VT Downing Small & Mid-Cap Income Fund
Quarterly Commentary – March 2026

Markets were volatile during the first quarter and served as a salient reminder of how quickly prevailing views and themes can reverse. The perceived "winners" and "losers" appeared to change on an almost monthly basis in the period. Markets entered 2026 with expectations that economic growth was going to remain robust within the backdrop of supportive monetary policy, with forecasts suggesting at least two 25 basis points interest rate cuts in the US and UK. Therefore, largely supportive of risk assets and in the case of the UK, finally supportive of better consumer conditions. This narrative quickly flipped heading into February as attention turned to the impact of further advancements in AI could have on a whole host of business models. This created a new financial markets acronym – "HALO" or heavy assets, low obsolescence. The view that as powerful as AI is becoming, it literally cannot dig holes and bash metal, and therefore these sectors were in vogue as investors sought to avoid any perceived AI disintermediation risk. This theme was particularly painful for the Fund, given lower overall exposure to HALO qualifying companies and generally more capital-light businesses as evidenced by the Fund's weighted average return on equity of 26.8%[1]. Finally, on the 28 February, the US and Israel launched airstrikes across Iran, to which Iran retaliated via strikes on Gulf states and closing the Strait of Hormuz. The subsequent rise in oil and gas prices impacted HALO winners, largely because most are energy-intensive and impacted by slowing economic growth. Further, markets switched from pricing interest rate cuts to hikes by the end of 2026, as the conflict continued over March. At the time of writing, all three nations agreed to a two-week ceasefire and to initiate negotiations to end the conflict completely.

Frustratingly, all of the volatility above overshadowed what was a largely positive earnings season in the UK. This was also seen at the Fund level, with companies who reported results in the period, largely reporting numbers ahead or in line of guidance. However, this is backward-looking and markets were more concerned with how the macro developments would impact future growth prospects. We hope that a more benign macro environment for the rest of the year can return to a focus on company fundamentals.

Fund performance was robust during the quarter on a relative basis, with the Fund delivering -5.86% compared to the IA UK Smaller Companies TR sector return of -6.86%.

The winners

The top contributor to performance in the period was Serica Energy, a company that engages in the exploration and development of oil and gas assets in the North Sea. In addition to being buoyed by elevated oil and gas prices, Serica announced full-year results that pointed to a much stronger operational outlook. The company had used its significant firepower to acquire additional operational assets in the North Sea that help diversify its production profile to reduce the impact of unforeseen outages on key assets. The board guided to current production rates of c.50,000 BOEPD (barrels of oil equivalent per day) in 2026, compared to 27,600 BOEPD during the course of 2025.

[1] as of end of February 2026

Cohort is the parent company of seven individual defence and security companies across two subsectors; communications and intelligence, and sensors and effectors. The company announced multiple contract wins during the period. Firstly, with a UK government customer for immediate delivery of uncrewed air systems, ultimately giving full year consensus revenue cover. This was followed by two contract wins with the Portuguese Navy to provide satellite communication terminals and integrated communication systems and networks to new patrol vessels. These contract wins underpin our view that Cohort remains well positioned with European NATO members and has high exposure to where we expect members to focus spend in areas such as counter-drone, sonar and communication systems.

The losers

FRP Advisory engages in the provision of financial advisory services, such as insolvency, restructuring and corporate finance. FRP announced no news during the period. However, we did notice that the company has been appointed as administrator on a few high-profile cases, which should help underpin future earnings. We believe the share price performance could have been impacted by AI concerns, although we believe that, given the majority of its revenue is generated by insolvency-related work, the highly sensitive and critical nature of the work largely reduces this risk. We have also noticed AIM-listed names coming under pressure as we assume some investors are seeking to capitalise on the different IHT relief attached to AIM shares and private IHT opportunities. These came into effect for the 2026 tax year in April and therefore created a degree of "forced selling" ahead of this. We expect the situation to normalise as the tax year commences and is completely detached from underlying company fundamentals.

Dunelm, an omnichannel homewares and furniture retailer in the UK and Ireland, announced interim results during the period. The market was concerned by a slowdown in Q2 sales compared to Q1 and guided to full year profit before tax towards the lower end of the guidance range. Whilst disappointing, the company announced a further 25p special dividend, putting it on close to a 10% dividend yield, supported by double-digit free cash flow yield on our forecasts. We took the opportunity to add to our position, given that historically investors have been well rewarded by buying Dunelm stock around the current valuation. In addition, the group has tended to win greater market share from weaker competitors when conditions are tough.

Portfolio activity

During the quarter, the Fund completed five full exits; Kitwave and JTC were both exited following bids for the companies by private equity. TP ICAP was exited after delivering a good return for the Fund, but the next catalyst of a potential IPO of its data business in the US appears less likely in the short term, leaving not much more additional upside. Kainos was exited as one of the companies we held with a high perceived AI risk given its exposure to Workday. Speedy Hire was exited due to concerns that despite good strategic action, the company would struggle to outperform without a sustained recovery in UK construction, which now feels less likely. The Fund initiated five new positions; Renew Holdings, a company that we believe is well positioned to benefit from increased spending in regulated water, energy transmission and distribution and general infrastructure in the UK. Nichols was added to the portfolio given soft drinks is a relatively robust sector and the company has meaningful cash resources to either return to shareholders or deploy in acquisitions. Mears Group was added as we believe it should benefit from increased regulation surrounding social housing maintenance and win market share as competition actively exits the market. Greencore was bought as we see meaningful revenue and cost opportunities following its merger with Bakkavor. Luceco was added because it is gaining market share as two key international competitors exited the UK market, and a new revenue stream linked to demand side response and EV charging which we believe isn't priced into future market forecasts.

Fund Merger

The proposal to merge VT Downing Unique Opportunities Fund, a sub-fund of VT Investors Funds ICVC with VT Downing Small & Mid-Cap Income Fund, a sub-fund of VT Downing Investment Funds ICVC was approved by VT Downing Unique Opportunities Fund shareholders on 27 March 2026. The Authorised Corporate Director and appointed Fund Manager believe this merge will deliver greater economies of scale, resulting in lower expenses for shareholders and improved prospects for future growth. This came into effect on the 10 April 2026.

Josh McCathie

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