TB Saracen UK Alpha Fund

Quarterly Review – March 2018

SARACEN
share success

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FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

Fund Performance & Market Overview

	TB SUAF	MSCI UK All Cap (TR)	Relative
Q1 2018	-4.4%	-6.9%	+2.5%

Source: Saracen Fund Managers, as at 29 March 2018

Background

The fund held up relatively well during a difficult quarter, falling by 4.4% versus a 6.9% decline in the MSCI UK All Cap index. Having navigated fairly calm waters during 2017 equity market volatility returned with a vengeance and the UK has been one of the weakest global markets so far in 2018. Whilst negative returns are never to be celebrated, the Fund was placed in the top quartile of its peer group during the three months period (source: FE Trustnet)

Over the quarter there was further modest outperformance from small and midcap companies relative to the FTSE100 index and this helped the Fund to avoid the worst of the market declines. However, in general there were precious few safe havens.

Index total returns: 3 months to 29 March 2018	
FTSE 100	-7.2%
FTSE 250	-5.7%
FTSE Small Cap	-4.8%

The key differentiator for our returns was a return to bid activity, of which more later.

The portfolio has remained focussed primarily on mid and small cap companies and this strategic positioning is helping our overall results. Our high exposure to industrial, basic materials and consumer discretionary sectors remains in place and we continue to have a correspondingly low allocation to defensive sectors. We struggle to find value in this area of the market and we are wary of their positive correlation with low bond yields. Overall our portfolio profile delivered solid results but there were wide variances of returns, even within the same sector. Equity market volatility as measured by the VIX index almost doubled in the quarter.

From a geopolitical perspective, there were several developments, most of which caused investors some concern. The prospect of a trade war between the US and China has raised its head in recent weeks, prompting nervousness in global markets, many of which were trading at elevated levels anyway. Tax cuts in the US are also giving rise to increased inflation concerns globally and bond yields in most key markets rose over the quarter, with US Treasury yields rising from 2.4% to 2.8%.

Closer to home we continue to see slow but important progress on the Brexit negotiations with some loose agreements being made on transitional arrangements. Sterling continues to steadily improve and rose almost 5% against the dollar, which partially explained the sluggishness of the FTSE100 index, where 75% of profits are non-UK. Mrs May seems to be weathering the storm for now and appears to have dealt well so far with the thaw in relations with Russia post the Salisbury attack. By contrast Jeremy Corbyn is increasingly tangled up in internal strife within his party as the left increases its grip on power.

Performance Review

Positive Contributors

Against a difficult market background only 6 stocks held in the fund rose in value over the quarter. However, two of those were subject to takeover bids which provided a major boost to the Fund's returns.

The standout performer was **Laird Group** which agreed to a takeover bid in early March. With extreme good fortune we had only just purchased our holding days prior to the bid, having taken the view the stock had some hidden gems within. It was very pleasing to have this analysis confirmed shortly thereafter and the stock rose 70%, boosting our returns significantly.

The second highlight was the takeover of **GKN** by Melrose which saw GKN shares rise by 45%. There have been many column inches devoted to this contested deal of late. Having held GKN shares in the fund for many years it had become clear that the company had lost its way and the strategic changes announced had been somewhat defensive. Our past experience of Melrose has been favourable and we will continue to hold the stock under their ownership whilst acknowledging that this is a major step up for them in terms of scale.

Against a grim backdrop for retailers our investment in **Joules** continued to shine, rising 13% on delivery of another set of good results, confirming their excellent progress since IPO.

Two of last year's winners in the industrial sector were good performers again. Shares in **Vitec** rose another 9% after a transformational year in 2017 which saw it exit non-core activities and reinvest in higher growth businesses. **Avon Rubber** rose a further 5% as the company continued to attract a wider audience of investors.

Negative Contributors

Inevitably in such weak markets we had our share of setbacks and, in general, it was an unforgiving environment for those who disappointed. The main culprit here was **Greencore** which fell 42% on a profit warning within its legacy US operations. Whilst the downgrade to expectations was far less than this, investors have no confidence in the management after the major acquisition of Peacock and the resulting debt. We shall reassess the investment imminently. Another disappointment was **Galliford Try**, which announced a fund raising in response to the demise of Carillion, one of its partners in the Aberdeen road project. Adjusting for the rights issue the stock fell by around 20% despite good trading in its core businesses. We see significant recovery potential here and shall be participating in the issue. Whilst their results were solid, **Tyman** also announced an equity raising to finance a US acquisition. The combination of this with weak equity markets saw the shares give up 18%.

There were some ongoing underachievers from last year. An old adversary for us was **TalkTalk**, which having disappointed in late 2017 then announced an equity fundraising at a depressed price, leading to a fall in the shares of 23%. In a similar vein **Wood Group** also struggled during 2017 and remains cautious going into 2018. The shares have fallen a further 12% and there is much to prove, with the major acquisition of Amec to integrate and ongoing tough markets.

Two of our more meaningful holdings lost ground over the quarter. **RPC Group** continued to drift, falling 12% on no significant news, other than general concerns about plastic usage. **Shire** is a more interesting tale. Despite some tentative bid interest from Takeda the shares fell 8% over the quarter, albeit they rallied strongly on this development in late March.

Some of our strongest performers previously saw some profit taking. **Restore** fell 8% despite announcing the purchase of the TNT document operations. We view this as a positive and a deal which is well within their core competencies. **Victoria** hit some profit taking, falling 10% after an excellent run in 2017. The business now has real scale and margins are improving rapidly. We remain confident about their prospects.

Portfolio Activity

The fund has 30 investments with a bias towards small and mid-sized companies. As at 29 March 2018, the split of investment was 14% in FTSE100, 27% in Mid250 and 58% Small Cap/AIM. The portfolio is currently fully invested.

Purchases

There were two new investments made in the period. As detailed previously one of them thankfully was **Laird Group** which subsequently rose 70% on an agreed takeover bid**.**

The other was **Premier Asset Management**. Premier has performed well since its IPO a few years ago. We see it as a small asset manager with great potential which is well managed and in a number of investment 'sweet spots'. With AUM of just over £6bn it has potential to become a much larger business in the years ahead and benefits from very high returns on investment and a strong balance sheet, with limited requirement for additional capital.

We increased positions in three stocks over the quarter to the point where they have become our three largest investments. Our largest holding now is **Alpha Financial Markets Consulting**. This is a small, high growth company. The shares trade at last year's IPO price despite producing a positive profit warning recently. We see strong demand for their services for many years to come and expect high compound growth in earnings and dividends.

We added again to the holding in **Shire**, which trades on a substantial discount to the global pharmaceutical sector. With management credibility somewhat stretched at the moment, the news that Takeda was interested in bidding for the company means that the upside could be meaningful, and we would expect others to dust off their files on this business. We hope for positive news from here.

Our final large position increase was in **Palace Capital**, a small real estate business that we started buying in late 2017. The shares trade at a meaningful discount to assets and now that they have a full LSE listing we would expect interest in the company to increase. It is a business which has a lot of self-help potential and should become larger in due course.

Sales

There were four holdings sold outright during the period.

Following on from some profit taking in late 2017 we exited **FDM, Ashmore** and **Berkeley Group,** all of which had delivered sterling returns for the fund. Following a disappointing results statement and unexpected further investment required we sold the holding in **Moneysupermarket.com** where we see growth prospects as increasingly uncertain.

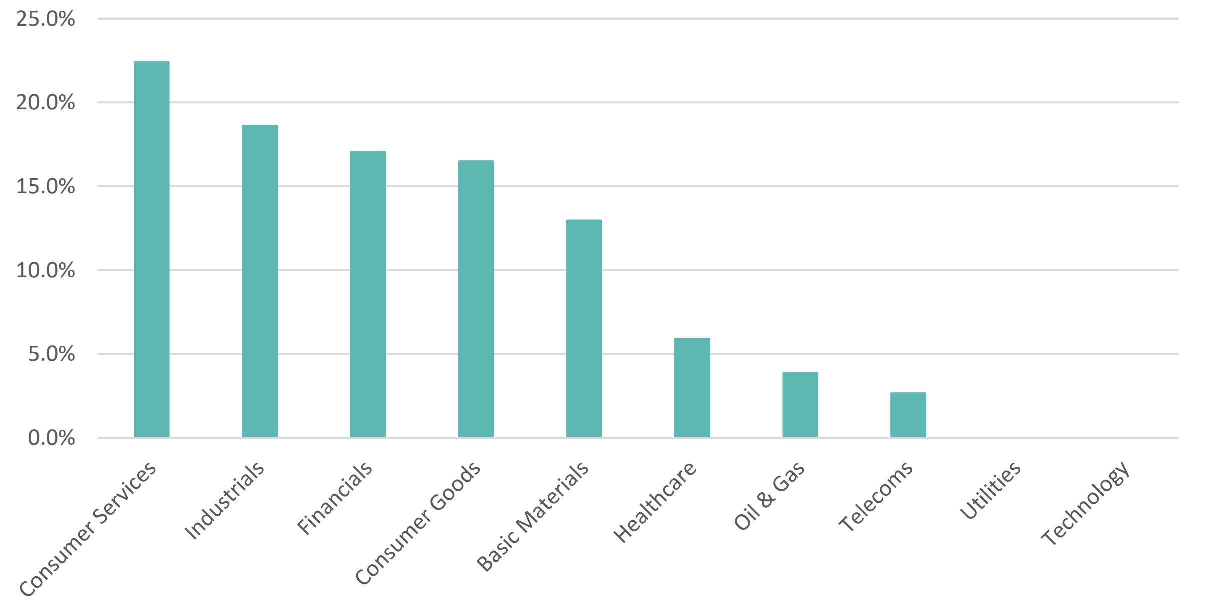
We also sold our holding in **Laird** after a short period of ownership**.** The bid is agreed and in cash, allowing us to reinvest in other holdings with more upside. We hope that another such stock comes along soon!

In general, we took profits in some industrial businesses which have been re-rated in recent years. These included **GKN** (post the takeover bid), **Hill & Smith**, **Rio Tinto** and **Victrex**.

Portfolio Strategy & Themes

The chart below highlights the mix of the portfolio by sector. It is important to note that we do not run the fund using a sector strategy – the portfolio construction remains resolutely bottom up. However, there are some stock selection themes which emerge.

TB Saracen UK Alpha: Sector Profile



Source: Saracen Fund Manager as at 29.03.18

Whilst on the surface the Fund appears to have a high exposure to the UK consumer, in reality we have a number of good growth companies operating under this broad heading. These would include Joules, MJ Gleeson and Clipper Logistics. In general though, we must be aware that consumers face an increasingly tough environment and whilst the Brexit negotiations intensify, these risks can only become heightened as the consumer is squeezed and confidence remains fragile. Despite this difficult UK economic outlook, we continue to have exposure to the housebuilding sector, where supply and demand remain unbalanced. Though falling prices are now possible in residential property, we believe that our holdings have great strategic value.

Our holdings in the industrial and materials sectors are mainly in smaller companies with strong global market positions and positive long-term growth drivers. These investments have proven to be a good antidote to the domestic exposure and generally offer significant diversification in overseas markets. The holdings in basic materials have similar characteristics, with Rio Tinto the only investment we would consider to be highly cyclical in this area.

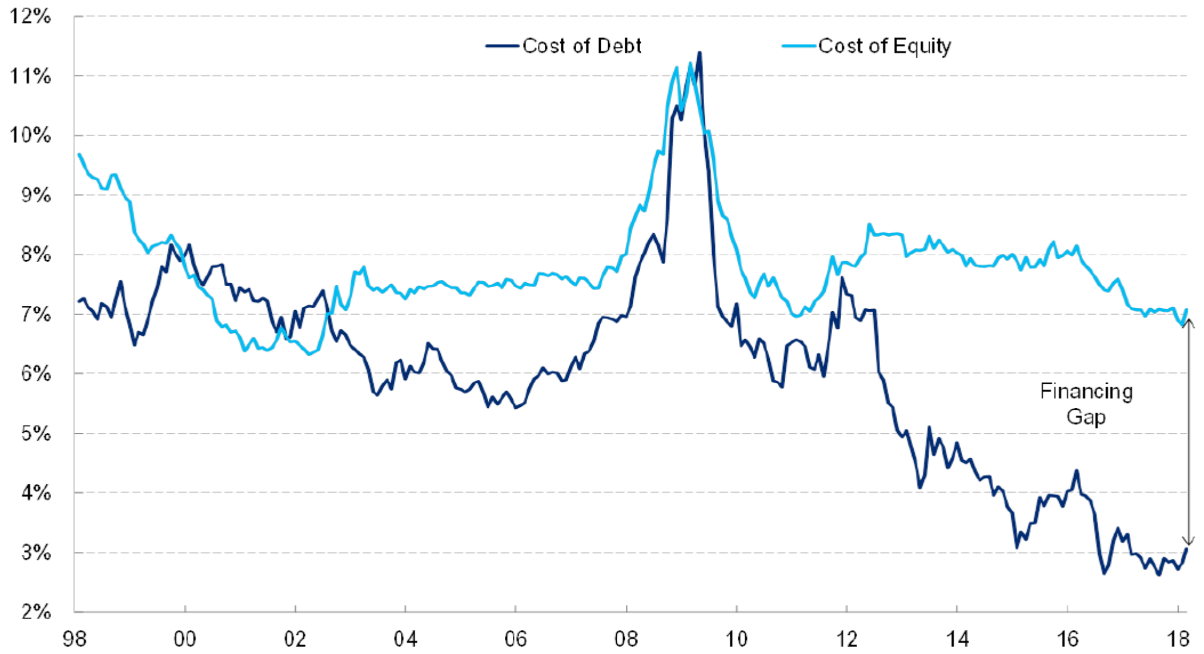
Given our high exposure to medium and smaller companies, in general we remain long sterling assets and short overseas earners. This was a significant headwind for the fund during 2016 but has been less of an obstacle recently as the pound has recovered.

In terms of sectors where we have low exposure, we continue to hold nothing in consumer staples where we see limited valuation support and weak underlying growth. We have no investments in utilities where a combination of high debt and increased political interference make dividend payments vulnerable in our view. Whilst the large oil majors offer high dividend yields and good value relative to history we don't see them as appropriate for a 'best ideas' fund such as this and have no exposure.

As a footnote it is worth noting the recent return of takeover activity in the UK equity market. The fund has been fortunate enough to benefit from two bids for industrial companies so far in 2018, namely GKN and Laird Group. There has also been a tentative approach for Shire, one of our largest holdings. Other sectors to have seen bids include media (UBM, Sky) and financial services (Fidessa, NEX). Whilst this is by definition difficult to predict it does nevertheless highlight a broad store of value to be had across many quoted UK companies.

The chart below highlights the attractive gap between the cost of equity and debt for acquirers at present. We anticipate that even more corporate activity will follow in the UK markets.

MSCI UK: Cost of Borrowing



Source: Datastream, Citi Research

Investment Approach

The TB Saracen UK Alpha Fund's investment objective is to achieve a long-term total return above the total return from the MSCI UK All Cap Index.

We have a focussed portfolio of 30 quoted UK companies making up a 'best ideas' fund with a very high active share, currently at 95%. We generally ignore index construction considerations and each position within the portfolio must be meaningful enough to make a difference to shareholder returns. 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 86% of the fund with large companies only 14%.

We target low levels of turnover in the fund. We like to be patient shareholders in businesses and invest for the long-term. If the underlying business is performing as we expect and the valuation is palatable, we remain invested. Stock prices can be volatile in the short-term and we take advantage of this by adding to existing holdings if prices weaken and trimming large positions if valuations get out of kilter at any point.

We spend very little time analysing what is 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 one of the following categories:

Core growth (50%* of portfolio assets)

We would expect the majority of the fund's assets to be held in core growth companies, businesses which can deliver consistently strong compound earnings growth rates over a long-time period, allowing us to hold them for many years to come.

Special situations (30%* of portfolio assets)

The special situations investments are businesses where the long-term prospects may not be sparkling but where we see significant catalysts for change. These catalysts would include new management and takeover / breakup potential. Patience is often required with this approach but it can be highly rewarding if executed well. This type of investment should be able to perform even in challenging stock market conditions.

Cyclical recovery (20%* of portfolio assets)

The final group are high quality, cyclical businesses where we recognise that economic conditions may not always be ideal but the company has sufficient strength of management and balance sheet to justify an investment.

**asset mix shown as at 29.3.18, source Saracen Fund Managers*

Our ‘Wish List’

When we aggregate the above groups and distil what we are looking for in our research, we have a ‘wish list’ for our investments which we hope will include some of the following qualities:

- Market leading positions
- Self-funded roll-out
- Unique assets
- Sustainably high margins
- Long-term visibility

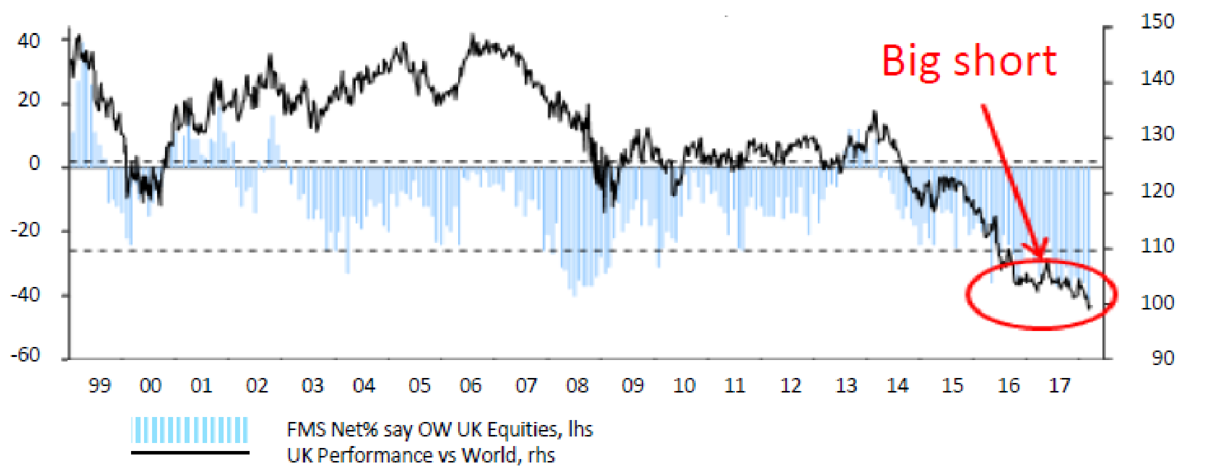
Not every investment (in fact very few) will have all of these attributes, but if a company possesses some of them, we will analyse them in more depth using our detailed financial templates before considering them for the fund.

Outlook

After a bumper period for global equities, the threats to markets are now beginning to materialise, with cracks appearing in high growth sectors such as technology, increases in market volatility and new fears of global trade wars. Monetary policy has begun to normalise globally and the huge central bank stimulus programmes which have been vastly beneficial to most asset classes must now inevitably unwind. Inflation expectations are generally rising everywhere leaving bond as well as equity markets vulnerable to shocks.

That’s the bad news. The good news for UK investors is that the UK stockmarket has rarely been less loved by fund managers. Yes, the Brexit process remains slow, ponderous and highly uncertain and timescales are now likely to extend beyond the initial 2019 deadline. However, since June 2016 global investors have fled from UK equities and this has led to material underperformance against the MSCI World. To compound this effect the BAML Global Fund Manager Survey now has a balance of -40% of asset allocators underweight UK shares, the highest since their records began.

Asset Allocation: UK Equities



Source: BofA Merrill Lynch Global Fund Manager Survey

The black line above shows the material recent underperformance of UK shares against global equity markets. The blue bars show us how much investors **currently** loathe UK shares.

The Fund delivered much improved results during 2017 and performance over both the short and long term remains strong. Our strategic commitment to investing in medium and smaller companies has remained intact and has enhanced overall investment performance. The recent addition of takeover activity within the portfolio has given our returns an added boost.

It is difficult at the moment to find good, long term growth companies at sensible prices and we must proceed with caution from here. A key challenge, as always, is to avoid complacency, particularly after a period of strong market returns and higher valuations than before. On the other hand, there are now many sensible businesses which are currently out of favour and offer significant upside potential. The recent takeover bids are testament to that.

Our ongoing priority is to keep increasing shareholder returns whilst being mindful of downside risks. We believe that our flexible ‘multi-cap’ approach, combined with a focus on core growth stocks, should continue to serve us well over the long term.

Scott McKenzie, Investment Director
6th April 2018
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