TB SARACEN UK INCOME FUND QUARTERLY REVIEW 30 DECEMBER 2016

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SARACEN
share success

Scott McKenzie

Fund Performance & Market Overview

	TB SUIF	MSCI UK All Cap (TR)	Relative
Q4 2016	**+4.7%**	**+3.8 %**	**+ 0.9%**

Source: Saracen Fund Managers, as at 30 December 16

Background

The fund continued to build on the strong recovery we saw in the third quarter and produced a positive return of 4.7% in the final three months of 2016. This was ahead of the 3.8% return from the MSCI UK All Cap index. Over the quarter the FTSE100 rose 4.3% and the FTSE Small Cap 4.0%. The Mid250 index lagged a little, rising 1.7%.

After the disappointing performance we endured during the first half of the year, it was pleasing to end the year in better shape. Our strategy is unchanged, with a focus on mid and small cap companies and a high exposure to financial and consumer sectors remaining in place. We continue to have a correspondingly low allocation to defensive sectors. This positioning was broadly beneficial during the fourth quarter, with defensive stocks being sold off heavily post Mr Trump's election and financial sectors generally performing strongly in the aftermath. As always with a focussed portfolio we are vulnerable to stock-specific disappointments but the good generally outweighed the bad during the period.

In our previous report we referred to the abnormal conditions apparent in the global bond markets. Subsequently, it proved to be a torrid quarter for bond investors and yields rose significantly from the all-time low levels we had witnessed in the autumn. The US presidential election proved to be a turning point, with investors speculating about the expansionary nature of Mr Trump's possible future policies. There is now a general view that both US growth and inflation are likely to increase in the years ahead. This led to a significant increase in ten-year US Treasury yields, from 1.6% to 2.4%. The other consequence was the ongoing strength of the Dollar, which rose 5% against the Pound and 15% against the Yen over the quarter. The oil price rose 14% to $57, reflecting bullishness on the OPEC production cuts announced. Gold fell sharply, however, down 12% as investors retreated from safe havens and into riskier assets.

In the UK Sterling continued to fall against the US Dollar but was stable against the Euro. UK economic indicators and confidence surveys continue to suggest a solid economic position but this is likely to be fragile with future investment and consumer intentions uncertain. Having reached all-time low yields of 0.6%, UK ten year gilts rose to 1.2%. The progress (or lack of) in the Brexit negotiations will be a dominant theme impacting UK assets going into 2017.

Positive Contributors

The star performer for the fund was our investment in **Sky** (see portfolio activity) which returned around 30% during the brief but profitable period in which we owned it.

Resource stocks continued their return to form with **Rio Tinto** rising 22%, **Royal Dutch Shell** 17% and **BHP Billiton** up 11%. All three benefitted from better commodity prices across the board and their Dollar-earning profiles. As mentioned before, oil producers responded positively to the proposed production cuts from OPEC. Another highlight for the fund was the speciality chemical company, **Victrex**, which rose 23% during the period, again driven by a significant potential boost to its profit from the fall in Sterling. In a similar vein, **Vesuvius** also did well, rising 13%, as investors focussed on better times ahead for the global steel industry.

Generally, our high exposure to financial stocks continued to be helpful. We took advantage of a significant recovery in **Barclays** to exit our holding and it was also pleasing to see **Lloyds** recovering after a fairly difficult 2016 in share price terms. **Intermediate Capital** continued to deliver strong results and rose 18%, whilst our large positions in life assurers, **Aviva** and **Standard Life** had a positive impact, with increases of just under 10% in each case.

Finally, a couple of our smaller companies made good contributions with **Kainos** rising 17% and **Palace Capital** 10%. We took the opportunity to reduce position sizes in both as a result.

Negative Contributors

The fund was blighted by one major disappointment, **Laird Group**, during the final quarter of the year. Having had lacklustre interim results in summer, a major profit warning in October compounded the problem, resulting in the shares falling 50%. To make matters worse the company will be cutting its dividend to preserve cash and is likely to raise equity in early 2017. All in all, a bitter pill to swallow and not a holding which we will retain in the fund longer term, albeit, we believe that the price can recover from currently depressed levels.

Stocks and sectors highly exposed to the UK consumer continued to lag the broad market recovery. The pub company **Greene King** fell by 10% as they expressed some caution over rising costs going into 2017. **DFS Furniture** also declined by just over 10% as a major investor reduced their holding. In our view, both share prices offer excellent long term value.

Following Mr Trump's election victory, we saw a major sell-off in defensive sectors. Whilst the fund has limited exposure to this trend, our two holdings**, Astra Zeneca** and **Imperial Brands** were impacted, falling 11% and 12% respectively.

Other fallers included **TalkTalk,** which has been an ongoing sore, and **Amec Foster Wheeler,** where poor progress on asset disposals saw the shares fall 17%. We have added to TalkTalk and await better news from Amec but acknowledge both are in the high-risk category.

Portfolio Activity

The fund has 32 investments which are spread across a variety of market capitalisations. As at 30 December 2016, the split of investment was 31% in FTSE100, 37% in Mid250 and 24% Small Cap/AIM, with a cash balance of 8%.

During the quarter, we made only one new investment, **Sky**, the tenure of which proved to be somewhat short-lived, but for good reasons. Sky is the leading pay TV business in the UK, Germany and Italy and also has a meaningful broadband subscriber base in each country. It is a company we had monitored for some time, being both a market leader and a business which has paid high, and rising, dividends consistently. When the fund began buying in October, the share price was in the doldrums with investors fretting over the inflated price of content (particularly football) and the perceived threat from online platforms such as Netflix. We built up the holding as the price continued to fall, to the extent that we had a meaningful investment when Sky was eventually bid for in December by its largest shareholder, 21st Century Fox. Our holding was sold on the day of the approach for a book profit of over 30%, ending a short-lived, but profitable, investment for the fund. If only it were always like this …

Other than the sale of Sky, we sold only one further investment outright. Our holding in **Barclays** had not always been an easy or profitable one and during the first half of the year the company not only halved its dividend but also saw a significant share price fall, as global banks remained firmly in the mire. On the basis of its much reduced dividend, the holding was no longer appropriate in the longer term for an income portfolio and we were able to take advantage of a rally of around 50% in the price from its low point in June. The company now appears to be on the road to recovery under new management but it is time for us to move on and seek better opportunities.

As is usual, we increased position sizes in a number of existing holdings where we felt value was most apparent. After much deliberation, we bought more **TalkTalk**, an investment which has let us down consistently. Whilst it is possible the dividend could be cut, we believe there is already a great deal of bad news in the price. Other additions included **Greene King**, **Astra Zeneca** and **Imperial Brands**. The latter two stocks were impacted by rotation out of defensive sectors in the light of Mr Trump's election. Both offer very high dividend yields whilst we wait. We trimmed position sizes in a number of smaller companies, including **Palace Capital, STV, Kainos** and **Eurocell**, all of which had enjoyed good price recovery since the middle of the year.

Portfolio Strategy & Themes

In previous reviews, we have written about Brexit and both its immediate and potential impact on the fund. We continue to assume lower UK GDP growth, a subdued housing market and weak Sterling going into 2017, although it is now possible we have seen the worst of the Pound's fall.

Our portfolio strategy is largely unchanged, and from a sector perspective, we have just under 30% of the fund held in financial sectors and around 25% in companies directly exposed to UK consumer confidence. The financial sector is now enjoying a rare period in the sun and we expect this to broadly continue into 2017. The stocks exposed to the UK consumer face an increasingly tough environment, however, as the consumer is squeezed, inflation rises and profit margins fall.

Our main portfolio themes are therefore largely as before.

1. Overweight financials: dividend growth remains solid and yields high

The prospects for dividend growth have diminished a little in recent months but we do not expect any current dividends to be under threat even on our worst-case scenarios. The life assurance sector in particular remains an attractive area for income investors.

2. UK housing and property: supply continues to lag demand

Whilst falling prices are now possible in residential property we believe that our holdings are robust. We have reduced slightly our exposure to commercial real estate. In every case, balance sheet strength will be key and the prospects for increased dividends are now fairly muted.

3. UK consumer: back the winners, focus on value

This segment of the fund is likely to continue to find life more difficult in 2017. This has been demonstrated in the first few days of the new year by a profit warning from Next. Whilst this is disappointing in the short term, businesses such as Next, DFS Furniture and Greene King have strong track records during times of adversity and trade on very low ratings compared to their history.

In terms of sectors where we have limited exposure, we continue to have a lower-than-average weighting in consumer staples and utilities where we see little valuation support despite recent falls.

Given our high exposure to medium and smaller companies, we are long Sterling assets and short overseas earners. This has been a significant headwind for the fund during 2016 and we can only hope that it will be less pronounced in the year ahead.

Investment Approach

The TB Saracen UK Income Fund aims to provide income exceeding 110% of the dividend income of the FTSE All-Share and an overall return (income plus capital growth) which is superior to that index.

We have a focussed portfolio of 30-45 quoted UK companies, a 'best ideas' fund with a high active share, currently at 84%. We generally ignore index construction considerations. Our approach is 'multi-cap' with significant investments in smaller and medium sized companies and correspondingly limited exposure to the largest companies found in most UK equity portfolios. Mid and Small Caps are currently 61% of the fund and large companies, 31%.

We spend virtually no time analysing what's in the news or pointlessly predicting random economic variables. Instead our time is spent searching for companies which the fund can invest in. These companies will fall into either of the following categories:

High Yield

Businesses which are facing challenges at present but who we believe offer secure, high dividend yields. A typically uninspiring bunch of companies but there to do the heavy lifting for shareholders' income. At times this group will cause us anguish and heartache, often being reviled by others and with real danger of dividend cuts.

Dividend Growers

These are companies with essentially bright or improving prospects which can compound into high levels of dividend growth. They may offer modest yields at purchase but have potential to become high yielding over the medium term. As we grandly proclaim them - 'the dividend stocks of tomorrow'.

To summarise, TB Saracen UK Income Fund looks to invest in companies with secure and (ideally) growing dividends. If we do this job well, they should be able to be held in the portfolio for many years, thereby minimising trading costs.

Fund Dividend

The year to 31 December 2016 marked the first full year of dividend income paid by the fund. Our interim dividend covering the six months to 30 June was 2.20p per share and for the six months to 31 December was 2.19p, giving a total for the year of 4.39p. This represents a yield on the issue price of 4.4%.

The forecast portfolio dividend yield based on our current expectations is 4.7%. This assumes modest growth in income from the portfolio over the next twelve months of around 4%. Our forecast dividend yield for the UK market as a whole is just under 4% with dividend growth of 6-8% expected, mainly due to the translation of Dollar dividends into Sterling. At this stage, it is too early to give firm guidance as to the level of distributions per share for 2017 but it is our firm intention to grow income per share well ahead of inflation in the year ahead.

Outlook

2016 proved to be a difficult year for the fund, in particular the immediate aftermath of the Brexit decision in June. With our high exposure to medium and smaller companies and low weighting to the overseas earnings of the largest FTSE100 companies, this proved to be a torrid period for shareholders. It is therefore pleasing to report improved results in the last two quarters of the year, albeit not quite enough to give a good outcome for 2016 overall. Throughout the difficult summer months, we conducted extensive stress testing across many of our investments and added to many of our holdings at depressed prices. This has helped shorter term performance whilst retaining our longer term focus.

Market returns in 2016 were surprisingly strong despite two seismic and unexpected political results in Brexit and Trump. These strong returns in the UK were led by the very largest index constituents where the fund has low exposure. If we are brave enough to assume a more 'normal' year ahead, then we would hope for better relative returns and solid absolute returns, with dividend yield making up a good proportion of total return.

Taking a more micro perspective, we believe that there remains significant potential value to be unlocked from the portfolio. A key challenge, as always, is to avoid the 'landmines' which can derail performance given our value and yield based approach.

We are wholly committed to improving shareholder returns and believe that our flexible 'multi-cap' approach, combined with a focus on a high and growing income, should serve us well over the long term.

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For further information on TB Saracen UK Income Fund please contact:

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Regulatory Status:
FCA Recognised: Yes
Scheme Type: OEIC

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