ARTEMIS UK Smaller Companies *Fund*

Manager's Short Report

For the six months ended 30 June 2016

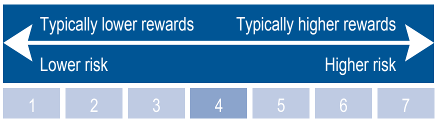
Investment objective and policy

The objective of the fund is to achieve long-term capital growth. The emphasis of the fund will be investment in smaller companies listed, quoted and/or traded in the UK and in smaller companies which are headquartered or have a significant part of their activities in the UK which are quoted on a regulated market outside the UK.

The manager actively manages the portfolio in order to achieve the objective and will not be restricted in respect of investments by industrial sectors. The securities of companies listed, quoted and/or traded in the UK but domiciled elsewhere and the securities of companies traded on ISDX may be included in the portfolio.

The fund may also invest in other transferable securities, units of collective investment schemes, money market instruments, warrants, cash and near cash, derivatives and forward transactions and other investments to the extent that each is permitted by the regulations.

Risk and reward profile



- This indicator is based on historical data and may not be a reliable indication of the future risk profile of the fund.
- The risk category shown is not guaranteed and may change over time.
- A risk indicator of "1" does not mean that the investment is "risk free".
- The indicator is not a measure of the possibility of losing your investment.

The risk indicator for the fund is as above because:

- The price of units, and the income from them, can fall and rise because of stock market and currency movements.
- Stock market prices, currencies and interest rates can move irrationally and can be affected unpredictably by diverse factors, including political and economic events.
- A portion of the fund's assets may be invested in a currency other than the fund's accounting currency (sterling). The value of these assets, and the income from them, may decrease if the currency falls in relation to sterling, in which the fund is valued and priced.
- Investing in small and medium-sized companies can involve more risk than investing in larger, more established companies. Shares in smaller companies are often not as easy to sell as shares in larger companies are. This can cause difficulty in buying, valuing and selling those shares. Also, reliable information for deciding their value or the risks may not be available.

Fund information

Launch date	3 April 1998
Unit types	I accumulation R accumulation
IA sector	UK Smaller Companies
Historic yield *	
I accumulation	1.7%
R accumulation	0.9%
Accounting dates	30 June & 31 December
Distribution date	28 February

* The historic yield reflects distributions declared over the past 12 months as a percentage of the mid-market unit price, as at the date of this report. It does not include any preliminary charge and unitholders may be subject to tax on their distributions.

ARTEMIS
The PROFIT Hunter

Investment review

- The Brexit vote caused shares of smaller companies to weaken.
- The fund fell by 7.3%* versus a 5.6%* drop in the benchmark index.
- Amid economic uncertainty, attractive valuations offer reason for hope.

Performance – Held back by Brexit and the mining sector's bounce …

Our investment philosophy is to seek good businesses with attractive financials and buy stakes in them at reasonable valuations. We look for stocks that will perform well across the economic cycle and try to avoid taking a strong view on economic trends. This approach tends to steer us towards companies with defensive, predictable cash flows and strong balance sheets and we therefore expect our holdings to perform relatively well in more challenging markets. With this in mind, we are disappointed with the performance of the fund over the first six months of 2016.

The two main hindrances were both macro events: the UK's decision to leave the EU and a sharp bounce in the mining sector. Although the fund is relatively defensively positioned, some of its stocks are exposed to the domestic UK economy. These holdings fell in anticipation of a prolonged period of uncertainty and an increased risk of recession. This was compounded by the fact that we have little invested in the mining sector. We will probably never have significant exposure to mining companies, whose reliance on commodity prices and high capital requirements do not fit our investment philosophy. And while that stance was helpful in 2014 and 2015 it has been unhelpful this year.

Review – A story of stocks …

The fund's biggest winners were an eclectic mix of stocks exposed to a reassuringly broad variety of different themes. In contrast, the main negatives were concentrated in two specific areas: not owning mining stocks (which did well) and owning stocks exposed to the UK economy (which were lacklustre ahead of the referendum and very weak after it).

The fund's worst performer was Centaur Media (business publishing and conferences). Its initial weakness came as a simultaneous upgrade of its financial and sales IT systems caused cashflows to disappoint. The shares fell again following the referendum, which seemed to point to a deterioration in the advertising market. Believing that the valuation already reflects the challenges Centaur Media faces – but not the improvements it has made to the business and the anticipated resolution of its working capital issues – we retained our holding. Other stocks hurt by the deteriorating outlook for the UK economy included Lookers (the UK car dealer), STV Group (the Scottish broadcaster) and Creston (the marketing services group).

The fund's best performer was Somero Enterprises (laser-guided machinery for levelling concrete) which continued to grow quickly in its main markets of the US, Europe and China. This has been a great investment for the fund over the last few years as demand from the construction industry recovered following the banking crisis. The company has a near-monopoly position, high returns on capital and high margins. The main risk lies in its dependence on the economic cycle. We feel Somero Enterprises is in a far better position now than it was after the banking crisis: it has a wider geographic spread and is amassing a considerable pile of cash. But conscious of the cyclical risk, we have trimmed our weighting despite the modest valuation.

Other winners included Ithaca Energy (in anticipation that, after a long delay, production at its Greater Stella Area oil field in the North Sea is about to begin); H&T Group (the leading UK pawnbroker which benefitted from the rising price of gold) and Tarsus Group (an exhibitions provider with strong underlying trading in overseas markets).

A new holding was Consort Medical, a world leader in the manufacture of specialist valves for medical inhalers. We expect the company to benefit from the investment it has made in adapting its technology to develop a range of new products (such as auto-injectors, valves that can push very viscous drugs through syringes safely). Since acquiring Aesica (a company which formulates and manufactures drugs) in 2014, it has made good progress in improving its margins and we are confident that there is more to come. This should drive solid earnings growth in a stock that has relatively little exposure to the economic cycle. A joint project with British American Tobacco to sell the first medically approved e-cigarette in the UK and cross-selling Aesica's offering to Consort Medical's established customer base – and vice versa – also represent opportunities.

We also started a small new holding in FDM Group Holdings. This company has an exceptionally strong record of providing graduate IT consultants to large corporate customers in the UK and, increasingly, in the US where the potential to grow looks very positive. While not cheap on 20x next year's earnings, the shares look reasonably valued given its 5% free cash flow yield and the scope for annual growth of 20% to continue.

We had very little exposure to real estate at the start of the year and had become slightly nervous that the sector might rally had the referendum produced a vote to 'remain'. We therefore added property developers Helical Bar and U & I Group (both of which were trading on a discount of around 40% to their assets) as well as to Hansteen Holdings, which

* Source: Lipper Limited, class I accumulation units, bid to bid basis, in sterling with income reinvested to 30 June 2016. Benchmark is the Numis Smaller Companies (excluding Investment Trusts) Index.

specialises in industrial property in the UK and Europe. While the 'leave' vote hurt Helical Bar and U & I, Hansteen Holdings performance was helped by its European exposure. And it was encouraging to see the managing director of U & I buying more shares in his company following the vote.

On continued positive trading and margin improvement, we also added to Severfield, a specialist in structural steel.

Investors seem happy to award steadily higher valuation multiples to those companies that can demonstrate structural organic growth in sales (of, say 10% per annum). While the fund has benefited from the higher ratings being awarded to 'growth' companies we began to worry that a lot of good news was already in the price. We therefore continued to take some profits in Dechra Pharmaceuticals, GB Group and Advanced Medical Solutions Group. While these remain high quality investments, we felt their potential was being more accurately valued by the market.

We also added to our holdings in Victrex and Senior, whose share prices we felt had been unduly hurt by short-term factors but where the long-term fundamentals remain attractive. In the case of Victrex, short-term worries over lower demand from industrial customers due to the lower oil price have overshadowed its strong market position, excellent returns on capital and the long-term demand for its lightweight 'super plastics'. The shares of aerospace supplier Senior, meanwhile, were hit by the worsening outlook for its industrial division. The market seems to be overlooking the positive long-term outlook for its commercial aerospace business. A growing number of aircraft are being built, order books at Boeing and Airbus are strong and Senior is supplying an increased value of work to both manufacturers.

Outlook – Too soon to be brave but valuations provide reason for hope ...

The Brexit vote, and the political turmoil and economic uncertainty it has produced, is not good news for the UK's smaller companies. Consumers and companies seem likely to defer their spending decisions, thereby reducing economic activity and lowering profits. In this context, the market's reaction to the vote does not appear extreme. Few companies have yet changed their earnings guidance and the likely future stream of earnings downgrades may prove difficult for share prices to absorb.

Because we think it is too early to be brave, we have let a little more cash build up than usual (around 4%). We will use this to take advantage should there be any kneejerk reactions to disappointing trading statements. In some cases, it may be that shares are being punished for a negative announcement despite having already been re-priced. But we have not seen many examples of this yet.

If worries about the economy are understandable, there are reasons for optimism. Sterling's weakness should make it more attractive for foreign buyers to pick up some cheap assets while also increasing the value of earnings derived overseas. Small caps are less indebted than large caps and are more likely to become takeover candidates – particularly given the increasing gap between the (falling) cost of money and free cash-flow yields. Despite these attractions, they currently trade on a 20% valuation discount to large caps (the discount on which micro caps trade is even greater). This compares to their 30-year average of trading on a similar rating to large caps. So, in time, we can expect the discount to narrow.

We find it encouraging that there has been a marked increase in directors buying shares in their own companies since the Brexit vote. We would also argue that small caps tend to be more focused, more nimble and offer greater long-term growth potential.

While stocks that will be hurt by any downturn in the UK economy (such as Centaur Media, Creston, Severfield and SafeStyle UK) make up about a quarter of the fund, a similar proportion is invested in exporters (like Victrex, XP Power, Ebiquity and Alliance Pharma) who will benefit from the weakness in sterling. Overall, around 45% of the sales made by companies in our portfolio are to markets overseas.

Our portfolio remains defensively positioned and highly selective. Amid economic and political uncertainty, we will stick to our investing principles: looking for companies that can produce a growing stream of recurring cashflows and high returns on capital on a three-to-five year view.

Mark Niznik & William Tamworth
Fund managers

Investment information

Portfolio split

	30 June 2016 % of net assets	31 December 2015 % of net assets
Industrials	26.12	26.93
Consumer Services	24.44	27.90
Financials	10.89	9.54
Healthcare	9.87	11.19
Technology	9.43	10.27
Consumer Goods	7.79	10.29
Basic Materials	2.71	1.41
Telecommunications	2.48	3.74
Oil & Gas	2.02	0.80
Net other assets/(liabilities)	4.25	(2.07)
Net assets	100.00	100.00

Ten largest investments

Investment	30 June 2016 % of net assets
Mears Group Plc	3.18
Alliance Pharma Plc	2.90
Somero Enterprises, Inc.	2.77
4imprint Group Plc	2.59
Tarsus Group Plc	2.55
Telecom Plus Plc	2.48
Victrex Plc	2.39
H&T Group Plc	2.39
Ebiquity Plc	2.24
Computacenter Plc	2.17

Investment	31 December 2015 % of net assets
Alliance Pharma Plc	3.05
Xchanging Plc	2.99
Mears Group Plc	2.89
Centaur Media Plc	2.88
Brooks Macdonald Group Plc	2.82
4imprint Group Plc	2.78
Tarsus Group Plc	2.64
Somero Enterprises, Inc.	2.52
Advanced Medical Solutions Group Plc	2.49
Ebiquity Plc	2.42

Comparative tables

Fund sizes & net asset values

Date	Net asset value of fund (£)	Net asset value per unit (p)	Units in issue
31 December 2013	374,773,996		
I accumulation		1,069.71	3,035,743
R accumulation		1,042.81	32,824,779
31 December 2014	352,564,346		
I accumulation		1,030.36	7,254,602
R accumulation		996.90	27,867,898
31 December 2015	362,833,433		
I accumulation		1,226.58	12,277,533
R accumulation		1,177.82	18,019,746
30 June 2016	321,964,009		
I accumulation		1,138.61	13,167,597
R accumulation		1,089.27	15,793,785

Net revenue distribution & unit price range

Year	Net revenue per unit (p)	Highest offer price (p)	Lowest bid price (p)
I accumulation			
2011	10.4173	776.31	647.37
2012	13.0988	850.36	668.72
2013	13.4033	1,109.43	827.87
2014	13.2081	1,152.02	976.02
2015	19.0415	1,273.98	1,027.43
2016 *	-	1,268.07	1,112.33
R accumulation			
2011	4.5341	801.49	642.48
2012	7.2179	868.21	661.67
2013	6.3963	1,124.37	812.96
2014	4.9573	1,166.14	945.81
2015	9.9780	1,271.79	993.92
2016 *	-	1,264.08	1,064.16

Net revenue includes all amounts paid and payable in each calendar year.
* To 30 June 2016.

Ongoing charges

Class	30 June 2016
I accumulation	0.84%
R accumulation	1.59%

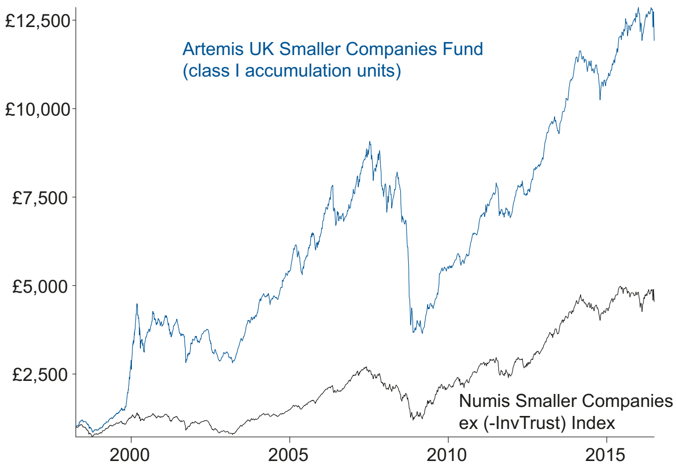
Ongoing charges shows the annual operating expenses of each unit class as a percentage of the average net assets of that class for the preceding 12 months.

Class I performance

	Since launch *	5 years	3 years	1 year	6 months
Artemis UK Smaller Companies Fund	1,092.3	56.0	27.5	(1.1)	(7.3)
Numis Smaller Companies ex (-InvTrust) Index	354.6	56.7	24.0	(6.6)	(5.6)
Sector average	357.2	50.9	25.8	(6.0)	(9.1)
Position in sector	2/17	27/41	27/46	11/47	15/47
Quartile	1	3	3	1	2

* Data from 3 April 1998. Source: Lipper Limited, data from 3 April 1998 to 1 September 2010 reflects class R accumulation units, bid to bid in sterling to 30 June 2016. All performance figures show total returns with income reinvested, percentage growth. Sector is IA UK Smaller Companies, universe of funds is those reporting net of UK fees.

Value of £1,000 invested at launch to 30 June 2016



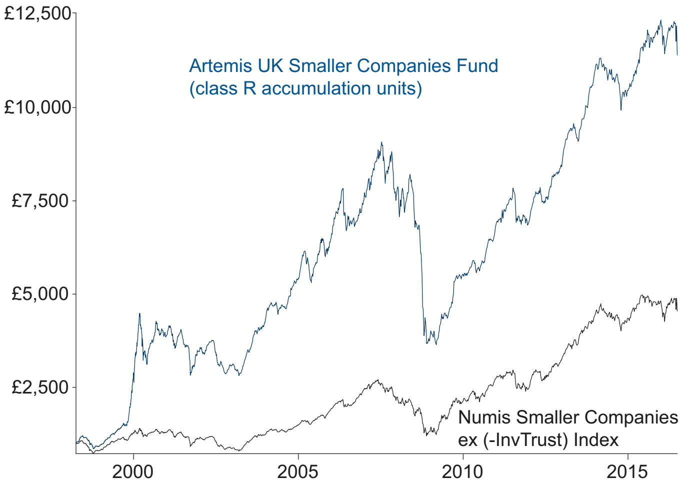
Comparative tables (continued)

Class R performance

	Since launch *	5 years	3 years	1 year	6 months
Artemis UK Smaller Companies Fund	1,040.6	50.2	24.7	(1.9)	(7.6)
Numis Smaller Companies ex (-InvTrust) Index	354.6	56.7	24.0	(6.6)	(5.6)

* Data from 3 April 1998. Source: Lipper Limited, class R accumulation units, bid to bid in sterling to 30 June 2016. All figures show total returns with income reinvested, percentage growth.

Value of £1,000 invested at launch to 30 June 2016



Changes to performance reporting

Following recent guidance from the Investment Association, changes have been made to fund performance disclosure. The majority of investors now buy 'clean class' fund units (typically those with the lowest charges), which for Artemis is the class I units. Sector performance information is therefore now shown for class I units, rather than for class R units.

Performance reporting periods for Artemis' fund class I unit classes are now shown from the launch of the fund, rather than from the launch of the unit class. Where class I units were launched at a later date than the fund, the earlier period reflects the performance of the class R units, and from the launch of the class I units, reflects the class I performance.

General information

Report & accounts

This document is the Short Report of the Artemis UK Smaller Companies Fund for the six months ended 30 June 2016. The Half-Yearly Report can be obtained from the manager's website **artemis.co.uk**, by contacting the Client Services team on 0800 092 2051 or by writing to the manager's address below.

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