Smithson
Investment Trust

Dear Fellow Shareholder,

The performance of Smithson Investment Trust ('Smithson'), along with comparators, is laid out below. In 2022 the Net Asset Value per share (NAV) of the Company decreased by 28.1% and the share price declined by 35.2%. Over the same period, the MSCI World Small and Mid Cap Index ('MSCI World SMID'), our reference index, declined by 8.7%. We also provide the performance of UK bonds and cash for comparison.

	Total Return 1 January 2022 to 31 December 2022	Inception to 31 December 2022	
		Cumulative	Annualised
	%	%	%
SSON NAV[1]	-28.1	+41.1	+8.5
SSON Share Price	-35.2	+30.8	+6.6
SMID Equities[2]	-8.7	+34.9	+7.4
UK Bonds[3]	-15.0	-9.9	-2.5
Cash[4]	+1.4	+2.8	+0.6

[1] Source: Bloomberg, starting NAV 1000p.

[2] MSCI World SMID Cap Index, £ Net source: www.msci.com.

[3] Bloomberg/Barclays Bond Indices UK Govt 5-10 yr, source: Bloomberg.

[4] Month £ LIBOR Interest Rate source: Bloomberg.

In the first paragraph of last year's letter we suggested that it would not be possible to outperform every year and that there would be some periods of underperformance. Despite knowing that no strategy, if followed with discipline, can outperform in all periods, it is always unpleasant when a year of underperformance arrives, and the extent of the poor performance this year was particularly painful.

There was clearly one dominant factor at play contributing to this outcome, and it impacted the portfolio consistently throughout the year: the rising market expectation for interest rates.

As we now know, inflation started accelerating in 2021 and did not turn out to be 'transitory' as several of those in charge of central banks believed it to be at the time. In fact, it quickly became entrenched, and was exacerbated by the war in Ukraine, which further propelled energy and food prices.

This caused a sharp volte-face by central banks, which began raising interest rates in March 2022 by increasing increments until 75 basis point moves, a major increase by historical standards, became the norm. The effect this had on the market's expectations for future interest rates was profound. At the beginning of 2022, bond markets were indicating that the upper bound of the Fed's policy rate would be 1% by 2023. In December 2022, the Fed rate was already 4.5% and market expectations were for a 2023 peak of over 5%.

While not at the 19% level it took to shock the US economy into submission in 1980, it is difficult to overstate the impact this move had on asset prices. By which, of course, I am not just talking about stocks, bonds and crypto currencies, where price movements are observed most immediately, but also real estate, art, classic cars and anything else that was a recipient of the world's recent savings glut. We always restrict ourselves to a maximum of one quote from Warren Buffett per letter and it is probably best used here, to cement the importance of the relationship in our minds: "Interest rates are to asset prices like gravity is to the apple".

The reason for this is because the value of any asset, companies included, is the total of the future cash flows you can expect to receive, discounted back to today's monetary value using the prevailing interest rate. As rates rise, today's value of the future cash flows decreases, and thus the value of the asset declines.

While this increase in interest rate expectations affected the whole stock market, unfortunately the shares owned in the portfolio were affected more than most. This is because our high quality companies are growing faster than the market average and generating more cash flows in the future. In practical terms, their faster growth meant the valuations of our companies at the end of 2021 were higher than the average in the market, and therefore fell further than the market as rate expectations moved.

Another way of explaining the relative underperformance is by looking at the sector performance of the MSCI Small and Midcap Index alongside the sector weightings of the portfolio.

2022 Sector Performance (%)

Sectors	MSCI World SMID Cap Performance	Smithson portfolio weight (%)
Energy	+64%	–
Utilities	+12%	–
Consumer Staples	0%	4%
Financials	-2%	3%
Materials	-3%	–
Industrials	-8%	23%
Health Care	-15%	15%
Real Estate	-16%	–
Consumer Discretionary	-18%	13%
Information Technology	-20%	38%
Communication Services	-23%	3%

It becomes immediately apparent that the worst performing sectors of the index were also those to which Smithson is most exposed and, just as unfortunately, the positively performing sectors were commodity driven and therefore contain companies which we will never own.

Other factors weighing on share prices are the potential effects of cost inflation, and a likely recession brought about by the tightening of monetary policy. In fact, it was expected by the International Monetary Fund at the end of 2022 that a third of the global economy could enter recession over the next 12 months, although more recent commentary has indicated a reduction in this threat.

While recession holds some trepidation for us, the quality of the companies held in the portfolio, including their lower level of cyclicality and generally strong balance sheets, should enable them to weather the storm better than other companies in the market. However, they will still be susceptible to share price falls should the recession turn out to be worse than currently expected by market participants.

It is perhaps worth stating again that we are not particularly concerned about the effects of inflation on our portfolio companies, especially compared to other companies in our reference index. The reason for this is that our companies tend to have high gross margins and low capital requirements, which mean that they are less susceptible to cost increases than other companies. They are also in strong competitive positions, which typically allows them to increase prices to offset higher costs, should they choose to do so.

So what next? While we would like to say that all the poor performance is behind us, there is no guaranteed way to tell what is ahead. The best we can do is to follow the advice of veteran bond investor Howard Marks by attempting to understand where we are at this given moment. We observe market expectations for future interest rates to move back to historical averages, regional inflation rates decelerating, commodity prices declining, supply chain bottlenecks easing and employment growth moderating helping to temper wage inflation.

We also observe signs of significant bearishness in the market. The December 2022 Bank of America Fund Manager Survey indicated that more fund managers are now overweight bonds (a sign of seeking safety) than at any time since 2009. Another interesting gauge is

to observe the reaction of the stock market to major news events and data releases. Typically, there are both positive and negative elements to most news items, for example, a strong employment number means the economy is likely to keep growing, but on the flipside, central banks might also keep raising interest rates. The market reaction will indicate overall investor sentiment, and it feels to us that for most of the year, the stock market was reacting negatively to such news.

We therefore suspect that we are potentially close to the end of stock market declines for reasons of inflation and interest rates, although possibly not yet through the worst in terms of recessionary fears, given these have yet to be realised (or disproved). This last point might be helped in the near future by the recent reopening of China from Covid restrictions, which, given the sheer size of its manufacturing sector and consumer demand, will provide a noticeable boost for the global economy. To illustrate the powerful effects that both the Federal Reserve and the Chinese economy have on global stock markets, we can borrow from investor Michael Howell, who said, “the stock market’s price-earnings multiple is determined in Washington and its earnings Beijing”.

Unfortunately, not all of the underperformance against the market was inflicted upon us by macroeconomic factors; we made some mistakes too. Principal among these was not selling certain companies which were overvalued at the end of 2021. These included Domino’s Pizza Enterprises and Fortinet, two positions that we reduced in size due to our concerns over valuation, but on reflection, could have trimmed more aggressively or perhaps even exited. We remain holders as the falling share prices quickly returned the valuations to more comfortable levels.

There is some good news. Save for a couple of positions, we are very confident in the fundamentals of the businesses held in the portfolio. While a recession may continue to hold back cash flow growth for a while, none of these companies will suffer meaningfully, and certainly not to a degree which would keep us awake at night.

As the below list of largest detractors of performance shows, there are a couple of exceptions to this; companies whose poor share price performance was exacerbated by deteriorating fundamentals.

	Country	Contribution %
Fevertree Drinks	United Kingdom	-3.2%
Temenos	Switzerland	-2.6%
Nemetschek	Germany	-2.1%
Rightmove	United Kingdom	-1.7%
Domino’s Pizza Group	United Kingdom	-1.3%

Fevertree suffered very strong cost inflation in logistics (until recently much of their product was shipped around the world from bottling plants in the UK and Europe) and packaging including glass and tin, compressing the gross margin from over 50% in 2019 to under 40% by the end of the year. This decline in margin has taken place because management decided not to put up prices, as they wanted to maintain the strong sales momentum that they are enjoying in large markets such as the US. We remain holders for now as we believe that over time the company can improve the margin, with our confidence boosted by the likelihood that margins in more mature markets such as the UK, which are not disclosed separately, are still very favourable. If this is combined with continued growth in revenue, the potential for future cash generation is substantial.

Temenos has been going through a transition from selling its banking software as a perpetual licence, to selling it as a subscription or a service, otherwise known as ‘SaaS’. This should make little difference to the business structure over the long term, although some argue it could be a positive due to higher potential revenue from individual customers over time, but in the interim it causes a decline in profits and cash flow as the high up-front payments for licences are substituted for smaller annual or monthly subscription payments. On top of this, there appears to have been a slowdown in the number of new contract signings for the company, as its bank clients are hesitating to spend more on their IT systems ahead of a potential recession. Having spent some time with the CEO and Chairman to understand what

was going on behind the scenes, we were growing concerned that these issues weren't being managed as well as they could be, and so were not upset by the recent announcement of the CEO stepping down and a previous CEO taking over in the interim.

Nemetschek is a company selling design software to the construction and media industries and suffered from a combination of a high valuation owing to its fast growth, and market concerns regarding a future recession in the construction industry.

Rightmove, the UK online property portal, fell due to concerns over the UK housing market in an environment of rising mortgage rates, a cost of living crises and a potential recession. It is worth remembering that Rightmove's revenue, being generated by subscriptions from estate agents, has no direct link to house prices or sales volumes, and has actually continued to increase. However, should some estate agents go out of business, which tends to happen when the housing market declines, then they will lose subscribers and Rightmove's sales will fall. The positive to this is that a new estate agent only needs a laptop, phone and contact list, which means that the number of estate agents tends to rebound quickly after any market correction.

Domino's Pizza Group declined due to market worries about a UK recession, although we are a little more sanguine. While a reduction in disposable income will put some sales at risk, we believe that those in the food industry most likely to suffer are casual dining outlets, while 'better value' takeaway options might prove more insulated from such pressure as people continue to treat themselves to 'affordable luxuries' when times are tough. We also suspect the men's football World Cup will have provided a tailwind to sales into the end of the year.

Top five contributors to performance are shown below.

	Country	Contribution %
Rollins	United States	0.4%
TechnologyOne	Australia	0.2%
Moncler	Italy	0.2%
IDEX	United States	0.1%
Qualys	United States	-0.1%

It may come as a surprise that there were some companies in our quality growth portfolio that rose during the year.

Rollins, a US pest control company, was the best performer. This is a business with highly repeatable earnings given that in some parts of the US where it operates it is necessary to have frequent visits from pest control to keep buildings habitable. This leads to much of its revenue being paid on subscription and thus fairly dependable, which is almost certainly why the shares performed well in a period of concerns regarding inflation and recession.

TechnologyOne is perhaps the most surprising performance contributor, given that it is a fast growing software company. However, the shares reacted well as sales and earnings continued growing strongly throughout the year, more than offsetting the downward pressure on market valuations. The institutions it sells to include governments, universities and the military, which are yet to be affected by the macroeconomic environment.

While Moncler's share price declined during the year, we were fortunate to acquire the position at a relatively low point, which meant that it was a positive contributor to the fund by the end of the period. This was also the case for IDEX.

Qualys, the US cyber security company, did better than average as its revenue growth continued accelerating throughout the year. While we do expect a recession to weigh on companies' information technology budgets, and therefore cyber security sales, it should still be more robust than other categories given the constant and increasing threat of cyber crime.

As ever, we continue to follow the same simple strategy:

- Buy good companies
- Don't overpay
- Do nothing

To demonstrate that we do indeed buy good companies, we include the table below, which is the weighted average operating metrics of our owned companies over the last 12 months compared to the reference Index.

LTM Figures	Smithson Investment Trust	MSCI SMID
ROCE	43%#	11%
Gross Margin	65%	34%
Operating Profit Margin	25%	9%
Cash Conversion	101%	66%
Interest Cover	34x	7x

Data for the MSCI World SMID Cap Index is shown ex-financials, with weightings as at 31.12.2022.

Data for MSCI World SMID Cap Index is on a weighted average basis, using last available reported financial year figures as at 31.12.22

Data for Smithson portfolio is on a weighted average basis, ex-cash, using last available reported financial year figures as at 31.12.22

Interest cover (EBIT ÷ net interest) data for Smithson and MSCI SMID is done on a median average basis.

ROCE for Smithson includes Rightmove (206% ROIC) and Verisign (330% ROIC). Excluding Rightmove, the ROIC is 38%; excluding Verisign it is 30%; and excluding both, it is 23%.

The table shows that our portfolio companies remain superior to those in the Index on every metric, with return on capital employed, gross margin and operating margin being of significant importance in the current environment and particularly in excess of that observed for the Index.

The next step, of not overpaying for these companies, can be assessed by looking at the average free cash flow yield (the free cash flow divided by the market capitalisation) of the portfolio. Valuations are now more attractive than they were a year ago. The free cash flow yield of the portfolio is 3.3%, having been at 2.0% at the start of 2022. By coincidence, the current level is roughly where the portfolio was trading when we launched the Trust at the end of 2018, although it is worth bearing in mind that this figure includes Sabre and Ambu, two companies which did not produce any free cash flow in 2022, but did in 2018. They also contributed to the fact that the free cash flow generated by the portfolio was actually 7% lower than in 2021. Much of this was also due to companies in the portfolio spending more cash on re-building their inventories from a low point in 2021 as supply chains eased, but at higher component prices, due to inflation. This dynamic is confirmed by looking at the average growth of earnings per share, which excludes working capital expenses, and which was +7% in the period. It is perhaps worth mentioning that if recession starts to bite in 2023, we may have to wait some time for these figures to improve meaningfully. But we are confident that they will.

Regarding the final step, do nothing, it must be noted that as share prices were volatile throughout the year, trading activity increased significantly as we set out to take advantage of buying new positions or increasing existing ones at lower valuations. This meant that discretionary portfolio turnover, excluding any buybacks and the investment of proceeds from new shares issued, was 48.5% compared to just 9.5% in 2021. While this sounds like a high level, it is worth noting that according to Morningstar, the average turnover for actively managed equity funds tends to be above 60% and in 2020, the last year of such volatile markets, it was 86%.

Costs of dealing, including taxes, amounted to 0.03% (3 basis points) of NAV in the period, slightly higher than the 0.02% incurred in 2021. This may seem odd given there was much more discretionary turnover this year, but the reason is that the *overall* turnover of the fund, including the investment of the proceeds from share issuance, which was very limited in 2022, was not that much higher than last year. The Ongoing Charge Figure was 0.9% of NAV compared to 1.0% in 2021. This includes the Management Fee of 0.9%, applied to the market capitalisation of the Trust, which was lower than the NAV for most of the year. Combined, this means the Total Cost of Investment in the Trust was 0.93%.

Part of the turnover was generated by buying three companies during the year after the decline in share prices resulted in attractive valuations. Moncler, the Italian clothing company which designs and produces high-end branded apparel, traces its roots back to 1952 and the invention of down-filled mountaineering coats, but fell on hard times in the 1990s before being rejuvenated in the 2000s. It now produces luxury items across several categories in clothing and accessories. The company has until recently been expanding by opening new Moncler branded stores, but this growth has been boosted by acquiring the Stone Island brand in 2020. Stone Island is another Italian luxury clothing company which has a similar profile to Moncler's in 2000, which is why management believe they can greatly improve and grow the Stone Island brand, much as they have done over the last 20 years with Moncler.

Since the inception of the fund, we have experienced success in owning decentralised industrial conglomerates such as Halma and Diploma. While the organic growth of these businesses is acceptable, around the mid-single digit percent level, it is the consistent, disciplined acquisition of high quality 'bolt-on' companies that allow the groups to create substantial shareholder value over time. In fact, we believe that in an era of higher interest rates and lower asset prices, companies such as these, making frequent small acquisitions – without significant additional debt - should stand to benefit greatly. We acquired Addtech as it is another high quality example of this type of company, with a very small head office directing the allocation of the cash flow that is generated by its independently managed businesses. Addtech, based in Sweden, has 140 subsidiaries and 3,000 employees grouped into five industrial business areas including Industrial Process, Energy, Automation, Components and Power Solutions. Its origins date back to 1906 and it has had the same business concept for over 100 years. We can therefore be confident in its strategy over the next decade at least.

Finally, we bought a position in IDEX, an industrial company based in the US. IDEX is another decentralised industrial conglomerate which grows through small acquisitions, but this time in areas such as pumps, meters and systems for high-value materials, high-precision instrumentation for health and science industries, and tools, valves and controls for the fire and rescue industry and other applications, including clamping devices used on the Mars rover.

We also sold three companies in the period. The first was a US-based boiler and heater manufacturer, AO Smith. While the company has a very attractive US business operating in a tight oligopoly, its future growth opportunities lie in areas with much more aggressive competition, such as water heaters in China and water purification in the US. For this reason, we became less optimistic on its ability to sustain profitable growth and sold, fortunately before fears of recession caused a significant decline in its share price.

The second company we sold was Wingstop. After the shares troughed in the summer, the share price more than doubled into the autumn, at which point they were trading at levels we no longer felt comfortable with given the decline in cash flow the company was experiencing post its pandemic boost. In addition, we were concerned about the long-term CEO deciding to leave for 'another challenge', a potential capital intensive investment into chicken farming and an increasingly levered balance sheet.

Towards the end of the year, we also sold Ansys, a US company producing simulation software. While we still appreciate the dominant position it occupies in its software niche, maintained by the most advanced and accurate physics simulation engines, we have growing concerns about its frequent acquisition of companies that are clearly producing little or no profit. In the three years prior to our original investment in 2018, the company spent $29m per year on acquisitions on average. In the three years since our investment, the company has spent an average of $623m per year. As a result, invested capital has increased 112% since 2018 while operating profit is up only

12%, depressing return on capital employed to below 10%. This indicates to us that the cost to sustain its competitive position is perhaps greater than it first appeared.

The result of this activity is shown below, with a breakdown of the portfolio in terms of sector and geography at the end of the period. The median year of foundation of the companies in the portfolio at the year end was 1973.

Sector	31 December 2022 (%)	31 December 2021 (%)
Information Technology	38%	44%
Industrials	23%	22%
Healthcare	15%	11%
Consumer Discretionary	13%	9%
Consumer Staples	4%	5%
Communication Services	3%	5%
Financials	3%	3%
Cash – Uninvested	1%	1%

Information Technology now has a lower weighting, mostly due to the sale of Ansys. As we say every year, while the Information Technology weighting appears large, we do not think of ourselves as running a ‘tech fund’, because this is an MSCI defined sector which includes a number of diverse businesses and end markets. To illustrate this more clearly, we list below the companies that fall into the sector definition, along with a more detailed business description and country of listing.

	Country of Listing	Business Description
Cognex	United States	Logistics Electrical Equipment
Fortinet	United States	Cyber Security
Halma	United Kingdom	Safety and Environmental Electrical Equipment
IPG Photonics	United States	High Powered Lasers
Nemetschek	Germany	Software – Construction and Media
Paycom Software	United States	Software – Human Resources
Qualys	United States	Cyber Security
Sabre	United States	Travel and Leisure
Simcorp	Denmark	Software – Asset Management
Technology One	Australia	Software – Government Institutions
Temenos	Switzerland	Software – Banks
Verisign	United States	Internet Domain Management

Hopefully from this list it is possible to see that the companies have a diverse range of end markets, and even the collection of software companies provide software products to very different industries. This serves to highlight the fact that we would not expect the revenue trends of these companies to move in lock step through economic cycles, as perhaps the single sector weighting might suggest.

While the size of the Industrials weight was little changed, Health Care increased due to adding to existing positions, while Consumer Discretionary increased from the addition of Moncler to the portfolio.

Country of Listing	31 December 2022 (%)	31 December 2021 (%)
USA	40%	47%
UK	17%	21%
Italy	10%	4%
Denmark	8%	5%
Australia	7%	7%
Switzerland	6%	7%
Germany	6%	6%
New Zealand	3%	2%
Sweden	2%	–
Cash	1%	1%

The USA is the largest country by weighting but has decreased by 7 percentage points from the end of last year due to all three of the companies sold from the portfolio being listed in the country. After a decline in the UK weighting and an increase in Italy (again, due to Moncler), the European weighting now appears more balanced than it has done historically.

The geographical weighting that we pay most attention to though, is the economic exposure of our companies, measured by the origin of revenue. This year, Europe increased slightly to become the largest, with a decrease in US exposure now making North America number two on the list. The other entries are broadly unchanged from last year. While Smithson only invests in developed markets, some of those companies generate revenue in emerging markets, shown by the EMEA and Latin America lines below.

Source of Revenue	31 December 2022 (%)	31 December 2021 (%)
Europe	39%	38%
North America	36%	38%
Asia Pacific	19%	19%
Eurasia, Middle East, Africa	4%	3%
Latin America	2%	2%

Given the importance of Environmental, Social and Governance (ESG) issues in investing, we outlined our ESG approach in last year's report. Instead of repeating what was written there, it might be more interesting for you to read about some of our engagements with portfolio companies regarding ESG issues during the course of the year. One of the most challenging situations experienced by our companies this year was when Russia invaded Ukraine. IPG Photonics was particularly affected because a third of their employees were based in Russia, producing much of the semi-finished goods being shipped to other countries for final assembly. We were, of course, greatly concerned by this and approached the company to discuss the matter. We were reassured by the fact that the management team had swiftly determined and begun executing a plan that would transfer all manufacturing out of Russia within 12 months. We have since been tracking the progress of this plan and are pleased to report that they have made significant headway.

Another situation which immediately attracted our focus was the announcement that the recently hired CEO of Domino's Pizza Group was leaving to re-join his previous employer, Whitbread, to become CEO of that company. Our first call was to the Chairman of Domino's Pizza Group to express our frustration at this outcome. What had driven him away - colleagues or company culture? Undue pressures from the Supervisory Board? We were also eager to understand whether the remuneration structure was motivating enough to keep the right person in the job.

Once you find the managerial talent that you believe will create value for shareholders, you want to be able to compensate them to a level and in a method that keeps them in that role and working as effectively as possible to increase the value of the company. Through several further interactions with the company, including meetings with the CEO, Financial Director and Investor Relations executive, we came to the conclusion that neither the culture, Board or incentive structure had pushed out the CEO, but he was simply driven by his desire to manage a larger company, one where he had already spent several years of his career, and already knew many of the people that he would now be leading. There is therefore a simple one-word explanation for the departure – ego – which probably means that we need not worry about the company itself. The search for a new CEO is ongoing and we will remain shareholders in the interim.

Finally, we would like to once again thank all shareholders for their support of Smithson Investment Trust. We acknowledge that this is by far the worst period of ownership for most and as such will not have been easy or comfortable. Perhaps a simple analogy for what we are currently experiencing is to imagine the relationship between our performance and the market as like a car being towed by an erratic driver. There may be brief periods of smooth acceleration, but for the rest of the time you will be subjected to periods of drift when the rope goes slack, before being jolted forwards again when the car reaches the end of the tether. The current period is clearly one of the car drifting backwards, but to end up at the final destination of superior long-term returns, it makes sense to still be in the car when the rope snaps back.

While we hope that market conditions are more favourable in 2023, we continue undiscouraged with our strategy of buying high quality, growing companies. Although style drift – the act of becoming less disciplined in the execution of your original strategy in an attempt to make money in all periods – may sound attractive after a year like 2022, it’s only a short while before your North Star becomes so clouded by opportunism that you end up far away from a cohesive strategy and no longer know what type of investments you are looking for. Be assured, this will never happen at Smithson. As Mike Tyson famously said, “Everyone has a plan ‘till they get punched in the mouth”, but while we took plenty of punches this year, the plan has survived. We will continue to strive to allocate your capital as effectively as possible using the same long-term strategy, whatever the environment.

Simon Barnard
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