TB Saracen UK Alpha Fund

Quarterly Review – June 2018

SARACEN
share success

Scott McKenzie
Fund Manager

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

	TB SUAF	MSCI UK All Cap (TR)	Relative
Q2 2018	+13.3%	+9.3%	+4.0%

Performance Summary

The fund enjoyed a strong recovery in the second quarter, rising by 13.5% compared to a 9.3% increase in the MSCI UK All Cap index and a return of 9.1% from the IA UK All Companies sector. The Fund was placed in the top decile of this peer group during the three-month period and is also ranked top decile over six months, one year and five years, as well as being top quartile over three years, too (source: FE Trustnet). A summary of performance over the past five years is shown in the table below.

Cumulative Performance after all ongoing charges to 30 June 2018

	3 months	1 year	3 years	5 years
TB Saracen UK Alpha B Acc	13.3%	18.9%	36.1%	93.5%
MSCI UK All Cap Index (TR)	9.3%	9.2%	31.5%	51.3%
Sector Average	9.1%	9.1%	28.2%	56.4%
Quartile Ranking	1	1	1	1

Source: Financial Express *Sector: IA Sector (UK All Companies)*

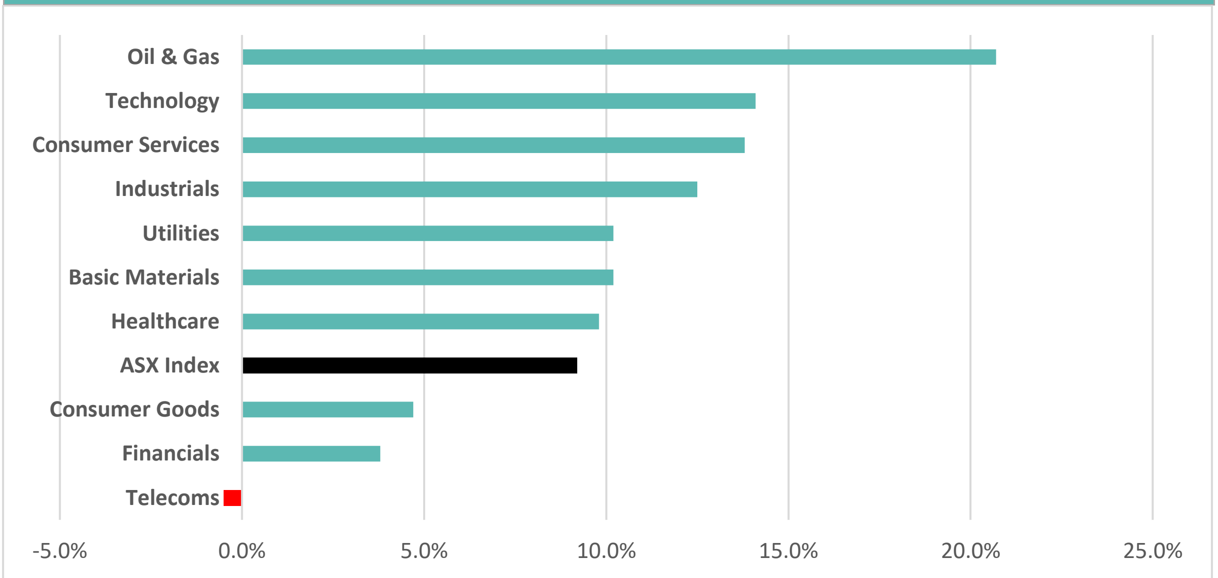
Market Overview

Over the quarter there was a strong recovery in the FTSE100 index, which outperformed small and midcap companies, in a reversal of the trend in recent years. Despite this headwind the Fund delivered strong returns, with our focussed, valuation driven approach serving us well.

Index total returns: 3 months to 30 June 2018	
FTSE 100	+9.6%
FTSE 250	+8.1%
FTSE Small Cap	+6.1%

Within these returns there were some dominant sector themes, notably the significant performance of oil stocks as the oil price recovered, which had a meaningful impact on index returns. Also noteworthy were the drag effects seen from the weakness in financial stocks and telecoms, which was the only subsector to show negative returns, driven by falls in BT and Vodafone.

UK sector total returns: 3 months to 30 June 2018



Source: Bloomberg

Other notable trends included further takeover activity, with Sainsbury announcing a merger with Asda and Shire agreeing to a bid from Takeda.

From a geopolitical perspective, there were further developments in two ongoing concerns for markets, Brexit and global trade. The increasing prospect of a trade war between the US, Europe and China has brought nervousness to global markets, with emerging markets and Europe seeing a selloff as the US dollar continued to strengthen.

Bond yields were broadly stable over the period with US Treasury yields rising slightly to 2.85% and UK Gilts remaining at 1.3%.

Closer to home any previous progress on the Brexit negotiations appears to have been steadily eroded as Mrs May seems incapable of uniting her government behind a common negotiating stance. At this stage, with time rapidly running out, it is hard to see a positive outcome emerging and the UK economy looks vulnerable to further disappointment. As a result, there was notable weakness in sterling which fell from $1.40 to $1.32 over the quarter, which largely explained the better showing from the FTSE100 index, where 75% of profits are non-UK.

Portfolio Review

The portfolio has a ‘multicap’ structure with a high exposure to mid and small cap companies and this strategic positioning has been beneficial for our overall results as well as offering considerable long term flexibility. Our high exposure to industrial 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.

Positive Contributors

After a difficult market background during the first quarter the Fund bounced back strongly over the period, with 16 stocks out of a starting total of 30 rising by 10% or more.

In our previous review we highlighted a number of the larger investments we had made in early 2018. It was pleasing to see significant contributions from some of these stocks come through in the second quarter. The standout performer was **Alpha Financial Markets Consulting,** which rose 50% and remains a key holding for the Fund. We had taken the view that the shares offered excellent growth prospects on a low valuation and their strong final results saw a number of new converts to the story. The situation at **Shire** has moved on further with a takeover now agreed with Takeda, leading to a rise of 20% in the shares. As is often the way with Shire the story is far from straightforward with Takeda shareholders raising concerns about the scale and funding of the deal. Regardless of this Shire continues to trade on a substantial discount to both the global pharmaceutical sector and the agreed terms. We can still see upside from here and it remains the fund’s largest investment.

A few of last year’s small company laggards began to make good progress. **STV Group** rose 43% as the new CEO outlined a more focussed strategy, including a further dividend increase. **U&I Group** delivered strong growth in asset values and disposal profits, continuing its recent turnaround, and the shares rose by 30%. Amongst our smaller industrial stocks both **Tyman** and **Eurocell** made positive contributions, returning 13% and 27% respectively. There was limited newsflow on either company but again low valuations were a common theme in their share price appreciation. Two of our more recent smallcap purchases also made pleasing progress with **Premier Asset Management** rising 26% and **Palace Capital** 10%.

In the midcap arena **Greencore** had a long overdue recovery from the doldrums, rising 40% from a low base on delivery of in-line final results. We hope that the worst is now behind us here.

We also enjoyed strong returns from some old favourites, which have continued their track record of delivery. **Avon Rubber** rose by 13%, **Hill & Smith** by 13% and **Victoria** by 11%. **Victrex** signed off in style, rising 19% prior to our sale.

Negative Contributors

With the Fund performing well overall our losers list was much reduced, with only six stocks falling during the period.

The most notable casualty was **IFG Group**, where the disposal of the wealth management business did not proceed and senior management was changed as a result. An ongoing tax investigation also leaves the shares trading under a cloud and the stock fell 28% in total.

There were some ongoing underachievers from last year. **TalkTalk** fell another 9%, having disappointed in late 2017 and raised equity in 2018. There is widespread scepticism about the recovery plan, led by main shareholder, Sir Charles Dunstone. Our large holding in **RPC Group** struggled again despite improved disclosure at their results. There are persistent concerns about plastic usage and the pace of acquisitive growth, which saw the shares fall another 3%. Our last remaining retail holding, **Dunelm**, fell 4% in response to a weak trading statement, yet more management changes and a poor retail background in general.

Portfolio Activity

The fund has 26 investments which are spread across a variety of market capitalisations. As at 30 June 2018, the breakdown of the portfolio by index was 13% FTSE100, 25% Mid250 and 54% Smallcap/AIM. The portfolio held 7% in cash at the month end reflecting some sales in June and continued inflows into the fund. This cash shall be reinvested into new holdings in due course.

Purchases

There were no new investments made in the period and our buying activity was limited to adding to holdings in stocks which had lagged for various reasons. In general, we have added to businesses where we see hidden value but where short term prospects are more challenging. These included **Dunelm, Galliford Try** and **IFG Group**. We also added to **Prudential,** whose shares have gone quiet since the announcement of a demerger of the UK and global components earlier this year.

Sales

There were three holdings sold outright during the period, all of which had delivered strong returns for the Fund.

Two of those were genuine growth companies which had seen positive re-rating and where we could see no margin for error in valuations – **Joules** (retail) and **Victrex** (chemicals). We are always loath to sell good businesses such as these but in a bull market where growth companies attract ever-higher ratings we must retain the valuation discipline that our research demands.

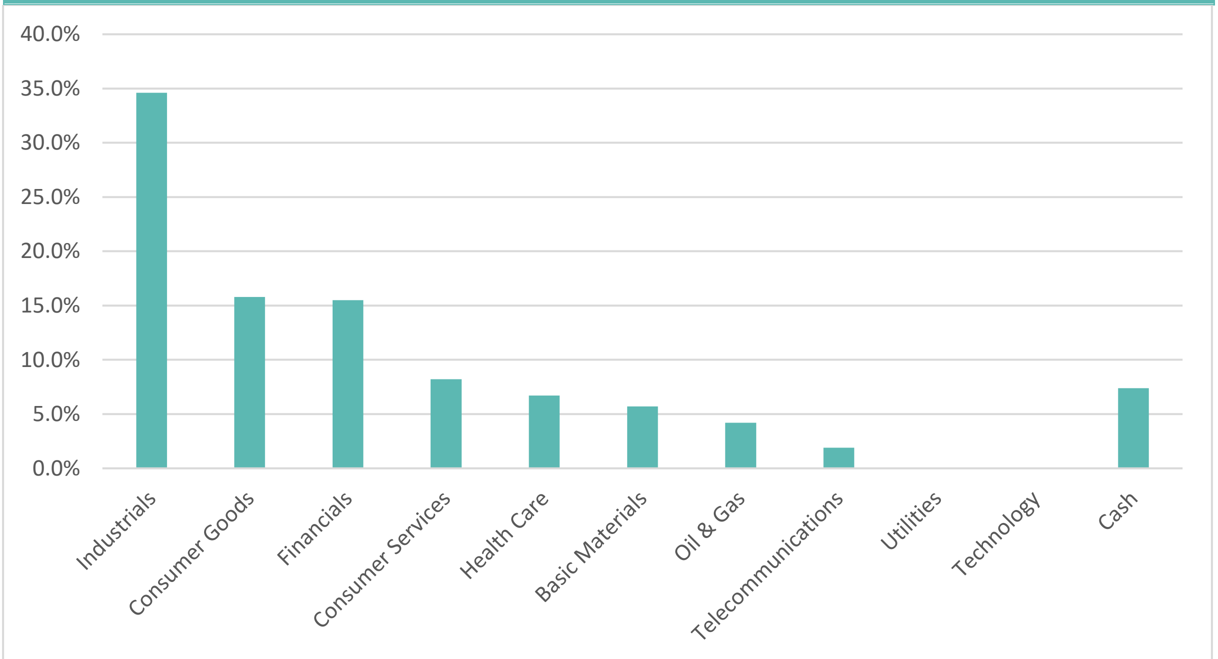
We sold the remaining **GKN** just prior to the completion of the Melrose takeover. Whilst we admire the Melrose team, the execution risks are high and we have already had the benefit of a significant takeover premium as GKN shareholders.

The final sale was a reduction in the large holding in **Alpha FMC** after the recent surge. This was purely for risk management reasons as the holding had exceeded our 7.5% maximum position size. We continue to believe that they can grow for many years to come.

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

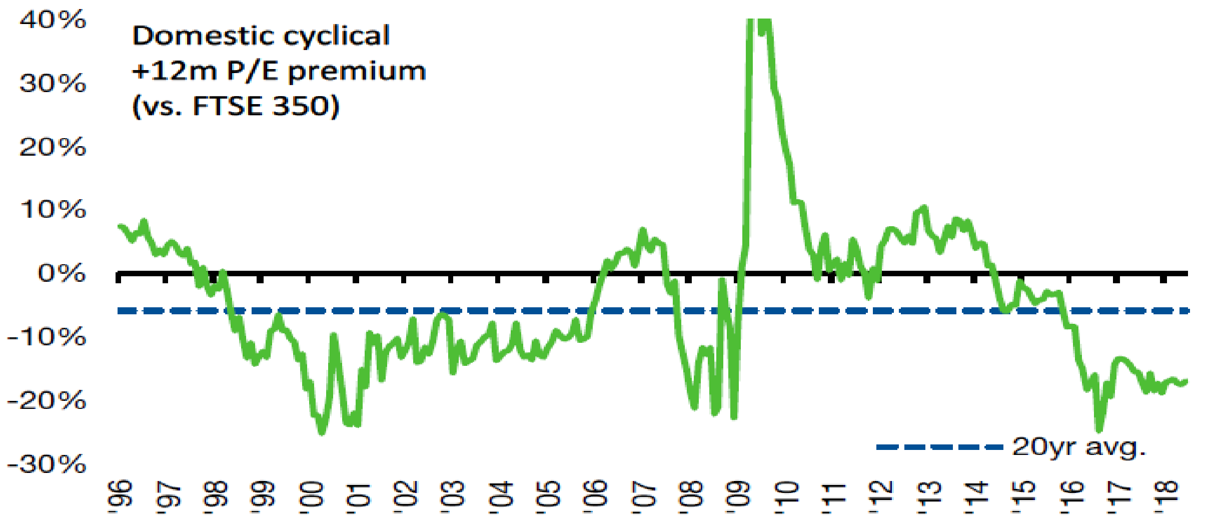


Source: Saracen Fund Manager as at 30.06.18

Our holdings in the industrial 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.

During the first six months of 2018 the Fund reduced exposure to the UK consumer, selling holdings such as Joules and Berkeley Group after strong performances. We are conscious that consumers face an increasingly tough environment as the Brexit negotiations intensify, and economic shocks are possible, leading to further dips in confidence. However, we remain alert for opportunities which may emerge in higher quality domestic businesses, many of which offer exceptional long term value now. Careful selectivity will be crucial in this area however.

Domestic cyclicals continue to trade at an extreme discount



Source: Liberum, Datastream

Given our high exposure to medium and smaller companies, in general we remain long sterling assets and short overseas earners compared to the benchmark. Despite this 'top down' headwind for the fund we have no plans to change our selection process.

In terms of sectors where we have low exposure, the structure of the portfolio is such that we tend to avoid 'deep value' ideas unless there are specific drivers for recovery. Whilst sectors such as tobacco and oil 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. We continue to hold nothing in consumer staples where we see limited valuation support and weak underlying growth. We also have no investments in utilities where a combination of high debt and increased political interference make profits vulnerable in our view.

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 26 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 80% of the fund with large companies only 13%. We have a cash balance of 7% at present.

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 (43%* of portfolio assets)

We would expect the largest component 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. The exposure to this segment has reduced from nearer 60% a year ago due to the scarcity value and high ratings currently applied to growth companies, leading us to take profits in certain holdings

Special situations (28%* 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. So far in 2018 we have seen takeover approaches for three portfolio companies. 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 (22%* 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 30.6.18, source Saracen Fund Managers*

<u>Our 'Wish List'</u>

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:

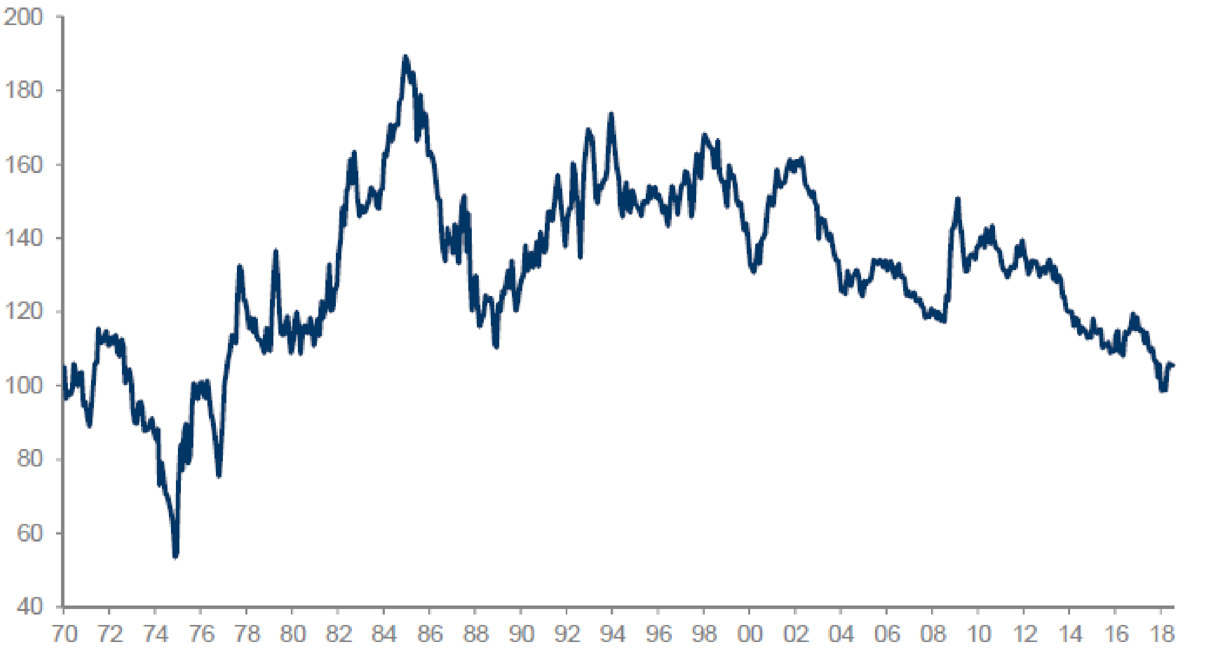
- Market leading positions
- Self-funded roll-out
- Unique assets
- Sustainably high margins
- Long-term visibility

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

It appears that the UK stock market has rarely been less loved by investors and since the Brexit vote in June 2016 global investors have fled from UK equities, leading to material underperformance against the MSCI World index. The recent BOAML Global Fund Manager Survey showed a balance of -40% of asset allocators underweight UK shares, the highest since their records began.

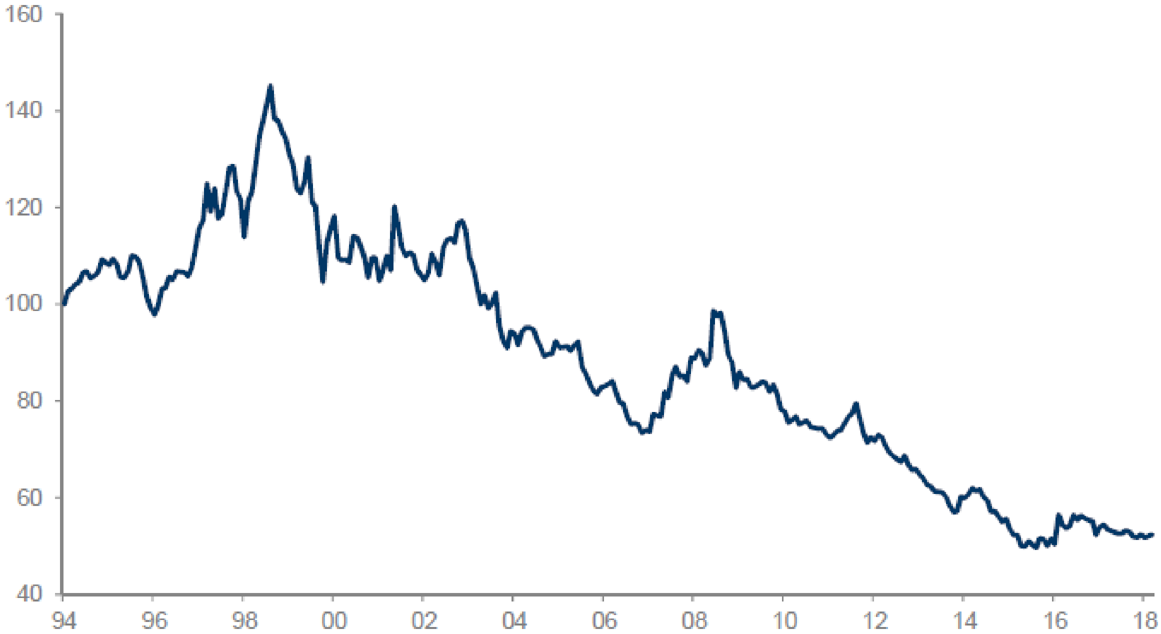
UK vs MSCI World Price Performance (LC)



Source: MSCI, IBES, Morgan Stanley

Within this context it has been large cap investors who have borne the brunt of the pain, with the mid and smallcap indices materially outperforming over the past decade, and major UK sectors such as banks, oils and telecoms largely remaining in the doldrums.

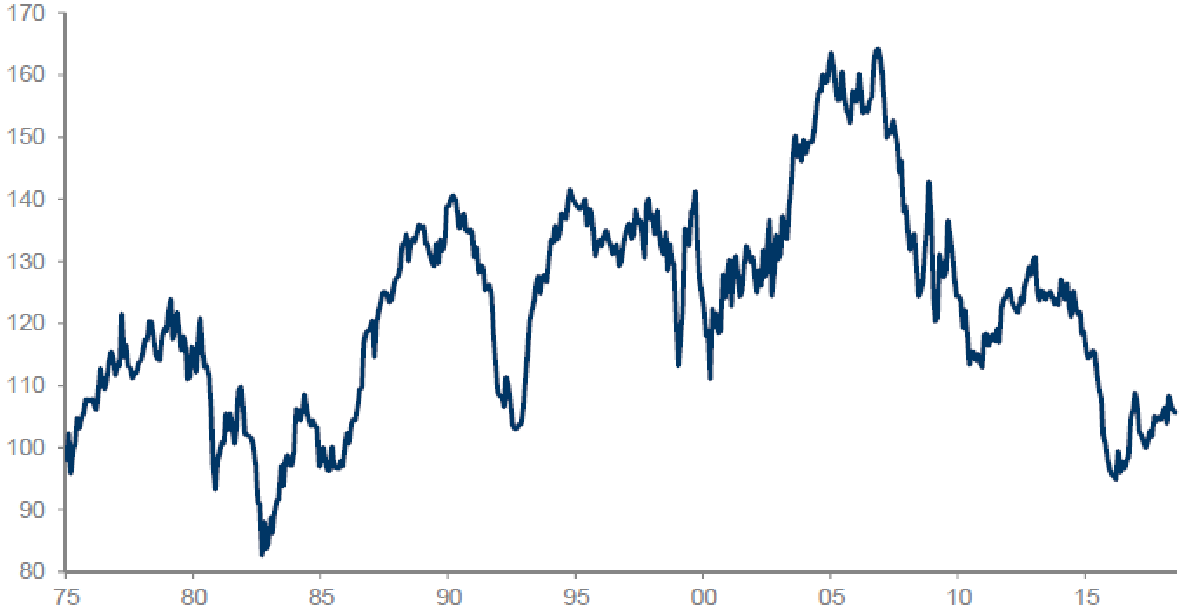
UK Large vs Small & Mid Caps Price Performance



Source: MSCI, IBES, Morgan Stanley

The astonishing dominance of the technology sector in recent years has also meant it has been a miserable time for value investors globally, although it is interesting to note now that value in the UK has begun to bottom out, partially helped by the absence of tech in the index.

UK Value vs Growth



Source: MSCI, IBES, Morgan Stanley

After a bumper period for global equities, threats to markets are becoming apparent, with increases in market volatility and real fears of global trade wars. Should cracks appear in high growth areas such as technology then such stocks could have material downside.

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.

In the UK the Brexit process remains slow, ponderous and highly uncertain with timescales now likely to extend well beyond the initial 2019 deadline. There is a clear and present danger to the economy as a result.

What does all of this mean for Saracen UK Alpha?

The Fund has continued to deliver good results in 2018 so far and performance over both the short and long term remains strong. Our strategic commitment to investing in medium and smaller companies will remain intact but we have to be mindful that the excess returns we have enjoyed from this positioning could well diminish from here.

It is difficult at the moment to find good, long term growth companies at sensible prices and we must now proceed with some caution, avoiding areas where there is excess optimism and hype. Consequently, a key challenge is to avoid complacency in the portfolio, particularly after a period of strong returns and higher valuations than before. It is therefore likely that the Fund shall become more focussed on value moving forward.

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

Scott McKenzie, Investment Director
6th July 2018

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Scheme Type: OEIC

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