

Fund Review

Downing

Small & Mid Cap Income Fund

June 2022

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Defaqto Fund Reviews

This document is designed to provide the reader with a quantitative overview of the fund reviewed. The review then goes on to examine information of a more qualitative nature, which has been obtained through an interview process with the fund manager/s.

The qualitative information covers specific areas including the fund manager’s philosophy, their people, and the processes they employ. Additional information is also provided on their research capability, the resources they have at their disposal and how they manage risk.. All of this information goes towards creating this comprehensive Fund Review.

Defaqto Ratings

Ratings to help advisers and their clients make better

The Defaqto experts have created a range of ratings to help advisers find the best product or proposition for their clients.



Show at a glance how a fund or fund family performs in comparison to the rest of the market.



Demonstrate the comprehensiveness of products across a range of areas, from pensions to DFMs.



An overall assessment of service – by advisers for advisers.

Suitability ratings to support compliant advice

Defaqto have created a set of ten Risk Profiles, and four Income Risk Profiles with corresponding ratings to which funds are mapped using a robust process. This helps advisers to evidence suitability for their clients in both the accumulation and decumulation phase:



Fund Review

Downing Investments
Small & Mid-Cap Income Fund
Jason Baran, CFA



Executive summary



- The Downing Monthly Income Fund is an equity income fund focused on small and mid-cap UK companies, and aims to provide a source of income uncorrelated with large cap UK equity and other more mainstream UK equity income funds
- Downing was founded in 1986 and has in-depth experience of private equity and venture capital
- The fund focuses on small cap and mid-cap companies with sustainable competitive advantage and strong balance sheets, to support growth of income and capital
- Uncorrelated with the UK equity income peer group
- Manager Josh McCathie took over the fund in April 2021, having worked on the fund as co-manager since 2018
- Fund oversight committee comprised of industry veterans with over 20 year's fund management experience each provides challenge and ensures that the fund is managed in accordance with the defined process

Investment objective

To achieve a quarterly income, together with capital growth over the long term (5 years).

The Fund aims to meet its objective by investing at least 80% in shares of small (those with a market capitalisation of less than £1billion) and medium sized (those with a market

capitalisation of less than £5 billion) companies which are domiciled in, have their head office located in, or (which if not established in the UK) exercise the significant part of their business in the UK and which the Manager considers to have the ability to increase returns over time.

About Downing Investments

Downing has been managing private equity and venture capital funds since the 1980's.

Downing Fund Manager's was launched in 2010 with the goal of exploiting the inefficiencies within the Smaller Companies segment of the UK market by applying a private equity style due diligence process. Initially this was via a suite of micro-cap strategies. In June of 2016 Downing became the sole manager of the VT Downing Small & Mid-Cap Income Fund (formerly known as the VT Downing Monthly Income Fund)

in order to capture these inefficiencies further up the market -cap spectrum while providing an often overlooked source of income.

The Fund's investment style builds on Downing's private equity heritage. The team takes a value-led, bottom-up approach to building a high conviction actively managed portfolio.



Quantitative Summary

While the fund has been in existence since 2012 and with an income generating objective, the mandate has been tweaked with Josh McCathie taking over as fund manager in April 2021, and a change in focus from exclusively small caps towards more weight in mid-caps.

Due to the small to mid cap nature of the fund holdings, liquidity is monitored closely. Each holding's 250-day liquidity is monitored to assess its impact on the overall fund liquidity. This detailed analysis allows the manager to ensure the Fund has sufficient liquidity at any given point in time. Ultimately Josh expects that the entire portfolio can be liquidated within 30 days, and 79% within five days. Additionally there is a 10% limit for aggregate exposure to other open-ended funds, such as property.

Considering fund performance, early in 2020 the fund was effected by the coronavirus sell-off. Again, relative to the

peer group, UK small caps were particularly hard-hit due to investors perceiving these stocks as more adversely effected by the national lock-down impact on domestically focused companies.

In 2020H and continuing into 2021, the fund performed ahead of the peer group as economies rebound sooner than initially expected, and the market repriced the risk of these domestic focused holdings. However, it should be noted that this has also been a period where the exposure of the fund has shifted towards UK mid-caps under the new manager, so a performance attribution is less clear.

Note the fund will invest in UK listed stocks but may have small holdings in companies with economic exposures outside of the UK.

Fund information and classification

Launch date	14 June 2010
Fund Manager	Josh McCathie
Domicile	GBR
Assets	Active
Approach	Return Focused
Type	OEIC

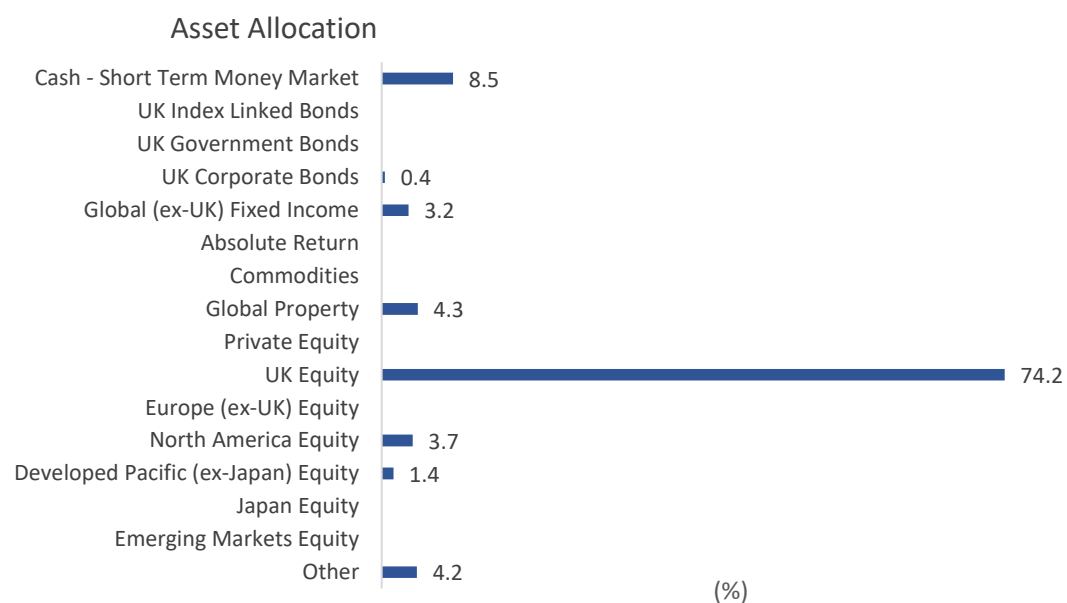
IA sector	UK Equity Income
Morningstar category*	UK Equity Income
Defaqto Diamond Rating Type	Equity Income
Diamond Rating	3

*Note: The Morningstar Category is used in all comparative analysis, over the following pages.

Fund size and fees

AUM	£43M
Date	31 May 2022
OCF Estimated	0.87%
OCF Actual	0.87%
Transaction Fee Actual	0.28%
Performance Fee (Yes/No)	No
Performance Fee Actual	n/a

Asset allocation



Source: Morningstar, 31/05/2022

Note

This asset allocation chart is drawn using the 16 asset classes (including 'other') that we use in our modelling.

This may differ slightly from the asset allocation described by the fund manager, due to various asset class roll-up and mapping variances.

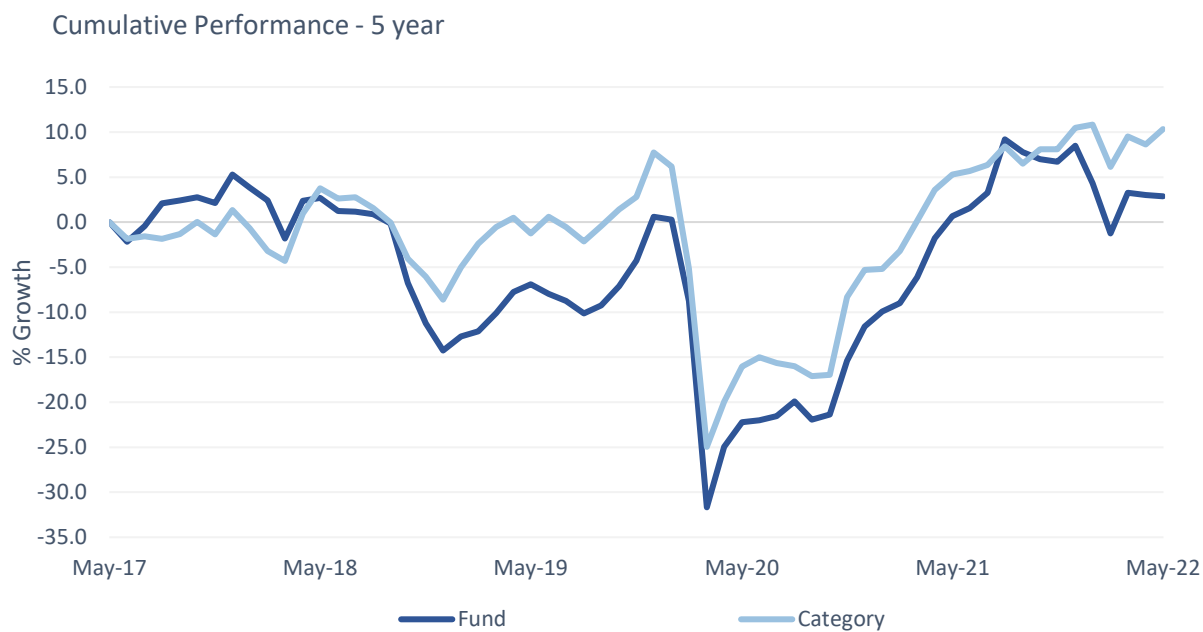
Top 10 holdings

Total Number of Equity Holdings	36
Total Number of Bond Holdings	2
Assets in Top 10 Holdings (%)	34%

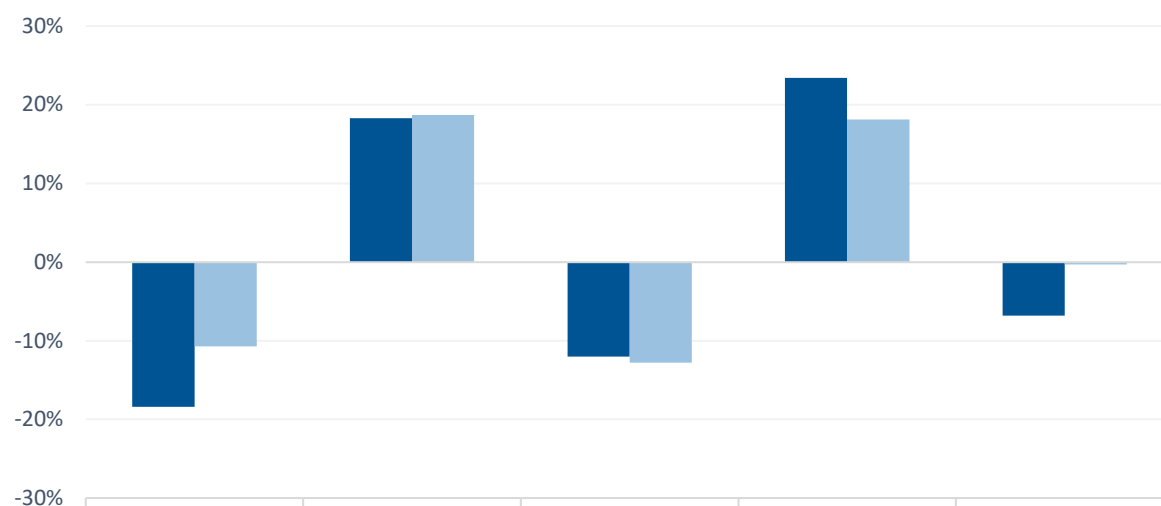
Name	Country	% of assets
Watkin Jones PLC	United Kingdom	4.1
Strix Group PLC	China	3.5
Smart Metering Systems PLC	United Kingdom	3.5
Drax Group PLC	United Kingdom	3.5
CareTech Holdings PLC	United Kingdom	3.4
ContourGlobal PLC	United Kingdom	3.3
Alpha Financial Markets Consulting PLC Ordinary Shares	United Kingdom	3.1
EMIS Group PLC	United Kingdom	3.1
Computacenter PLC	United Kingdom	3.1
Lok'n Store Group PLC	United Kingdom	3.1

Source: Morningstar, 14/06/2022

Performance



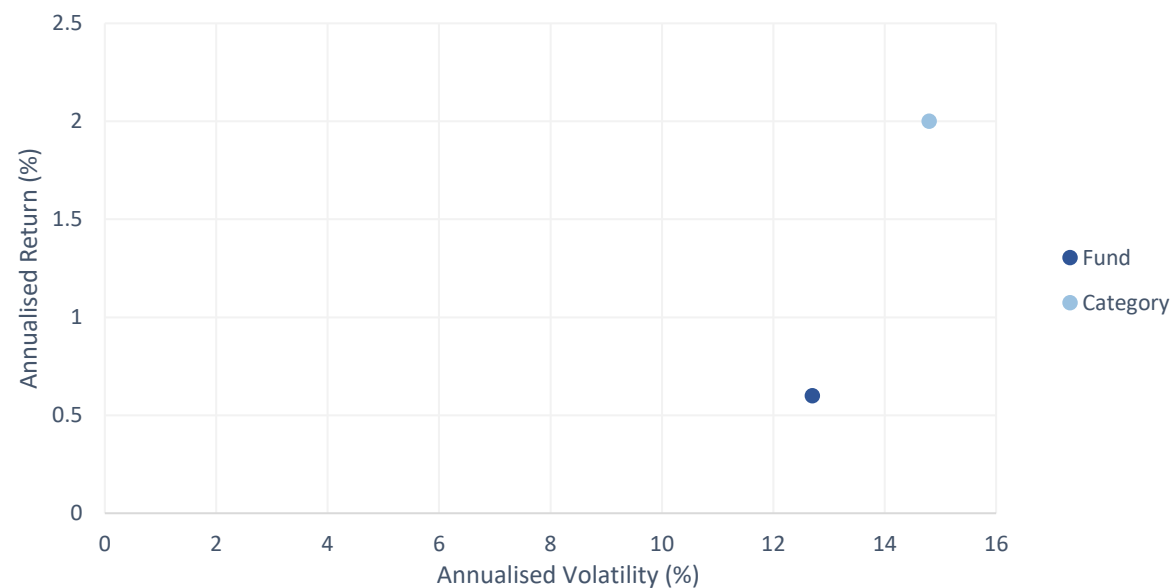
Annual Performance



	Year 2018	Year 2019	Year 2020	Year 2021	Year 2022 to date
■ Fund	-18.4%	18.3%	-12.0%	23.4%	-6.8%
■ Category	-10.7%	18.7%	-12.8%	18.1%	-0.3%

Risk

Risk vs Return- 5 year



Source: Morningstar, 31/05/2022

Drawdown

Last 60 Months	
Max Drawdown	-41.70%
Positive Months	33
Negative Months	27
Worst Month	-23.00%

Source: Morningstar, 31/05/2022

Liquidity

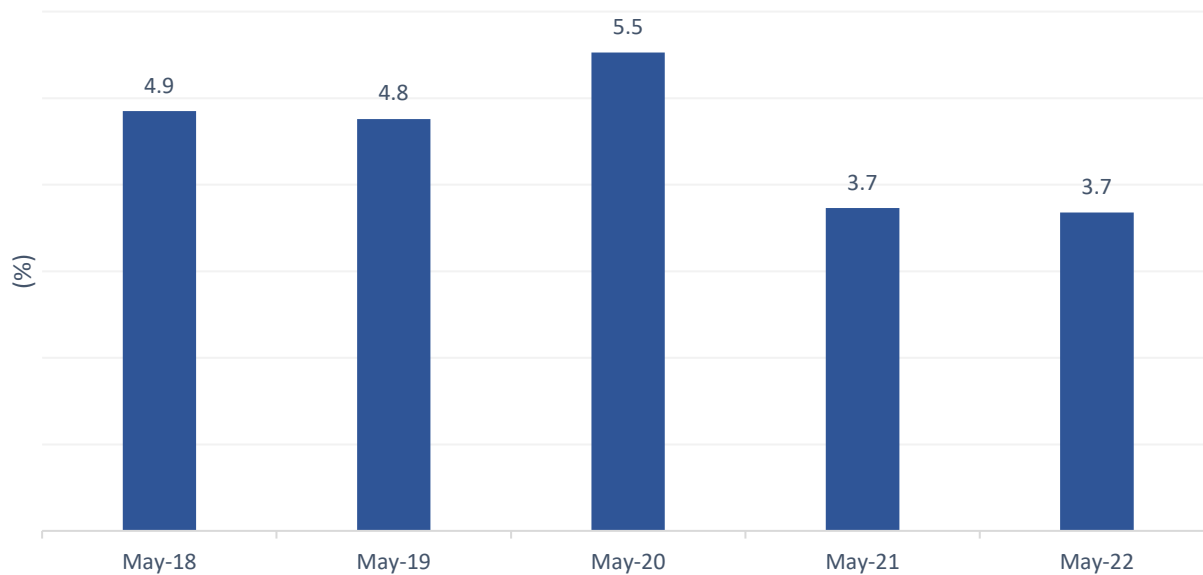
Days to liquidate holdings	% of portfolio
1 - 7 days (%)	79%
8 - 30 days (%)	100%
31 - 180 days (%)	-
181 - 365+ days (%)	-

Source: Downing, June 2022

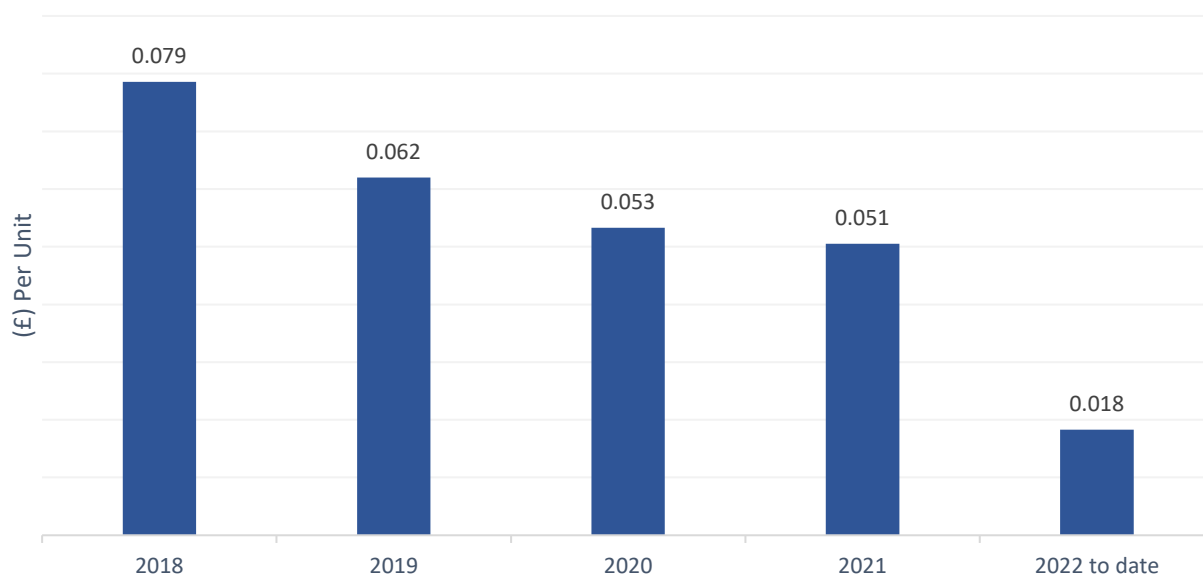
Income and yield

Distribution Yield	3.7%
Distribution Frequency	Monthly

Distribution Yield



Pre Tax Income



Philosophy

The fund manager's philosophy is based on strong active management, investing in quality businesses with a long-term view, and focusing on small to mid-cap businesses to take advantage of lower research coverage within the market. The fund also aims for diversification by avoiding many of the common large cap holdings held by UK equity income funds in the sector. This should mean that the fund returns and income distributions have a low correlation to the peer group.

The fund aims to generate returns and income via three main types of investment throughout the business lifecycle:

Income Incubators. Companies that are small but growing strongly, with clear growth visibility

Return Compounders. More established companies with an established track record of paying growing dividends, with

more growth likely to come

Core Yield. Companies that have matured, growth moderated, but with a clear track record of dividend payments and return on capital

The fund has evolved to focus on high quality, lower risk opportunities with good growth prospects that underpin earnings and dividend progression. In addition, the expected holding period is around 3-5 years, which will reduce unnecessary trading costs and re-investment risk.

Some consideration is made to ESG factors via exposure to sustainable structural themes, for example Sustainable Cities and Communities, of which currently comprise roughly 80% of the fund exposures. (The fund does not use a strict exclusions policy.)

People

Fund manager Josh McCathie has eight years industry experience, and joined Downing in 2018, having previously worked at BRI Wealth Management focusing on UK equity research.

He is supported by several experienced fund managers who have joined Downing in the last year. This enables a wider net to be cast in terms of company coverage, to help generate investment ideas, and provide a more thorough discussion of investments. In particular it was mentioned that the fund has a 15% overlap in holdings with Rosemary

Banyard's Unique Opportunities fund.

Judith Mackenzie was mentioned as also providing oversight and input into the investment process, as part of her role as Head of Downing Fund Managers. She began her investment career with Brewin Dolphin in 1997, and spent six years at Aberdeen as a fund manager before joining Downing.

In addition, the Downing investment committee provides oversight and a monthly review. This is comprised of senior investment personnel, all of whom have over 20 years' investment experience.

Process

The manager begins by screening for small to mid-cap companies and identifying at which point they are in their lifecycle. The manager described the capitalisation sweet spot of the fund's investments as around £250m to £1bn market cap. There is also a consideration of sectors relating to ESG risk and alignment with long-term sustainable structural trends.

Following this initial assessment, the process moves to an information gathering stage and to construct a financial model and valuation of the company.

A comprehensive picture of the company is built with a view to identifying its sources of sustainable competitive advantage and the strength of the balance sheet. A valuation model will be built to understand the nature of the company's free cash flow, and its valuation vs. the sector. The aim of this stage is to identify companies that are 'quality' but also represent an investment opportunity as a result of being misunderstood by the market.

ESG risk is considered in terms of how the company fits within the manager's identified long-term sustainable structural trends, and also an emphasis on company governance. Each potential company will need to respond to a proprietary ESG questionnaire, as well as pass a minimum threshold ESG score, as rated by Sustainalytics.

In order to gain an informational advantage, fundamental

research is conducted typically involving management and on-site operational meetings, customer, supplier, and ex-employee meetings, and using external consultancies. Typically Josh will take around 18 months to complete all their research and for a suitably cheap valuation appear before investing. However, this can be completed more quickly should the investment case require it, eg markets are currently presenting a valuation / buy-in opportunity.

Return catalysts will also be identified that may help kick-start a market revaluation of the company. Catalyst examples mentioned were: product releases, contract awards, M&A activity, deadlines (regulation, legal), earnings releases or company guidance announcements.

During portfolio construction, the risk/reward, liquidity and income characteristics are considered. New positions are typically added with a 1-1.5% weighting, which may be increased up to a max limit of 4.5%.

While there is an investment committee, responsibility for investment decisions rests with the fund manager, and he is free to invest without investment committee approval. Instead the investment committee's role is to provide oversight and risk management, and is comprised of senior investment personnel who meet monthly.

Investments are typically held for three to five years.

Risk management

Risk is considered mostly on-desk by the fund manager, in particular via a scoring of earnings risk based upon various macro factors and valuation metrics.

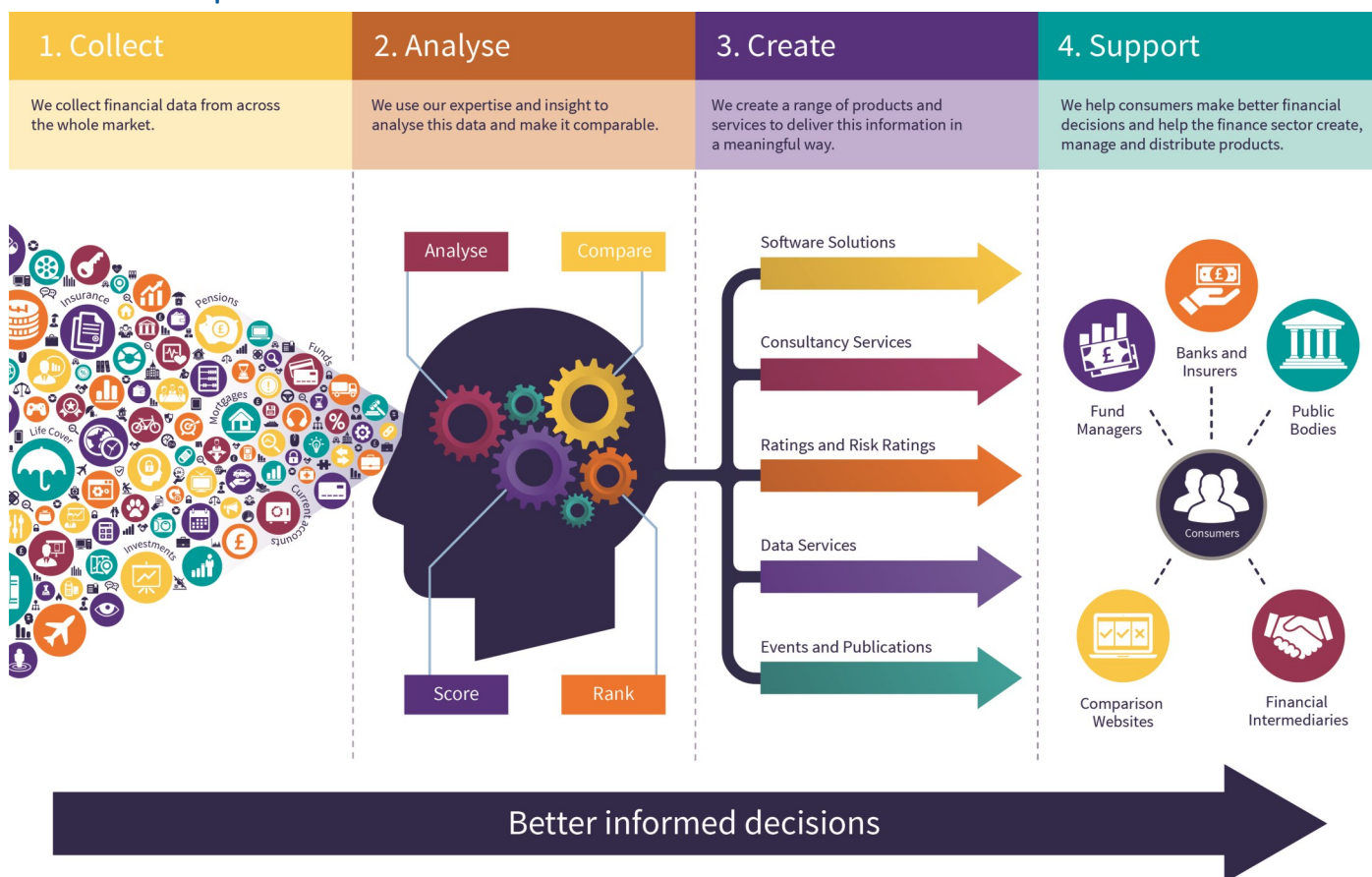
A final risk score is assigned to each company based on these liquidity and earnings based measurements. All else equal a highly liquid position with low risk, strong growth, strong upside and a high yield will receive the highest allocation in the portfolio. Equally, if a position becomes less liquid, or moves to a higher risk score, then the portfolio allocation is reduced.

Liquidity risk is measured using 250-day traded volume, and excludes the top and bottom 10% of trading days so as to create a consistent daily liquidity measurement.

Oversight is provided monthly via the investment committee, including Risk Director Jonathan Jordan who joined Downing in 2019. (Jonathon has over 20 years experience in compliance and risk, having joined from Maitland where he was Head of Fund Accounting, Compliance and Risk.)

StatPro is used within the firm to provide analysis of risk factors and stress testing.

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Defaqto has been operating for over 25 years and works independently. Defaqto employs over 60 analysts spending 400 hours a day monitoring the market and analysing more than 43,000 financial products and funds in the UK, ensuring that the information provided is accurate and up to date.

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