TB Saracen UK Income Fund

Quarterly Review – June 2018

SARACEN
share success

Scott McKenzie
Fund Manager

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

	TB SUIF	MSCI UK All Cap (TR)	Relative
Q2 2018	+12.5%	+9.3%%	+3.2%

Performance Summary

The fund enjoyed a strong recovery in the second quarter, rising by 12.5% compared to a 9.3% increase in the MSCI UK All Cap index and a return of 8.3% from the IA UK Equity Income sector. The Fund was the top performing fund in this peer group during the three-month period and is also ranked top decile over six and twelve months. We marked our third anniversary on 1st April 2018 and are pleased to report that performance is well ahead of the market index during this period as well as being ranked top quartile in the UK Equity Income sector (source: FE Trustnet). A summary of performance since launch is shown in the table below.

Cumulative Performance after all ongoing charges to 30 June 2018

	3 months	1 year	3 years	Since launch*
TB Saracen UK Income B Acc	12.5%	14.6%	28.6%	31.2%
MSCI UK All Cap Index (TR)	9.3%	9.2%	31.5%	28.8%
Sector Average	8.3%	6.0%	24.2%	23.6%
Quartile Ranking	1	1	1	1

*Source: Financial Express; * launch date 01 April 2015* *Sector: IA Sector (UK Equity Income)*

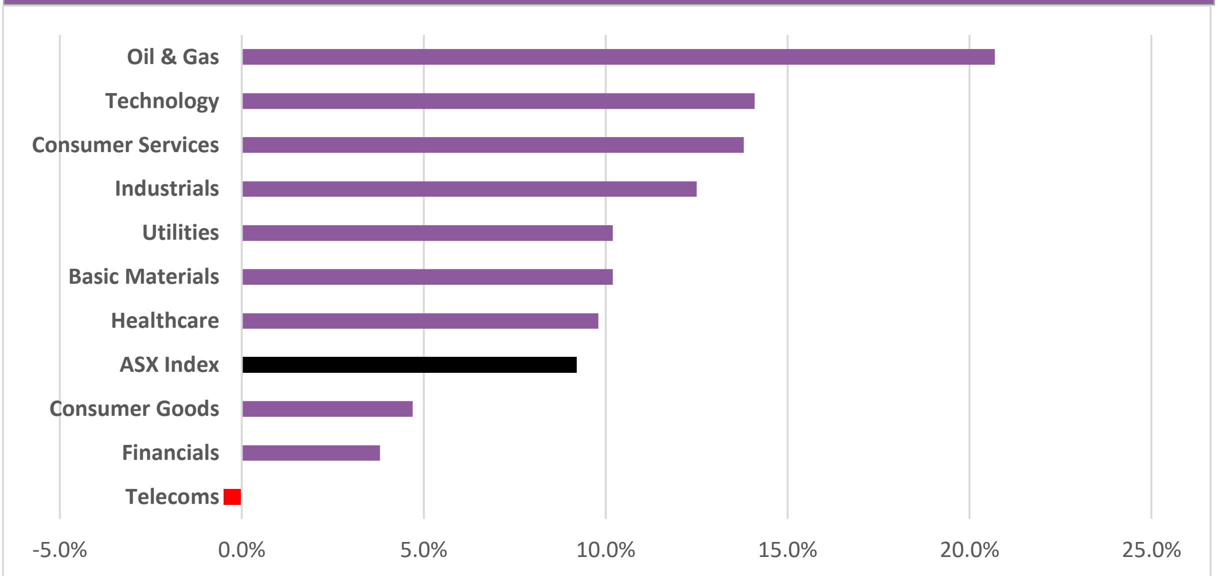
Market Overview

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, value 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 financial and consumer discretionary sectors remains in place and we continue to have a correspondingly low allocation to classically 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 total of 34 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 the largest holding in 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. We continue to believe that they can grow for many years to come.

In general, most of our winners had strong value characteristics, having suffered during the selloff earlier in 2018. Another large position which delivered good performance was **Imperial Brands** which rose by 18% from a very low base. There is widespread revulsion towards tobacco stocks for now but we see much more upside to come here. Despite very difficult conditions for the UK consumer **Next**, **Greene King** and **DFS Furniture** rose by 27%, 22% and 13% respectively. All three businesses face very challenging trading conditions but have strong market positions and low valuations which have enabled the Fund to make positive returns despite the obvious headwinds.

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%.

St Ives rehabilitated further with the shares rising 20% as results steadily improved and the remaining problem businesses were sold. 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.

From a sector perspective there were strong returns in general from resources stocks with both oil and mining companies responding well to generally positive commodity prices. Whilst the fund does not have a large exposure to this segment our stocks performed well with our mining holdings, **BHP Billiton** and **Rio Tinto** rising by 22% and 16% respectively. In oils **Wood Group** recovered well after a poor run previously and rose 20% on a better outlook statement.

Negative Contributors

With the Fund performing well overall our losers list was much reduced, with only six stocks falling during the period. At a sector level our large position in financial sectors did us no favours, being responsible for four of our six fallers. The main culprit here was **Standard Life Aberdeen**, which remains friendless in the face of significant strategic change. The shares fell another 5% despite announcing a share buyback and debt restructuring programme. We continue to believe that there is considerable hidden value in the stock which will become apparent should the dust ever settle. SLA's partner **Phoenix Group** was flat as they announced the terms of the upcoming rights issue. **Jupiter** continued to drift falling 5% as outflows from its bond funds continued and **New River REIT** slipped a little as investors continued to shun retail property.

Our final laggards were two businesses where our position sizes are low and therefore the impact fairly limited – **Low and Bonar** (-13%) and **Talk Talk** (-9%). Both are struggling with high debt levels and poor earnings momentum which have led to low investor confidence.

Portfolio Activity

The fund has 34 investments which are spread across a variety of market capitalisations. As at 30 June 2018, the split of investment was 33% in FTSE100, 29% in Mid250 and 33% Small Cap/AIM, with a cash balance of 5%.

Purchases

There were two new investments made during the period, both of which we think are in the 'deep value' category.

The plastic packaging business **RPC Group** has not had its troubles to seek of late with public anxiety about the environmental impact of plastics and investor anxiety about earnings quality leaving the shares friendless. We believe that some of the issues could well diminish from here and with the shares trading on a high yield for the first time we see RPC as a higher risk recovery buy.

We have followed flooring distributor **Headlam** for many years and the Fund was previously a holder of the stock. The shares have fallen sharply since our previous sale with weaker trading in 2018 so far and poor sentiment towards consumer spending taking their toll. It is likely therefore that trading remains tough in the short term. However, the company has good management, a very strong balance sheet and a dominant market position which should allow it to weather such storms. They have a proud dividend record and now offer a high yield after recent falls.

In April we used the ongoing market weakness to increase position sizes in a number of existing holdings including **STV** and **Alpha FMC**, both of which paid off handsomely. We also added to **Jupiter** and hope that the current outflows prove to be temporary in nature.

In June we built larger positions in three stocks which had lagged considerably – **Lloyds Bank**, **Galliford Try** and **Standard Life Aberdeen** (averaging down again!). As is often the way with the Fund's investment strategy none of these could exactly be described as market darlings and all suffer from investor hostility at present. In each case we see very limited downside and are prepared to suffer some short term pain whilst collecting healthy dividends.

Sales

We sold our holdings in **U&I Group** and **Berkeley Group**. Both stocks have delivered strong returns in recent years, having skilfully maximised the value of their assets in the London/South East property sectors whilst paying large special dividends to shareholders. We took the view that the best years are now behind us in their specific sectors and that future returns may well start to diminish.

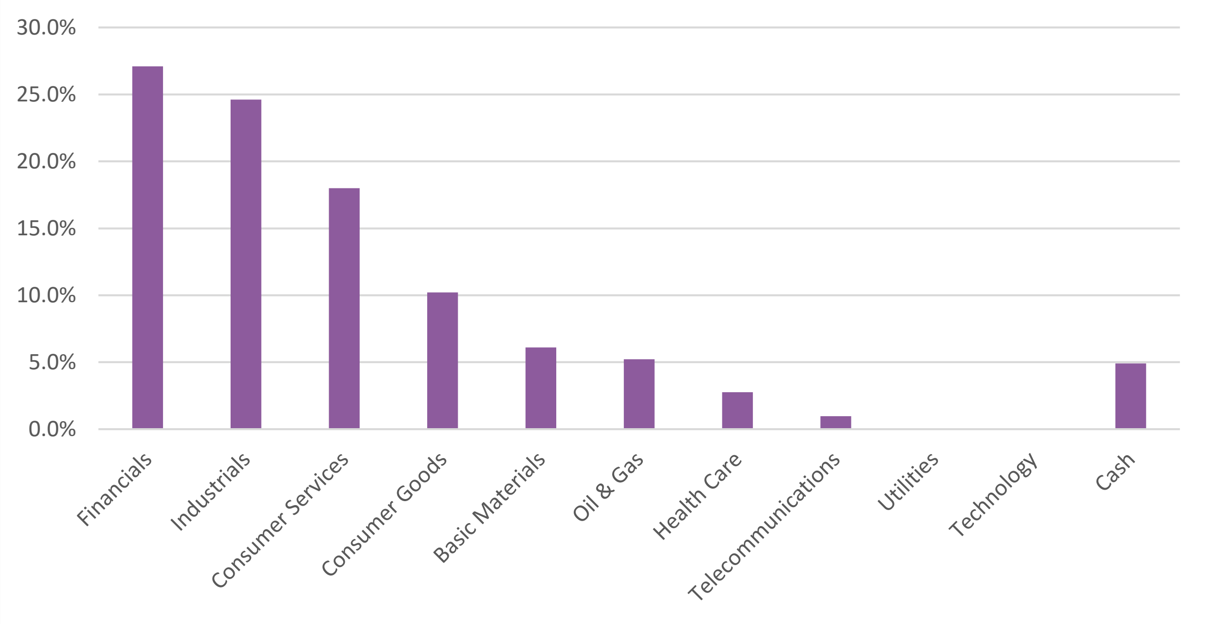
Given the strong showing from the overall portfolio we took the opportunity to reduce a number of position sizes, taking profits in **Intermediate Capital, St Ives, DFS, National Express** and **Alpha FMC.**

Portfolio Strategy & Themes

Our sector profile is largely unchanged. We have just under 30% of the fund held in financial sectors and around 20% in companies directly exposed to UK consumer confidence. We have low exposure to defensive sectors such as healthcare, consumer staples and utilities.

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.

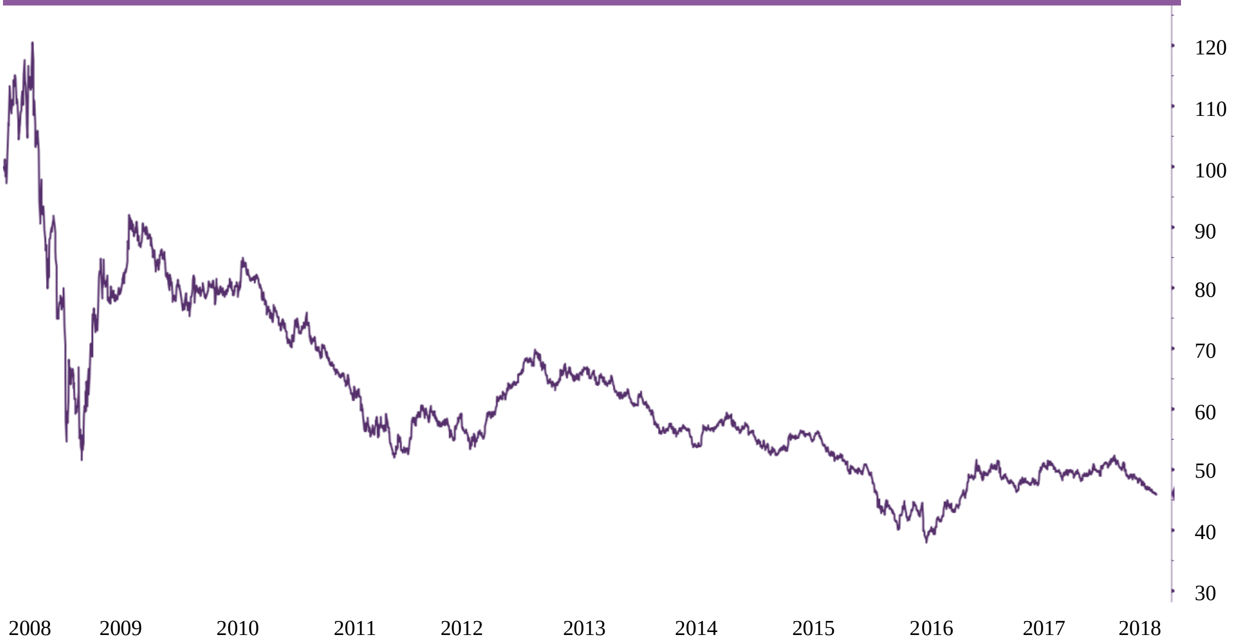
TB Saracen UK Income: Sector Profile



Source: Saracen Fund Managers as at 30.06.18

We continue to see the financial sector as an important source of dividend income for the Fund, with dividend prospects across the segment remaining robust. We do not expect any current payments to be under threat. A number of our holdings in life assurance and banks should benefit from higher interest rates and rising bond yields, whilst enjoying much improved cashflow and capital ratios. The chart below highlights the ongoing underperformance of the UK banking sector since the global financial crisis.

UK Banks relative to the ASX index

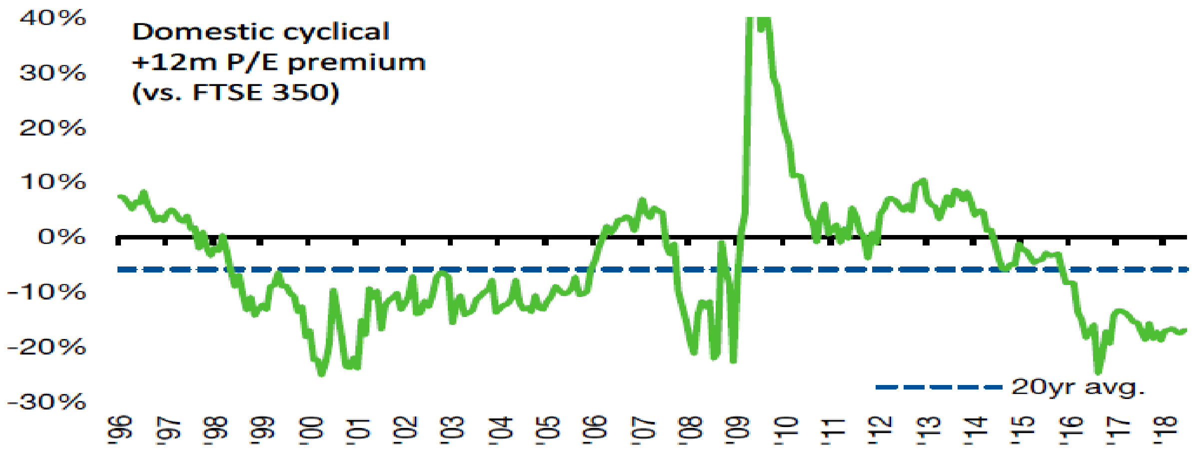


Source: Bloomberg

Our holdings in the industrial sectors are mainly in smaller companies with strong global market positions and positive growth drivers. These investments are a good antidote to the domestic exposure and generally offer diversification across a number of sector niches.

We are conscious that our investments which serve the UK consumer face an increasingly tough environment as the Brexit negotiations intensify, with economic shocks possible, leading to further dips in confidence. This segment of the fund is likely to find profit growth hard to come by over the next few years and is the part of the portfolio which has the greatest short-term earnings risk. Despite this we see exceptional long term value in some higher quality domestic businesses but it is a path which needs to be navigated carefully.

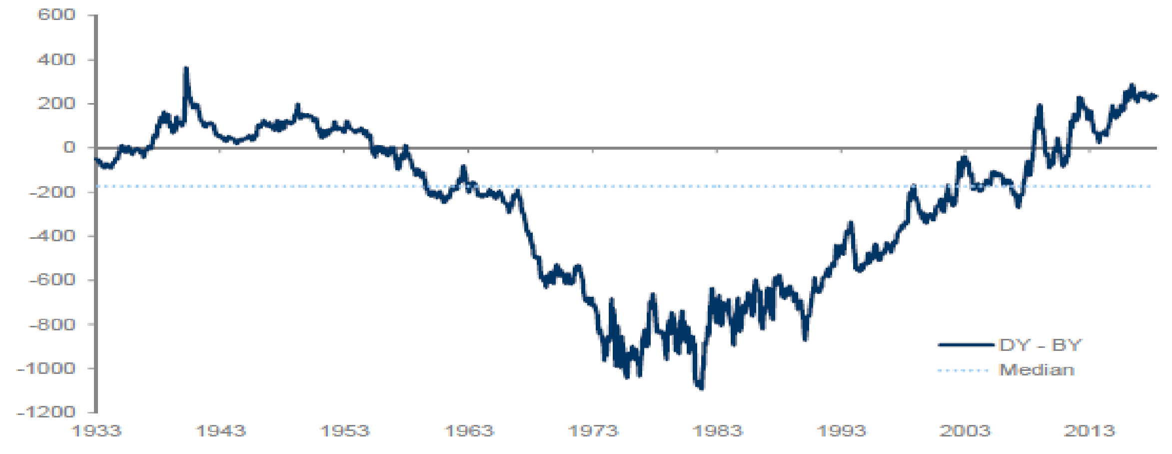
Domestic cyclicals continue to trade at an extreme discount



Source: Liberum, Datastream

The ongoing decline of UK equities against global equity markets and the yield gap between shares and UK gilts makes the investment case for UK Income strategies fairly compelling in our view. The chart below looks at the yield gap between shares and gilts. We have to go back to the world wars to see such a gap in favour of equity investment.

FTSE All-Share Dividend Yield – Bond yield (Latest = 237bp)



Source: MSCI, IBES, Morgan Stanley

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, we continue to be underweight 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 have made dividend payments vulnerable in our view. Whilst the large oil majors offer high dividend yields and good value relative to history we see them as having no real long-term attraction.

Investment Approach

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

We have a focussed portfolio of 25-35 quoted UK companies, a 'best ideas' fund with a high active share, currently 85%. 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 62% of the fund and large companies 33%, with cash held at 5%.

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 either of the following categories:

High Yield (40% of portfolio)

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 companies in this group will cause us some heartache, often being reviled by others and being vulnerable to the risk of dividend cuts.

Dividend Growers (55% of portfolio)

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 the potential to become high yielding over the medium term. We hope that in due course they become the dividend stocks of tomorrow, whilst driving increased income to shareholders.

**asset mix shown as at 30.6.18, source Saracen Fund Managers*

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 Income

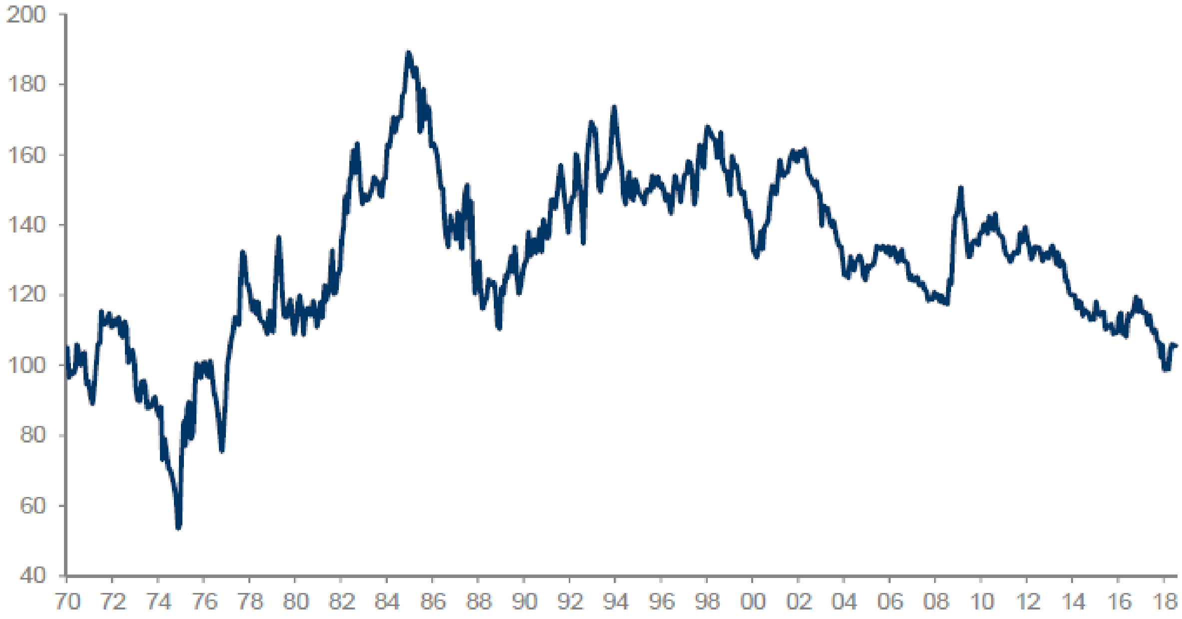
The forecast portfolio dividend yield based on our current expectations is 4.6%. This assumes growth in income from the portfolio over the next twelve months of just 2%, which we hope can be exceeded. The forecast dividend yield for the UK market as a whole is currently around 4.2% with expected dividend growth in the 3-5% range (source: Bloomberg). Only 14% of the Fund's income is dollar denominated, significantly less than the index and most other equity income funds.

An interim dividend per income share of 2.40p has been declared, which is a year on year increase of 5%. It is our firm intention to grow underlying dividends per share ahead of inflation again in 2018, but the absolute level of dividends per share may be impacted by any special dividends paid during the second half.

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.

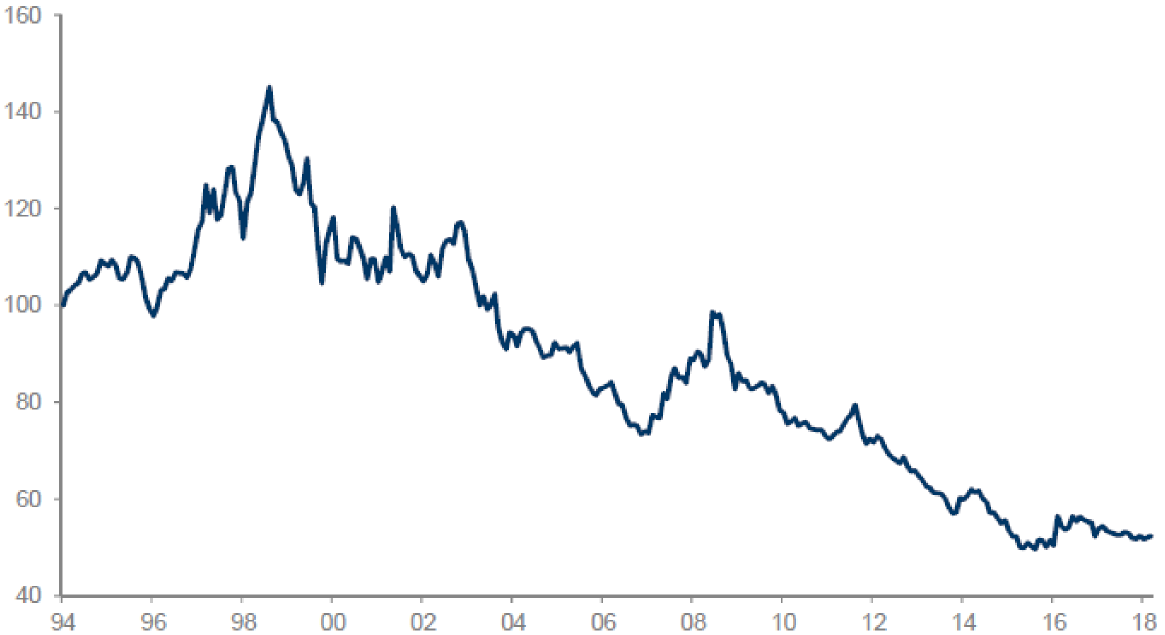
UK vs MSCI World Price Performance (LC)



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.

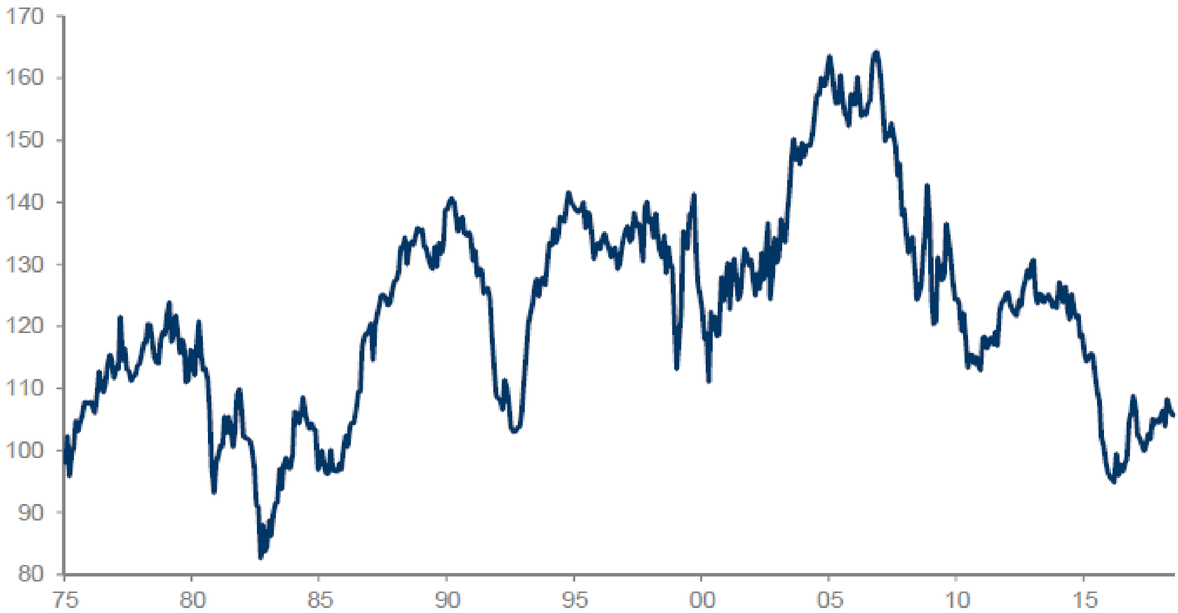
UK Large vs Small & Mid Caps Price Performance



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

In general, the fund is positioned to benefit from any recovery in value styles and an increase in bond yields.

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 Income?

The Fund continues to deliver strong results in 2018 and was well positioned for the recovery in UK equity indices we saw during this quarter. We have now reached the third anniversary of our fund launch and have managed to produce materially better returns than the average peer group fund whilst growing dividends ahead of inflation.

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. A key challenge therefore is to avoid complacency in the portfolio, particularly after a period of strong returns and higher valuations than before. Having established a solid foundation over the past three years, we must now maintain and build upon this.

Despite the improvement in the Fund's returns recently we believe that there is still plenty of potential value to be unlocked from many of our holdings. We will continue to invest where we see such value and, where possible, with some protection against any general market upsets. The income on offer from UK shares remains attractive relative to gilt yields and the market remains firmly out of favour with global asset allocators.

Our ongoing priority therefore 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 a high and growing income, should serve us well over the long term.

Scott McKenzie, Investment Director
6th July 2018

For further information on TB Saracen UK Income Fund please contact:
Scott McKenzie
0131 202 9100
scott@saracenfundmanagers.com

Important information:
This information should not be construed as an invitation, offer or recommendation to buy or sell investments, shares or securities or to form the basis of a contract to be relied on in any way and is by way of information only. Taxation levels, benefits and reliefs may all vary depending on individual circumstances and are subject to change. Subscriptions will only be received and shares issued on the basis of the current Prospectus, Key Investor Information Document (KIID) and Supplementary Information Document (SID). These are available, in English, together with information on how to buy and sell shares, on-line at www.saracenfundmanagers.com. Issued by Saracen Fund Managers Ltd, 19 Rutland Square, Edinburgh, EH1 2BB, authorised and regulated by the Financial Conduct Authority. Registered in Scotland No. 180545.

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.

Investment Manager - Saracen Fund Managers Ltd, 19 Rutland Square, Edinburgh, EH1 2BB Tel: 0131 202 9100/ Fax: 0131 221 1895

ACD & Fund Administrator – T Bailey Fund Services Limited (TBFS), 64 St James's Street, Nottingham, NG1 6FJ Tel: 0115 988 8274

Custodian – The Northern Trust Company, 50 Bank Street, Canary Wharf, London, E14 5NT

Depositary – NatWest Bank PLC, 135 Bishopsgate, London, EC2M 3UR

Regulatory Status:
FCA Recognised: Yes
Scheme Type: OEIC

Issue date – 30 June 2018