SARASIN UK THEMATIC SMALLER COMPANIES FUND

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ECONOMIC AND FUND REVIEW

The UK equity market recovered slightly in the opening quarter of 2023, as economic data proved more resilient than anticipated. A milder-than-expected winter across Europe triggered a sharp fall in energy costs, which in turn added support to both the UK economy and corporates. Expectations that inflation was starting to peak were confirmed although there is still limited visibility on when the rate maybe begin to fall or when the Bank of England can begin to reduce interest rates. The market rally stalled as several bank failures in the US and Europe caused concerns over the broader financial system. However, swift central bank action was successful at preventing the contagion spreading and reassured equity markets.

The MSCI UK Small Cap Index rose 1.7% during the quarter, which was broadly in line with the core large-cap index. Within the smaller cap space, a number of more defensive companies, notably those in consumer-related sectors did relatively well. This was in contrast to healthcare, traditionally also a defensive sector, which was surprisingly weak. In what was a mixed picture, the information technology sector held up well while financials and energy were among the worst performers, showing negative returns. The portfolio benefited from good stock selection in the consumer discretionary, healthcare and information technology sectors, with B&M, Alliance Pharma, Oxford Biomedica and Softcat all contributing positively. Online clothing retailer ASOS was the stand-out performer on the back of better-than-expected figures and an upbeat outlook. In industrials, both IMI and Howden Joinery had a positive quarter, but a number of other holdings in the sector contributed negatively, notably RWS Holdings, Restore, and Smart Metering Systems. The restructuring and insolvency consultancy, FRP Advisory had a particularly weak quarter as numbers reflected a slowdown in deal flows.

Having increased the number of holdings in the portfolio during the previous quarter, a number of the smaller holdings were rotated out of in order to bring the total number back down to 32 positions. AB Dynamics, Abcam, Alpha Financial Markets, Keywords Studios and Strix were all sold. No new positions were initiated.

OUTLOOK

The high levels of both UK inflation and interest rates continue to be the key concerns for investors. Global events, particularly in Ukraine, are negatively impacting the UK economy and growth through high energy prices, supply chain issues and weakening consumer confidence, which in turn have fuelled inflation. Domestically there is a risk that upward wage pressure will lead to Inflation remaining higher for longer. Interest rates, similarly, while not expected to rise much further, are likely to stay at higher levels at least until into next year when inflation should start to come down, allowing the central bank more flexibility in their policy. Despite these pressures, the UK has managed to avoid recession so far and looks to be entering a period of stagflation. From a market perspective, it would appear that economic weakness that should be relatively contained has already been discounted.

Other challenges also require close monitoring. The significant and rapid tightening of financial conditions over the past year may have unintended consequences for business activity and market functionality. Generally, company earnings will be put under pressure in the coming year as growth slows and liquidity becomes more difficult to access. The opacity of private markets - which have grown significantly in the past decade - raise contagion risks for public markets. As illustrated by the UK liability-driven investment sector last year, markets that have become used to low rates may have to adjust their operating strategies.

While the outlook for the equity market remains challenging, there are reasons to be optimistic particularly if the key driver of inflation, high energy prices, continue to normalise. Despite the cost of living squeeze, households and banks are also better capitalised than in previous years meaning they have more ability to withstand higher prices and disruption before altering their spending or lending actions. Within the UK market, particularly within smaller companies, valuations now appear more reasonable than they have been, which is offering many greater and more diverse opportunities to investors.

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IMPORTANT INFORMATION

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Prior to 15th October 2020, the fund was named Sarasin UK Equity.

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There is no minimum investment period, though we would recommend that you view your investment as a medium to long term one (i.e. 5 to 10 years). The investments of the fund are subject to normal market fluctuations. **The value of the investments of the fund and the income from them can fall as well as rise and investors may not get back the amount originally invested**. If investing in foreign currencies, the return in the investor's reference currency may increase or decrease as a result of currency fluctuations. **Past performance is not a guide to future returns and may not be repeated.**

The Fund may invest in smaller company shares which can be more unpredictable and less liquid than those of larger company shares. Frequent political and social unrest in Emerging Markets, and the high inflation and interest rates this tends to encourage, may lead to sharp swings in foreign currency markets and stock markets. There is also an inherent risk in the smaller size of many Emerging Markets, especially since this means restricted liquidity. Further risks to bear in mind are restrictions on foreigners making currency transactions or investments.

For efficient portfolio management the Fund may invest in derivatives. The value of these investments may fluctuate significantly, but the overall intention of the use of derivative techniques is to reduce volatility of returns. The Fund may also invest in derivatives for investment purposes.

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