise a loss on such shares.

Liquidity risk: the risk that arises when adverse market conditions affect the ability to sell assets when necessary. Such risk may be triggered by (but not limited to) unexpected events such as environmental disasters or pandemics. Reduced liquidity may have a negative impact on the price of the assets. For a full discussion of all the risks applicable to this Fund, please refer to the "Risk Factors" section of the current prospectus of Franklin Templeton Funds.

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The Numis Smaller Companies ex-Investment Trusts Index represents the performance of the bottom 10% by market capitalisation of the UK main listed market, excluding investment trusts. Source: Numis Securities Limited.

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