TB Saracen Global Income and Growth Fund

Quarterly Review – June 2018

SARACEN
share success

Graham Campbell
Chief Executive Officer

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FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

Fund Performance & Market Overview

	TB SGIG	Sector Avarge	Quartile
Q2 2018	+5.5%	+5.7%	3

Source: Saracen Fund Managers as of 29 June 2018

Background

The TB Saracen Global Income & Growth Fund has been trading for just over seven years. The current portfolio is the most 'value' orientated and cyclical one and invested in more European businesses that at any stage in the fund's history.

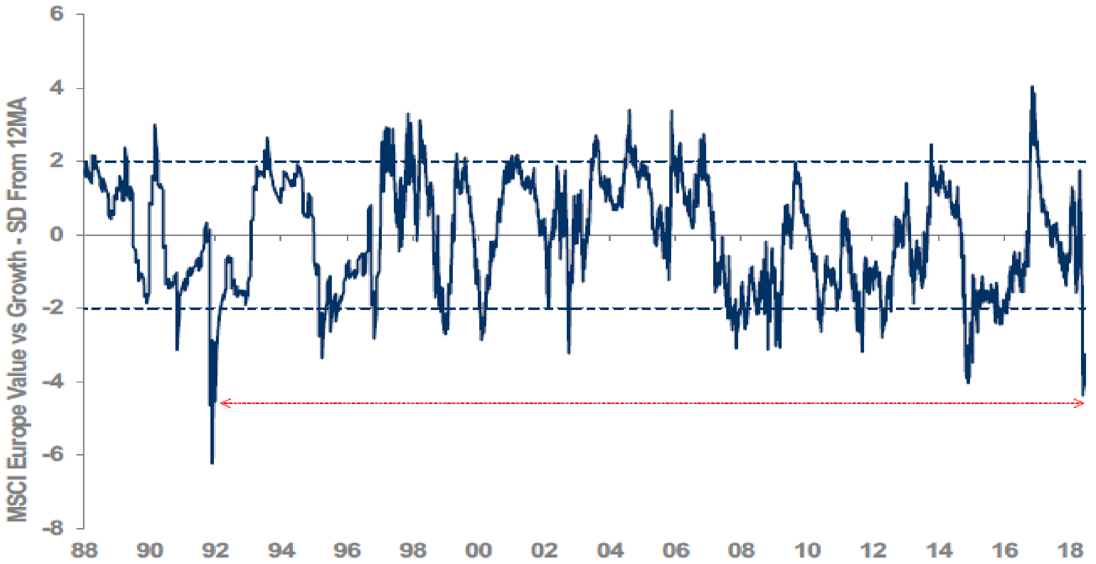
In this Quarterly Review, we will attempt to highlight some of the extreme valuation anomalies that we have identified and will hopefully explain the reason for the positions that we hold. It is tempting as an Analyst to find comfort in supportive evidence to justify a position. It is more useful however to constantly test the alternative hypothesis and re-evaluate our stance.

May we apologise in advance for the number of charts in this report. Our day to day work is 85% bottom-up, detailed analysis on individual investments and financial modelling. The resulting portfolio is therefore driven from the individual analysis, around some hard rules on valuations and weightings and is not constructed from a top-down macro or thematic view. Hopefully, the charts will help explain why we are finding investments of interest, that have these characteristics.

We are always wary of using broad-brush classifications such as 'Value' as they cover a variety of measures and the edges are often blurred. Our screens search for many positive attributes, such as balance sheet strength, interest cover, return on capital, etc. However, to be included in the portfolio, we are strict on the price we will pay. No matter how strong the business, it is a bad investment if the investor buys at the wrong price and overpays for actual growth. We are rarely attracted to a business that is not growing, unless we believe they trade at a significant discount to intrinsic value. At this stage of the economic and interest rate cycle, we are increasingly wary of high levels of debt.

As can be seen in the chart below, 'Value' has performed very poorly against 'Growth' styles.

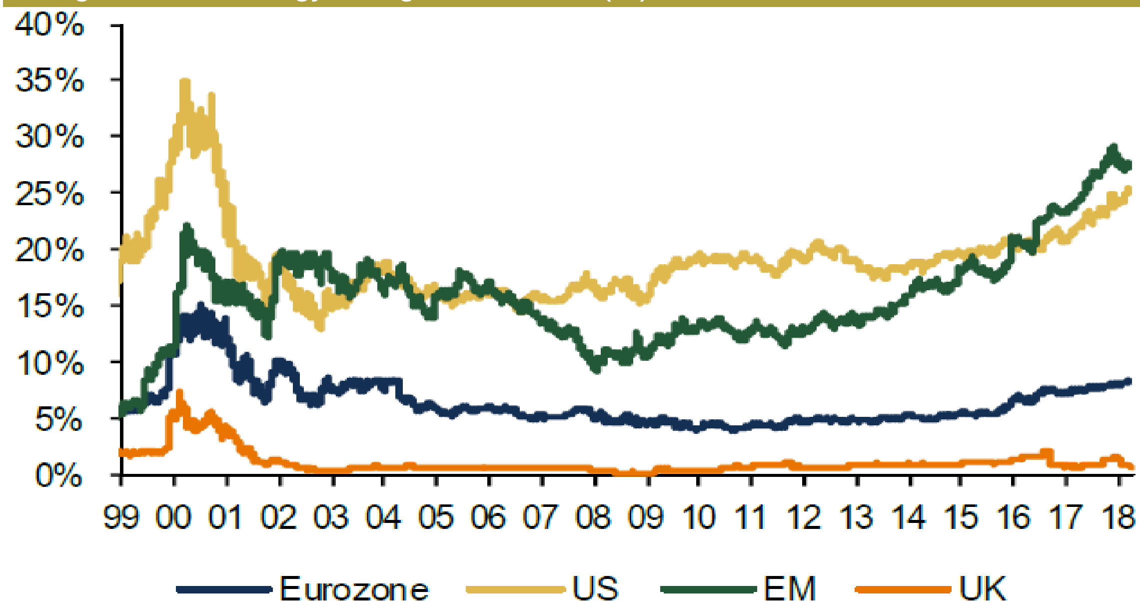
European Value vs Growth is the most oversold since the 1990s



Source: MSCI, Morgan Stanley

While 'Value' has clearly underperformed, it is also important to consider the drivers on the other side of the equation, namely 'Growth'. The chart below shows the rise of a major component in the 'Growth' weighting, i.e. Technology in major world indices. Post the tech boom and bust of the late 1990's – 2002, US and Emerging Markets Technology weightings have risen to account for around 1/3 of their respective MSCI indices.

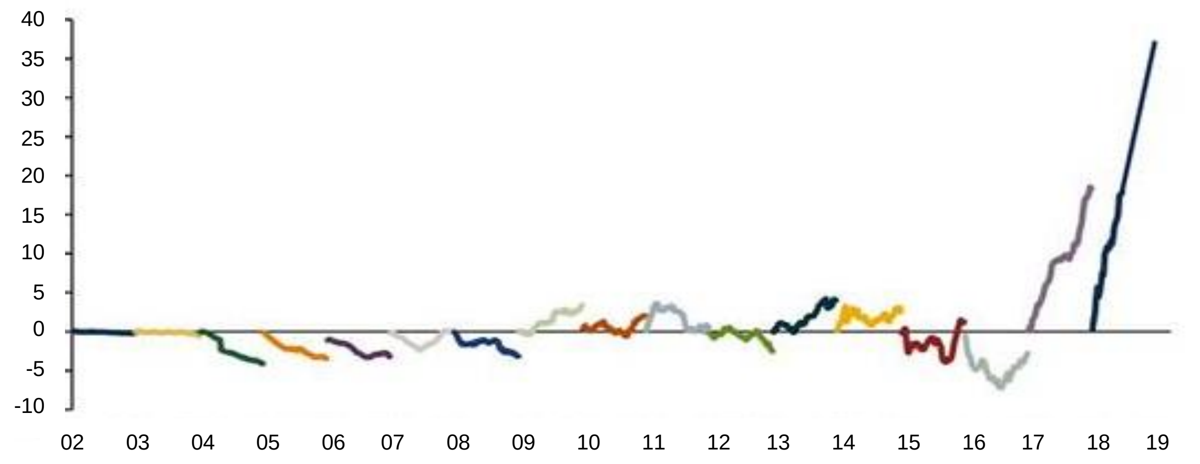
Weight of Technology in regional indices (%)



Source: BofA Merrill Lynch, Datastream, based on MSCI Indices

The next chart highlights the annualised flows into technology shares. The rapid growth into ETF's has exacerbated the flows to the sector.

Technology flows in $bn (2018 annualised)

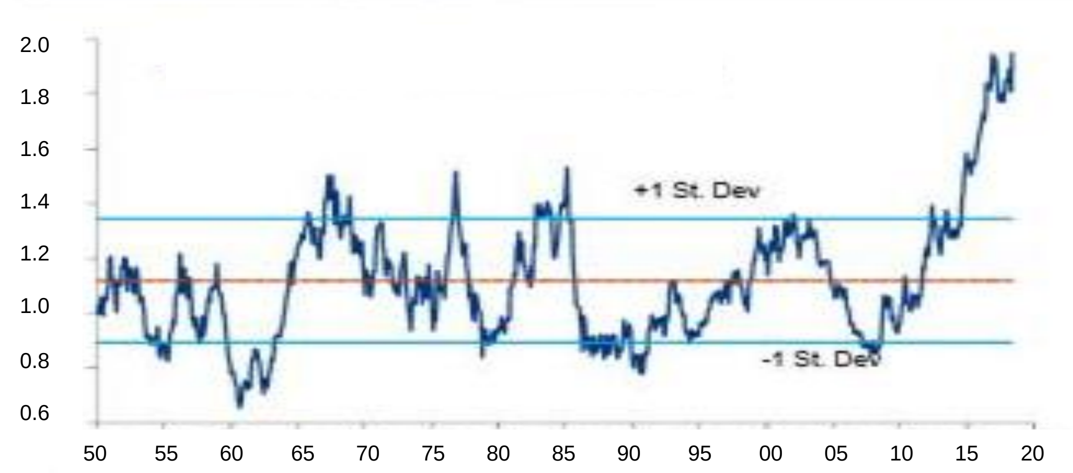


Source: BofA Merrill Lynch, Global Investment Strategy, EPFR Global

In an environment of lower global growth, there is some rationale for paying a premium for faster growing businesses. Nevertheless, many of the highly valued tech businesses are very large already, with market capitalisations in the hundreds of billions of dollars and share prices already discounting substantial future returns. Many of these tech businesses must therefore be considered high risk investments, with little if any yield protection to support the share price in the event of any disappointment.

We are agnostic to country of listing when we assess an investment. Our research aims to find global leading businesses and purchase the shares at attractive valuations. We have never had a discussion over a geographical weighting in the portfolio. We look carefully at the company's revenue footprint and obviously prefer the businesses to have a high percentage of sales in faster growing markets. We try to identify the global leaders wherever they are domiciled. The underperformance of European listed companies versus the US is remarkable.

US vs. Europe equity price relative (USD)



Source: BofA Merrill Lynch, Global Financial Data, Bloomberg

The out-performance of the US over Europe reached 2 standard deviations, or around a 5% probability. This can partially be explained by the weightings of Technology discussed above, but we also frequently find large disparities between share valuations on businesses that appear to have similar geographic footprints by revenue and offer comparable margin and prospects. The explanation in valuation frequently appears to be domicile.

The chart below brings both of the ‘Value’ and Europe vs US themes together. A logical explanation is always at hand to describe events that have already occurred. However, from the rationale standpoint of our research, we are finding more investment opportunities that would be described as ‘Value’ and these businesses are more frequently domiciled in Europe.

Eurozone vs US and Value vs Growth

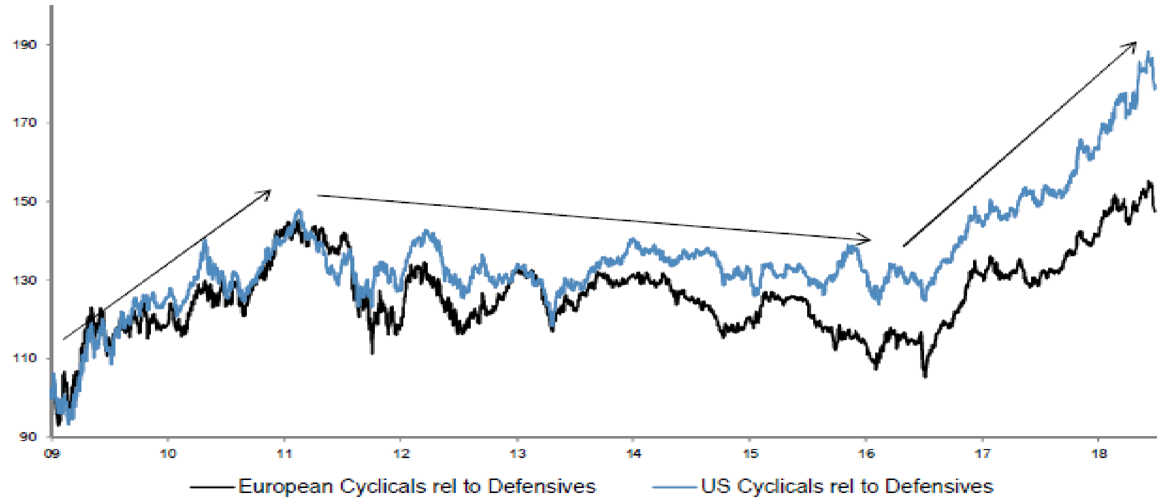
Source: Bloomberg MSCI EU Value vs. Growth (rhs) MSCI Europe vs. US (lhs)

We have experienced a very unusual recovery in equity markets since the Global Financial Crises in 2007-8: one that has been led by ‘defensive’ businesses, emulating the bull market in bonds. Economic growth continues to persist and while some of the foundations have been shaken by the threat of global trade wars etc, we are confident that this will continue, as many other indicators remain favourable: data points such as falling unemployment, positive PMI surveys and rising capex give confidence that growth will continue and we are still some way off from the top of the economic cycle. This scenario is probably now consensual. In this environment, ‘cyclicals’ should be leading the recovery!

Indeed, this is occurring, although again Europe is lagging the US. However, returning to the alternative hypothesis view highlighted at the beginning, a large part of this relative outperformance has not been a direct result of any re-rating of more economically cyclical businesses, but as a result in the recent de-rating of the expensive, defensives (bond-proxies) where growth prospects are now more reasonably reflected in valuations.

We were early and almost a lone voice, in highlighting the overvaluation of so called defensive consumer staples. These names are again returning to our value screens and we are dusting down old models, but we find they are typically not yet cheap enough.

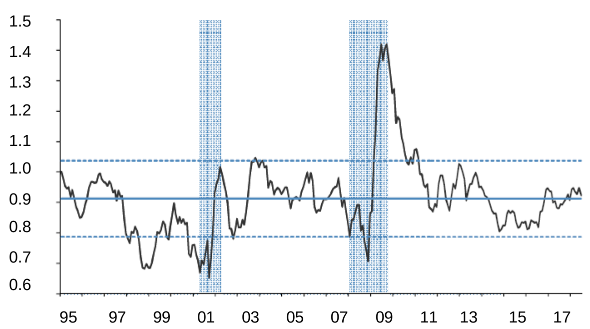
US and EU Cyclicals vs. Defensives



Source: Datastream, JP Morgan

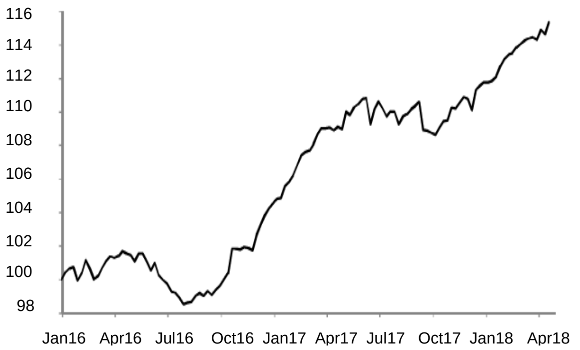
It is encouraging that the relative performance of cyclicals has not just been driven by a recovery in their share rating (see Forward PE chart, below on left) towards a more normalised level, but significantly by an improvement in earnings (chart on right).

EU Cyclicals vs Defensives 12m fwd PE



Source: IBES, JP Morgan

EU Cyclicals vs Defensives 12m fwd EPS



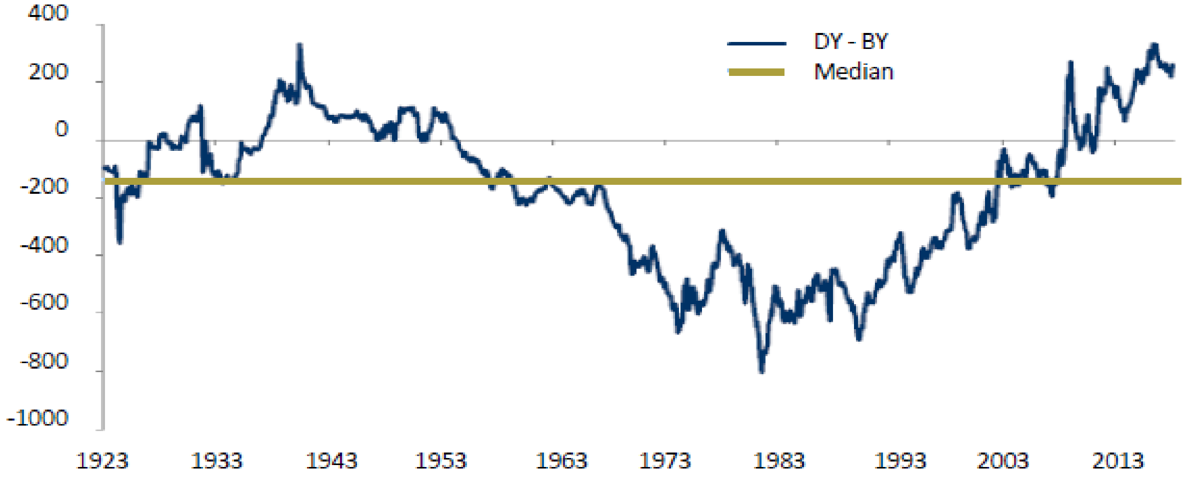
Source: IBES, JP Morgan

Equity markets are not valued in isolation, but relate to other asset classes, such as bonds, property and at times, commodities. The massive intervention of Central Bankers to buy bonds and stimulate growth is unprecedented. This has distorted the traditional signalling message of bond yields on growth and inflation expectations.

As a result, we fear we often read too much into bond market movements. Above charts highlight an improving earnings outlook, not stagnation or recession. We suspect that demographics plays a large part in the demand for bonds: consultants seem more concerned with matching duration, than considering valuation.

As can be seen in the chart below, equity yields remain at a significant premium to gilts.

MSCI Europe Dividend Yield – Bond Yield (Latest: 262bp)

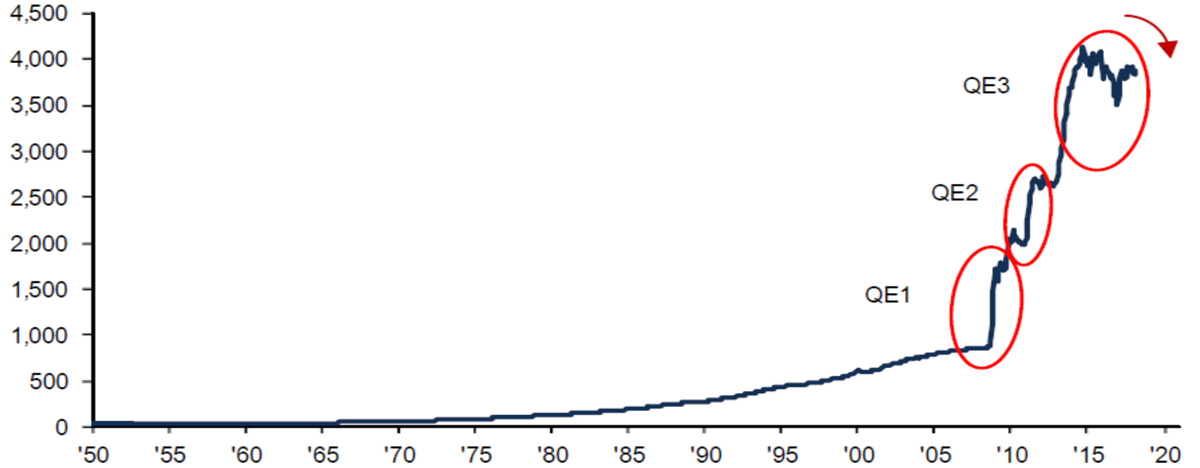


Source: Morgan Stanley

The chart below highlights the growth in the Fed's monetary balance sheet. This is shared by many other Central Banks who are all facing the tricky act of controlled 'tapering', aiming to reduce or stop bond purchases and prevent rates spiking and cutting off the oxygen of growth.

The collateral impact on asset prices from the reduction in central bank liquidity is unknown. The removal of the largest buyer is rarely good for price appreciation. It will be a difficult balancing act, but while authorities retain a bias to stay behind the curve, (not cut off growth too early), a modest pick-up in bond yields will signal a slow return to normality and should be welcomed by markets.

Federal Reserve monetary base (M1), US$bn



Source: BofA Merrill Lynch, St. Louis Federal Reserve Board

Performance Review

Fund Dividend

Our new charging structure came into effect in March 2018. As a reminder we now charge 100% of the AMC to capital.

The Interim Dividend of 3.29p was declared at the end of the quarter, compared to 2.98p in 2017 – this represents an increase of 10%.

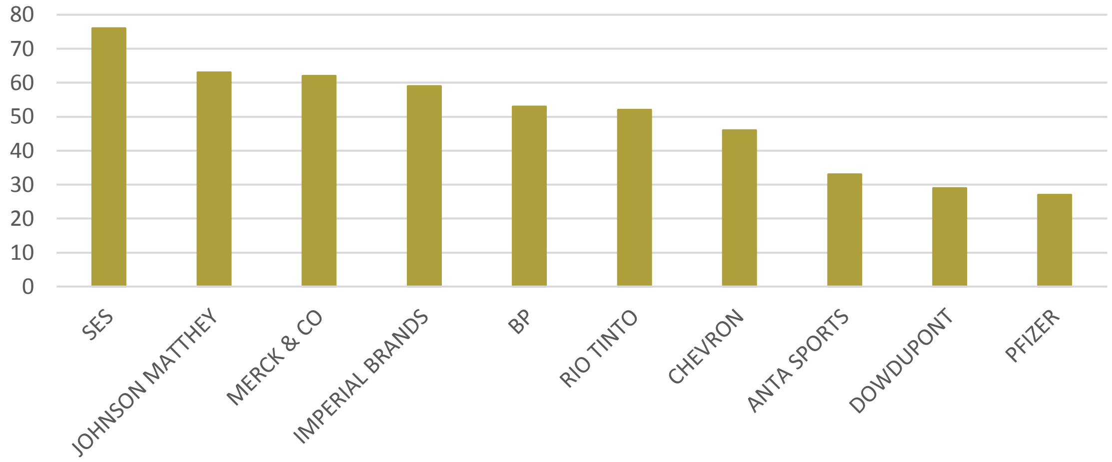
We target strong dividend growth over the long-term. In local currency terms, our estimates for growth in dividends for the portfolio are as follows:

2018 TB SGIG Forecast Dividend Growth

31% of Portfolio	**45% of Portfolio**	**10% of Portfolio**	**14% of Portfolio**
Ashmore	ABB	DowDuPont	Allied Irish Bank
Astrazeneca	AXA	Imperial Brands	Anta Sports
BP	BMW	Microsoft	Cisco
Chevron	Diageo		Heidelberg Cement
DBS	Evonik		UBS
Deutsche Post	IBM		
General Electric*	Intel		
Handelsbanken	Invesco		
HSBC	Harley Davidson		
Merck	Hugo Boss		
Pandora	Johnson and Johnson		
Prosieben	Johnson Matthey		
Schlumberger	Novo Nordisk		
SES	Pfizer		
	Rio Tinto		
	Roche		
	Saint Gobain		
	Schneider		
0% - 3%	**4% - 7%**	**8% - 12%**	**> 12%**

Source: Saracen Fund Managers Research (figures are calculated in local currency)
** dividend cut announced*

Positive Contributors



Source: Saracen Fund Managers

SES (+54%) rebounded from a very oversold position. Investors have more confidence in management returning the business to a stronger financial position, post several successful satellite launches and a peak in capex.

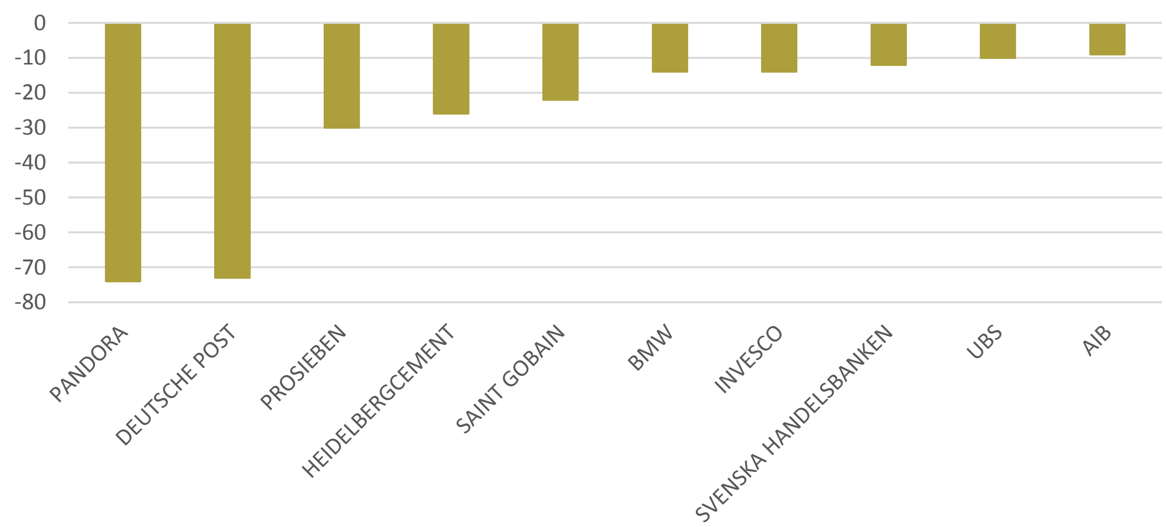
Johnson Matthey (+20.8%) reassured the market with better than expected FY numbers and guidance. Investors are increasingly more confident about growth in the Clean Air Division resulting from demand for more complex automotive catalysts and the prospect in developing new battery materials as well as the Health Division developing a pipeline of active pharmaceutical ingredients.

Merck (+19.4%) reported strong numbers and showed success in a number of drug trials. The current leadership in immunotherapy, through new drug Keytruda, has highlighted the attractive valuation of the shares.

Imperial (+17.5%) is finding support from new investors after having been friendless for almost two years. We added to our position over the period. This was covered in a previous Blog: Portfolio Activity Update

BP (+22.3%) benefitted from the rising oil price and strong cash flow. The company also signalled a potential dividend increase later this year if oil prices remain resilient.

Negative Contributors



Source: Saracen Fund Managers

Pandora (-30.8%) shares reacted very negatively to an in-line trading update and re-iteration of full year guidance. The sudden slowdown in China where growth decelerated from 62% to 16% quarter on quarter caused investors to question the longer-term growth potential of the business. The current forward PE of 8X (source: Bloomberg) is at odds with a business which should be able to grow its sales by mid-single digits and maintain its current margin profile.

Deutsche Post (-18.0%) discussed a labour issue in its mail division when it reported in line Q1 results in May. The following month it initiated a restructuring program for the division and cut its FY guidance. However, 2020 guidance is still intact and we view the shares as a promising long-term investment with a very attractive yield of over 4%.

ProSieben (-16.7%) shares fell after stating at its Q1 results that its guidance would be very back end loaded this year. The TV sector in general was weak towards the end of the quarter amid market concerns about structural changes in TV advertising.

HeidelbergCement (-6.7%) had to announce a delay in recovery from Q1 to Q2 due to the bad winter weather at the start of the year. However, the CMD a month after the result announcement reassured us that the current strategy and economic backdrop should lead to strong profit growth and generous returns of cash to shareholders. We added into weakness.

Saint Gobain (-7.1%) kept de-rating along with other European listed cyclical companies on no news flow. The shares are currently trading on a forward PE of 10.5x with a 3.5% yield (source: Bloomberg) – the lowest valuation since the European crisis in 2012. The position was increased over the period.

Portfolio Activity

We made no new investments in the quarter.

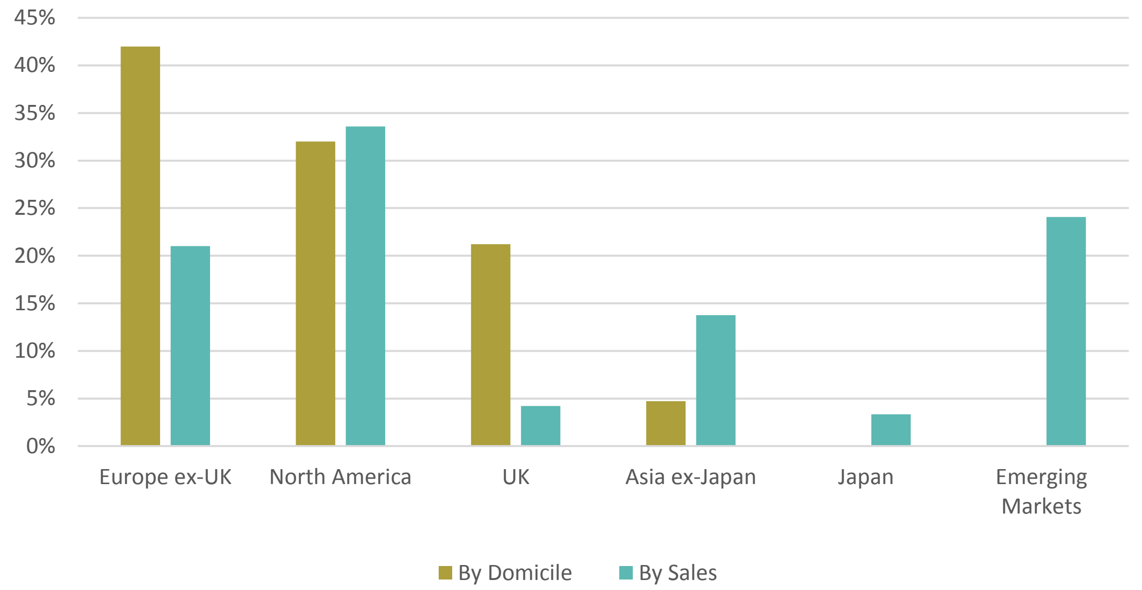
The only disposal was **Mizuho Financial Group**. We classified this as a portfolio upgrade as we reinvested the proceeds in HSBC, Svenska Handelsbanken and UBS, where we judged valuations more attractive**.**

We used the market weakness to top up core holdings in the portfolio including DowDuPont, Chevron, Evonik, Heidelberg Cement, HSBC, Imperial Brands, Intel, Roche, Saint Gobain and Schlumberger.

At the end of the Quarter, the portfolio consisted of 40 holdings, which is at the base of our 40 – 60 range.

The geographical split and split by domicile is shown below.

TB SGIG geographical split by domicile and sales



Source: Saracen Fund Managers

Portfolio Strategy & Themes

Our objective is to deliver growth in capital and dividends over the long-term from a diversified portfolio of global leading companies. We take a long-term investment horizon with holdings in companies such as Deutsche Post, Diageo, Johnson & Johnson, HSBC and Microsoft all held since the launch of the fund in 2011.

We have been searching for new names to invest in for some time, but are not finding many that both meet our valuation criteria, or add diversification in the portfolio. The search for new investments remains the focus of our research activity.

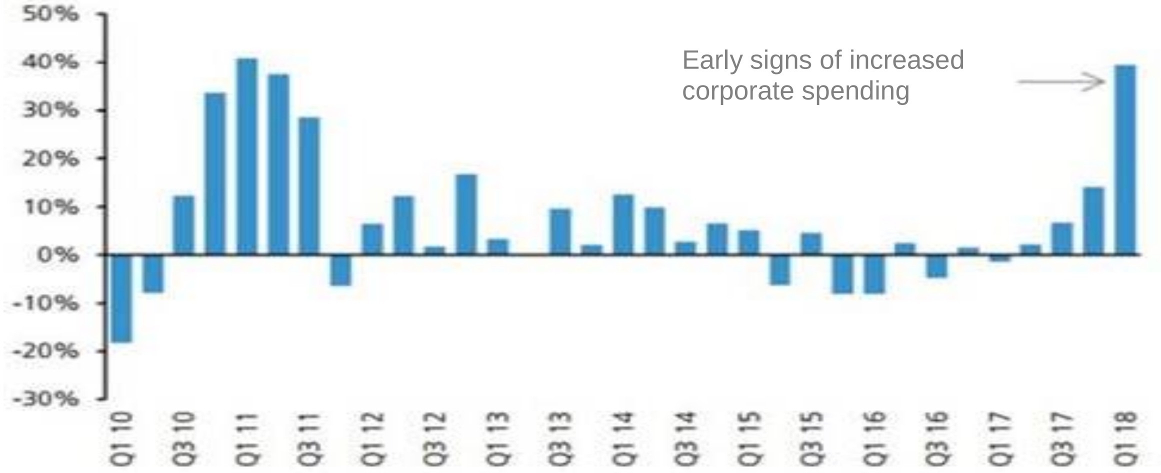
There is always political noise. Recent history suggests that markets have tended to look through some surprising political developments and focus on the economic implications. While a global trade war is a possibility, it is more likely that common sense will prevail and global growth will continue to persist.

It is always frustrating having to wait, but we are under no illusions that we either can, or should try to time investments. As a result, we tend to be early, both on the way in and out of a stock, for example buying banks and selling consumer staples. There is a cost to activity and we expect long holding periods and not to trade frequently.

The last 10 years have been dominated by the repercussions of the global financial crisis. Fines are still being imposed and regulations are being tightened. As a result, companies and individuals have been slow to rebuild confidence, borrow or invest. However, there are signs that this is slowly changing.

The chart below highlights the pick-up in capital investment. Some of this is necessary to improve efficiency, develop new products and add capacity. We are encouraged that this cyclical recovery is occurring and we are hopeful that this will soon be more evident in orders and profitability.

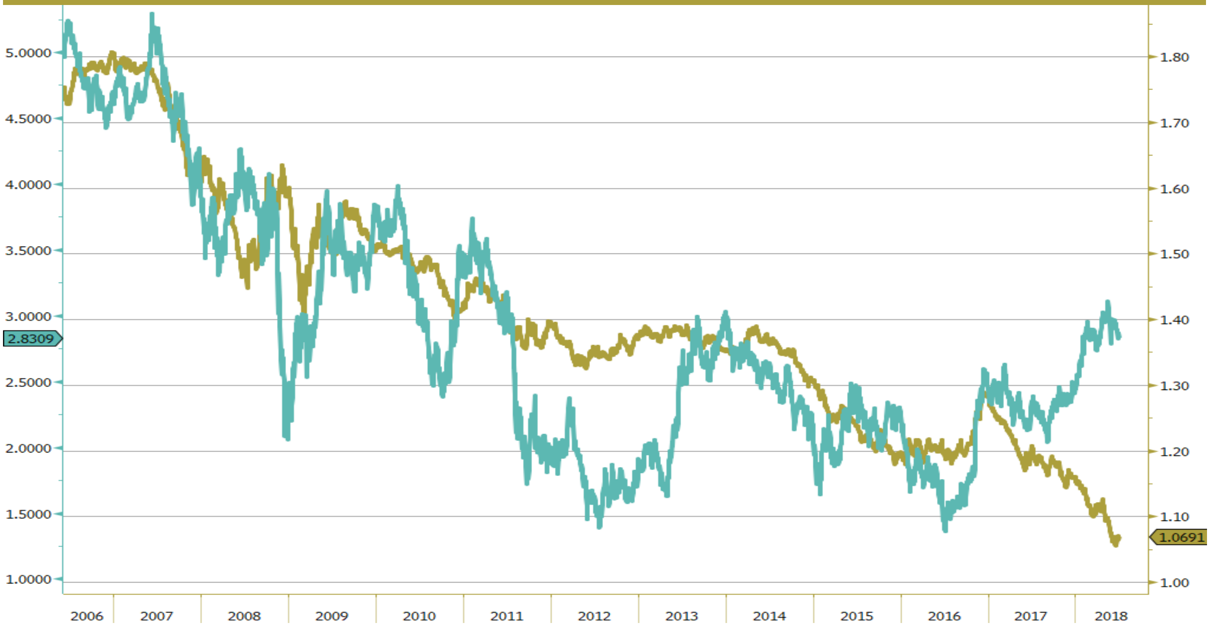
Capex growth (%, Y/Y)



Source: CompuStat, FactSet, UBS

There is a long history of correlation between bond yields and the out-performance of 'Value', which currently covers many more economically cyclical businesses. As discussed above, the dominance of the technology component in 'Growth' has distorted the relationship in recent years. Nevertheless, the logic of improving prospects for the numerator remain intact. We remain hopeful that more cyclical businesses will rerate on higher earnings.

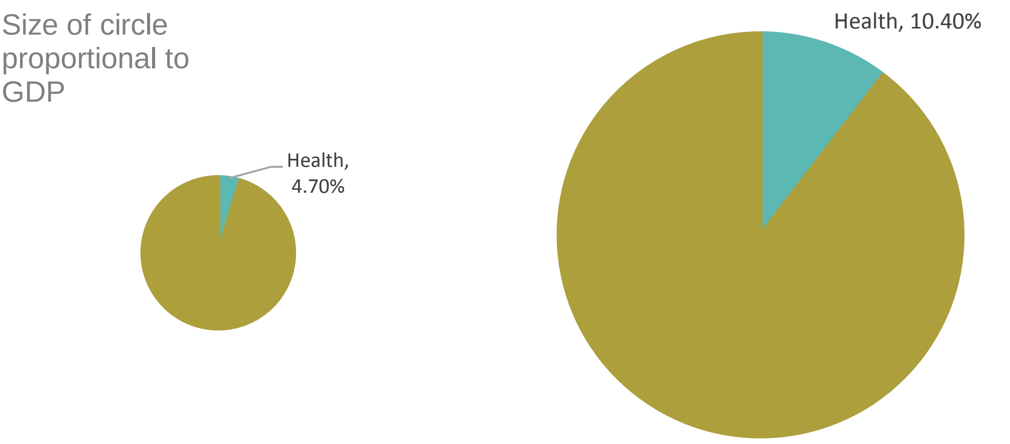
MSCI World Value vs Growth & US bond yields



Source: Bloomberg US 10YR bond yield (lhs) MSCI World Value vs Growth (rhs)

In addition to more cyclical businesses, we remain positive on healthcare. While there is pricing pressure in some areas, especially following the introduction of a generic and political pressure on both drug prices and healthcare costs. However, the sector is a massive beneficiary of demographic trends. The charts below highlight the growing proportion of spending on healthcare as a percentage of GDP.

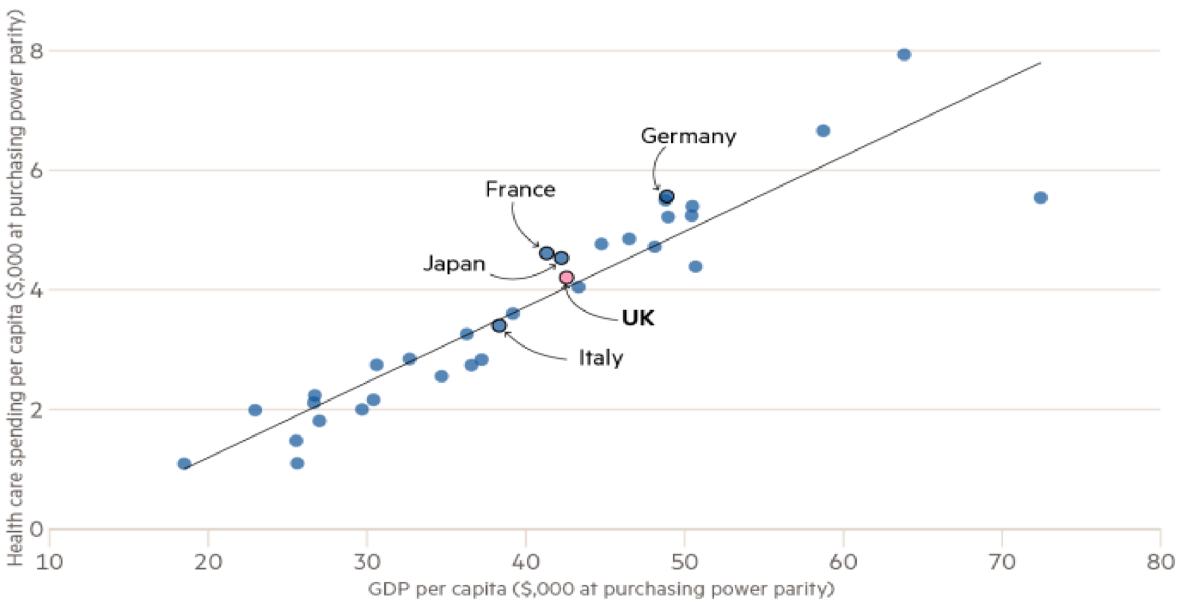
EU6 spending on health (% of GDP) 1970 and 2010



Source: OECD; (Belgium, France, Germany, Italy, Luxemburg, Netherlands)

As countries get richer, they spend more on health. There remains a huge opportunity in Emerging markets where populations are willing and able to spend more on healthcare.

GDP per capita relative to Health Care spend per capita



Source: King's Fund analysis of OECD data; (Advanced economies ex US and Luxemburg as of 2016)

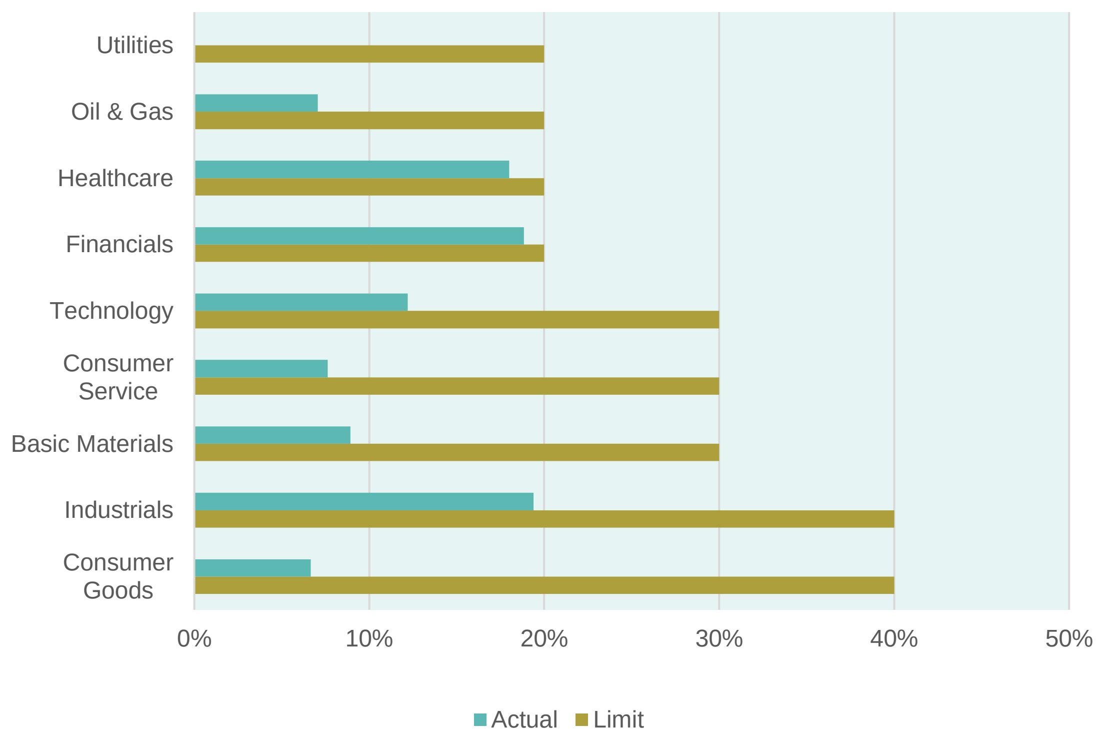
We remain wary of many of the pure biotech companies, due to their high-risk product pipelines. However, many companies appear to us to be on valuations that do not give due consideration to their current portfolios, pipeline or financial strength. By way of example, consider the following businesses and forward consensus valuations:

Johnson & Johnson is the world's largest healthcare company. It is diversified with over 250 operating businesses in 60 countries. The company has leading positions in Pharma, MedTech (hips, knees, surgical) and Consumer Divisions. Dividends have increased for each of the past 55 years. The current 12 months forward Yield is 3.1% and PE is 14.6x (source: Bloomberg).

Roche is the world's largest biotech firm and the leader in molecular diagnostic. 21% of pharma sales are re-invested in R&D and has Roche received more Breakthrough Therapy designations from the FDA than any other company. With 29 years of progressive dividend growth the current 12 months forward Yield is 3.9% and PE is 13.1x (source: Bloomberg).

In addition to Healthcare, the fund has been building exposure to more cyclical sectors such as Industrials and Financials. The sector breakdown is shown below.

TB SGIG portfolio spread



Source: Saracen Fund Managers

Hard limits are set to reduce style risk. The Limit percentage is set in relation to the number of available investments in the sector and their relative diversity. TB Saracen Global Income & Growth had 40 high conviction holdings at the end of the quarter. As of 29 June, the forecast PE on the fund of 12.6x compares favourably to the 14.5x for the FTSE All World Index. The fund also has a greater dividend yield at 3.9% versus just 2.4% for the Index. (Source: Bloomberg)

Investment Approach

TB Saracen Global Income & Growth Fund aims to provide a long-term return from investing in a portfolio of low risk, highly liquid global equity securities. There is an explicit recognition that income is an important factor for many investors and a significant contributor to long-term investment returns.

We have a focussed and highly differentiated portfolio of 40-60 quoted global companies, a high conviction fund with a significant active share, which is currently 90%. There is no formal benchmark for the fund, although we do report performance against the IA Global Equity Income Sector.

We aim to invest in global-leading businesses which are able to sustainably grow their revenues, their profits and ultimately, their dividends. We are attracted to businesses which have high and sustainable margin profiles, create value by generating a return on investment above the weighted average cost of capital and have a strong balance sheet. We also like to see directors owning shares in the business and being remunerated on total shareholder returns as opposed to an earnings-per-share measure, which can be easily manipulated. However, the most important things that we look for in an investment are an attractive valuation and a starting yield in excess of 2%. We don't simply buy great businesses at any price - they must be demonstrably cheap!!

Our Wish List for Companies

- Global Leading Businesses
- Long-term revenue growth potential
- Positive return on equity spread
- Sustainable margins
- Strong balance sheet
- Acceptable Worst Case (extent and likelihood)
- **Attractive valuation and starting dividend yield in excess of 2%**
- Alignment of interest with directors

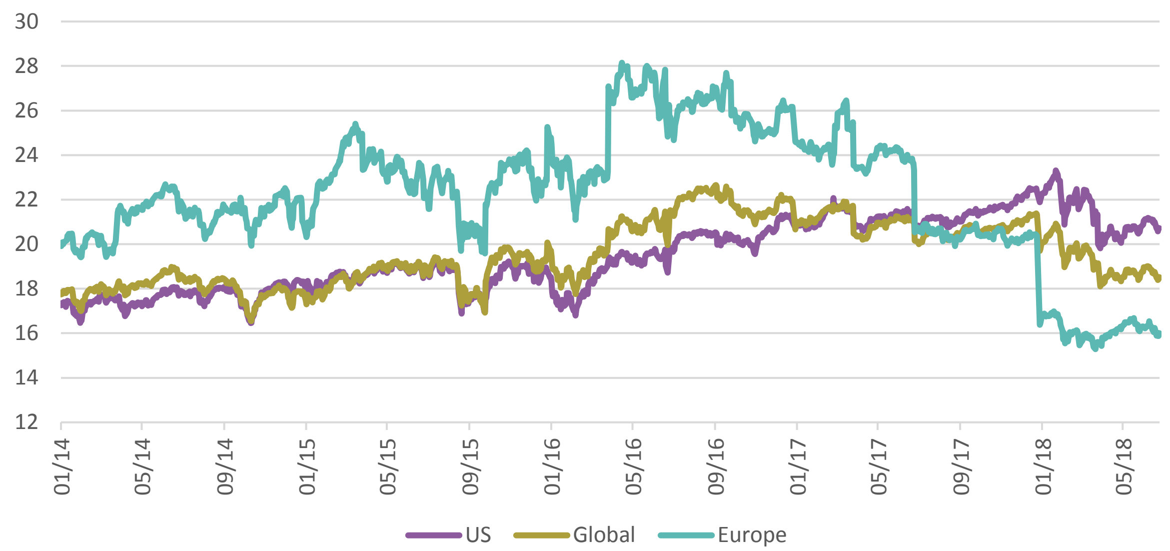
We have a long-term approach and the turnover in the fund has, on average, been less than 20% per annum since the fund was launched.

Outlook

We continue to believe that selected, well financed equities appear very attractively valued compared to conventional alternative investments. If we are correct in our assumptions that economic growth will continue to persist and modestly strengthen, then more cyclical businesses should benefit both from increased demand and firmer pricing.

As business and consumer confidence slowly improves and Central Bank bond buying slows, we expect bond yields to modestly increase. Equity valuations, in contrast, appear reasonable and particularly in Europe look attractive.

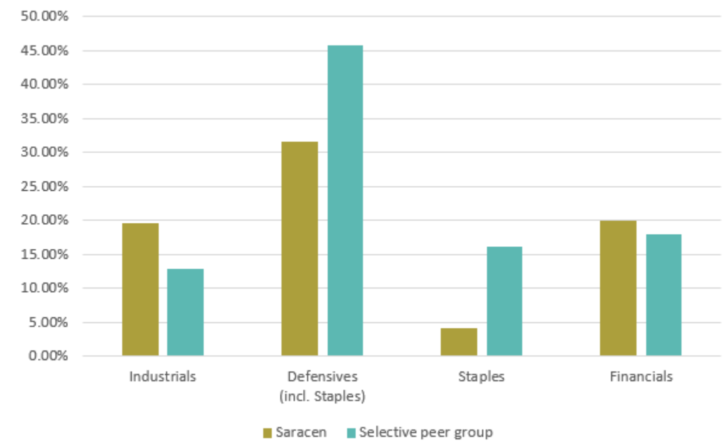
Regional current P/E

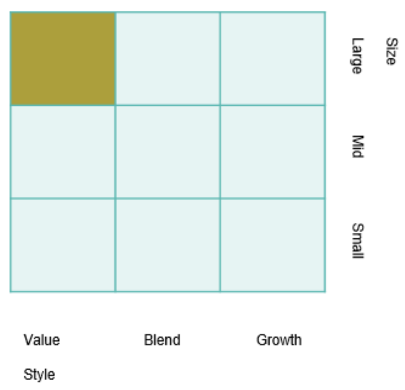


Source: Bloomberg

Whilst the portfolio may not flourish under recessionary conditions, we hope that the fund is of interest to clients who would like to increase their exposure to 'Value' and cyclical businesses, or who would like to blend this fund with many others which retain a defensive stance.

SGIG positioning versus selective peer group and equity style





Source: Saracen Fund Managers, peer group's fact sheets

Source: Morningstar

May we take this opportunity to thank our clients for their continued support.

Graham Campbell
David Keir
Bettina Edmondston

6th July 2018

For further information on TB Saracen Global Income and Growth Fund please contact:

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Regulatory Status:
FCA Recognised: Yes
Scheme Type: OEIC

Issue date – 30 June 2018