# SARACEN UK INCOME FUND QUARTERLY REVIEW 30 SEPTEMBER 2016

**FOR PROFESSIONAL INVESTORS ONLY- retail investors should consult their financial advisers**

SARACEN
share success

**Scott McKenzie**

## Fund Performance & Market Overview

| | SUIF | MSCI UK All Cap (TR) | Relative |
|---|---|---|---|
| **3 months** | **+13.9%** | **+7.7 %** | **+ 6.2%** |
| **Since 1/4/15 launch** | **-1.0%** | **+7.8%** | **- 8.8%** |

*Source:* Saracen Fund Managers, as at 30.9.16

After the very poor performance the Fund endured in the aftermath of the referendum on 24th June we are pleased to report a good recovery in our fortunes during the third quarter. 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. Whilst the focussed nature of our portfolio has heightened the volatility of results somewhat, we have taken the opportunity to add to a number of our favoured stocks at attractive prices and this has helped the Fund show some better results during the period under review.

Over the quarter we saw a welcome recovery in the FTSE 250 and FTSE Small Cap indices which rose by 10.7 and 12.1% respectively. Both indices are now above their pre-referendum levels having fallen sharply in the weeks after the Brexit decision. The FTSE 100 also continued to perform well and rose 7.1% over the three-month period.

Currency movements and the prospects for UK and European growth remain key battlegrounds for investors post the referendum. After a sharp decline in late June, the pound has continued to drift against the US dollar and the euro. Recent UK economic indicators and confidence surveys suggest a more stable economic position than the initial worst fears but this is likely to remain fragile with future investment intentions uncertain. In the light of the historic UK rate cut to 0.25% in August, medium-dated gilts are now yielding 0.6%, an all-time low. This has major implications for the funding of pension schemes going forwards. German and Japanese bond yields are also negative, highlighting the uncharted territory which investors must now navigate.

## Positive Contributors

After such a difficult period for the Fund in June a number of our former villains became heroes again during the third quarter.

Once again, our high exposure to mid and small companies became a virtue with many seeing material recovery. Our best performers included **St Ives** (+63%), **Galliford Try** (+41%), **Kainos** (+35%) and **FDM Group** (+37%). Our large position in **STV** also enjoyed a meaningful rally, rising 26%.

Resource stocks continued their return to form with **Amec Foster Wheeler** rising 18%, **BHP Billiton** 23% and **Rio Tinto** up 13%. All gained from better commodity prices and their dollar earnings profiles.

Our high exposure to financial stocks also benefitted with **Close Brothers**, **Barclays**, **Jupiter** and **Standard Life** each up more than 15%. **Aviva** also rose 10% and collectively our investments in this sector had a beneficial impact on the Fund's results.

Other notable positives were **Astra Zeneca**, which is the Fund's largest position and a major defensive dollar earner and **UBM**, which was very strong prior to its sale from the portfolio in late September.

## Negative Contributors

After such a strong recovery in markets we had only a handful of stocks which fell over the period.

In general terms, stocks and sectors highly exposed to the UK consumer continued to lag the broad market recovery. Retailers remain very much out of fashion with **Next** continuing to warn of tougher times to come for the UK consumer. In a similar vein, the pub company **Greene King** also expressed some caution. Both companies have strong track records in their sectors and we feel are being realistic rather than hopeful. Both share prices offer excellent long term value in our view.

**Berkeley Group** is another quality business whose shares continue to lag. With its high exposure to London residential property it is unlikely to be in fashion anytime soon but, again, its track record of managing cycles is exemplary.

Other fallers included **Laird Group,** where interim results were poor, with the CEO subsequently leaving to join Cobham. **TalkTalk** also continued to drift as competition concerns in the telecoms sector continued to hinder progress.

## Portfolio Activity

The Fund has 33 investments which are spread across a variety of market capitalisations. As at 30 September the split of investment was 31% in FTSE100, 41% in Mid250 and 23% Small Cap/AIM, along with a cash balance of 4%.

During the quarter we made two new investments. We added the furniture retailer **DFS**, where the share price had fallen over 30% in the weeks following the Brexit decision. Whilst the UK consumer undoubtedly faces some headwinds, DFS has very strong cashflow and a long history of gaining market share during tougher times. We see no reason why this will not continue and the low earnings rating and high dividend yield on offer was a compelling fit with our fund strategy. The shares have already begun to recover nicely since purchase, helped by a 'business as usual' trading statement in July.

Our other purchase was a small company, **Vitec**, which is a world leader in accessories for the broadcast and photography markets. These markets have been undergoing significant technological change and despite major disruptions, Vitec has continued to produce respectable results and a good level of dividend. After a number of years of limited progress, we believe that it is set to grow again, driven by a combination of exciting new products and complementary acquisitions. It is also a major beneficiary of sterling weakness with only 10% of sales in the UK.

To fund these investments, we sold two businesses, both of which had enjoyed significant upward re-ratings since purchase. **Ashmore** had seen a dramatic rally in 2016 as investors looked towards improvement in emerging market bonds, where it enjoys a strong position. Whilst there is evidence this recovery is now underway the share price has largely discounted better times ahead in our view. Similarly, our investment in **UBM** has delivered, with the company selling non-core assets and reinvesting in its key events businesses to good effect. The net result has been that earnings have been largely unchanged during this process but the share price has risen significantly and the dividend yield is not what it once was.

In the aftermath of the Brexit vote we increased position sizes in a number of existing holdings, most of which made an immediately positive impact as markets recovered. We added to holdings in Amec, STV, Victrex and FDM at depressed prices. As market recovery took hold we reduced positions in Astra Zeneca, BHP Billiton, Vesuvius and Jupiter, all of which had enjoyed strong recovery and added positively to fund performance.

## Living with Brexit – portfolio positioning

In our previous review we wrote extensively about Brexit's immediate impact on the Fund. Many of the initial assumptions we made then regarding very low GDP growth, the housing market and weak sterling remain intact. We do not intend to cover this in any further detail here.

We believe, more importantly, in what the outcomes of our stress testing have shown and how this impacts the strategy of the Fund. We performed significant reviews of investments in sectors which are perceived to be vulnerable going forward. These included retailing, construction, real estate and banking. Consequently, our strategy is broadly unchanged, although our market sensitivity as measured by beta has risen in recent months.

From a sector perspective we have just over 30% of the Fund held in financial sectors and we estimate around 25% in companies directly exposed to UK consumer confidence. We have a lower than average exposure to consumer staples and overseas earners in general.

Our main portfolio themes remain 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, however, expect any current dividends to be under threat even on our worst case scenarios.

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

This statement may still hold true but falling prices are now possible in both residential and commercial property. Balance sheet strength will be key but, again, the prospects for increased dividends have reduced.

**3. Technological change: focus on connectivity and efficiency**

Our holdings in Kenos and FDM Group are exposed to public sector spending and banking respectively which will require careful monitoring but currently appear positive.

**4. UK consumer: back the winners, focus on value**

This segment of the Fund is likely to find life more difficult in the months ahead. We are focussed on businesses such as Next and Green King which have strong track records during times of adversity and trade on very low ratings compared to their history.

The approach we take is unashamedly value-based and, therefore, the current environment, although difficult, also offers opportunity. Many of our current investments were in this category prior to the EU vote and remain so now.

## Fund Income

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.

The forecast portfolio dividend yield based on our current expectations is currently 4.6%. This assumes 0% growth in income from the portfolio over the next twelve months so hopefully a fairly prudent assumption. The outlook for UK market dividends has actually improved in recent weeks, mainly due to the significant impact of a weak sterling on the dividends of major multinational income stocks. Our forecast dividend yield for UK equities as a whole is just under 4% with 5-7% dividend growth now expected, mainly due to translation from dollars to sterling.

The year to 31 December 2016 will be 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. Our intention is to sustain shareholders' dividends in any calendar year and, whenever possible, grow them.

## Outlook

After a very difficult period for the Fund in late June we are pleased to report improved results for this quarterly review. We have conducted extensive stress testing across many of our investments in recent months and have added to some of our investments at depressed prices. This has helped shorter term performance whilst retaining our longer term focus.

Prospects for investors are now more uncertain than they have been since the financial crisis of 2008. The ongoing Brexit process is likely to be a lengthy one and this adds up to a considerable period of risk, not just for the UK, but for large swathes of Europe too. Additionally, from a more global perspective, we have the US presidential election looming and unprecedented central bank behaviour, none of which offers any comfort.

Taking a more micro perspective, we believe that there remains significant potential value to be unlocked from the portfolio. We are wholly committed to improving shareholder returns and believe that our flexible 'multicap' approach, combined with a focus on a high and growing income, should serve us well over the long term.

Scott McKenzie, Investment Director

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**Risk factors you should consider before investing:**
**Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up and you may get back less than the amount invested. A full list of the risks applicable to this Fund can be found in the Prospectus. All fund performance figures calculated on a single price basis.**

**This Factsheet is for Professional Investors only.**

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**Custodian - BNY Mellon Trust & Depositary (UK) Ltd, 160 Queen Victoria Street, London, EC4V 4LA Regulatory Status:**
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