

SARACEN NEWSLETTER

The problems being faced by banks, both in the USA and Europe, have come as a very big shock to investors and, as a result, have dragged down equity markets in the UK and elsewhere. There is even talk that this is the end of capitalism which I have not heard since the very severe UK stock market downturn in the early seventies. Before that, investors would probably have to go back to the depression of the 1930's in the USA following the Wall St Crash (and I was not around at that time!) to hear that kind of talk. The one point that I would make, however, is that, in my view this is not the end of capitalism and the sell-off in UK equities has been overdone. This provides investors with significant opportunities to purchase UK shares at what we believe to be bargain basement prices. The indiscriminate sell-off has been driven by shareholder anxiety and very little attention has been paid to the fundamentals. As always what we at Saracen are focusing on are these fundamentals and we continue to purchase shares in good companies with strong cash flows, sound balance sheets and good growth prospects at reasonable valuations. Highly financially-gearred companies are now being shunned by the stock market as the fundamentals are reasserting themselves.

Up to this point I have given you all the good news but let us take a closer look and give you the not so good news. For the nine months ending September 2008, the UK market as measured by the total return on the FTSE All Share Index is down 23% and during that period, Saracen Growth Fund has underperformed its benchmark. Although this is disappointing, nine months is a very short space of time in equity markets. The turmoil and volatility is providing wonderful opportunities to make significant amounts of money when the market turns. It is difficult to time the bottom of the market but it is our view, given the low valuations on offer, that we are very near to a turning point in the UK stock market. As such investors who can hold their nerve will be well rewarded in the future.

To get down to specifics, it is important for our investors to understand why our short term performance has been adversely affected and why we firmly believe we can return to our long term objective of outperforming and making money for our investors.

To give you some background on the Fund, we currently have 58 individual holdings diversified across a number of sectors of the UK stock market. Our investment philosophy and expertise is in stock picking and although we are benchmark and sector aware, we are not indexers or closet indexers. If we do not believe a particular share offers value, then we do not invest. For example, your Fund has benefited from previously having no holdings in the banking sector since we sold Barclays at the beginning of the subprime crisis last year at almost double the current market price. We also have no exposure to house builders and have had very little exposure to high street retailers. Very recently, following a substantial share price decline we invested in the shares of Marks & Spencer. Even more recently the Fund invested in three UK banks – Lloyds TSB, HBOS and The Royal Bank of Scotland following severe share price declines. On the assumption that the Lloyds TSB/HBOS proposed deal goes through we may be witnessing the formation of a Tesco of the banking sector with a very powerful presence in the domestic banking market. Even as little as six months ago no one would have contemplated this tie up on competition grounds.

Approximately 70% of the Fund is invested in the FTSE 350 with the balance in the smaller capitalised companies. To put this in perspective, the smaller companies in which we invest are usually capitalised at £100m+ therefore, in business terms, they are well established companies in their own right with growing sales, cash flows and profits. We very rarely invest in early stage

companies which have little or no presence in their markets as we believe the risks far outweigh the rewards for your Fund.

Reviewing our performance for the first nine months of 2008, eight of the top ten positive contributions to performance originated from our smaller company holdings. This reinforces our view that soundly financed fast growing smaller companies with strong cash flows can and do outperform in difficult times. The largest negative contributors to performance were our holdings in the larger companies within the stock market, particularly the FTSE 100. These included BP, Shell, British Telecom, Vodafone, Xstrata, International Power and Imperial Tobacco. Investors have shunned these companies in the market downturn but they are all selling on very low price/cash flow valuations and the majority have above average dividend yields. For example, BP and Shell are selling on dividend yields of 6.7% and 5.7% with price cash flows of 5.0-5.5x. On cash flow valuation measures this is a 50% discount to the market. Glaxo, usually regarded as a defensive stock is yielding c5%. BT and Vodafone also have above average dividend yields of c10.0% and 6.5% respectively which leads us to conclude that these ratings are not expensive.

We have, therefore, positioned the portfolio to benefit from inexpensive larger company holdings selling on low cash flow multiples and above average dividend yields. In addition, we have a good spread of faster growing smaller companies in the Fund which we believe will significantly enhance performance going forward.

Sharp swings in share prices brought on by uncertainty and emotions have made short-term investing difficult. We believe, nonetheless, that our fundamental analysis based on free cash flow will assist us in identifying inexpensive companies.

I can assure you fellow shareholders that with a large proportion of my personal wealth in Saracen Growth I share your short term pain. I am convinced, however, that we are near to a turning point and once again the fundamentals will reassert themselves and I firmly believe that our Fund is well positioned to benefit once we are in a more stable environment. Thank you once again for your continuing support.

Jim Fisher

Managing Director

Saracen Fund Managers