# TB Saracen UK Alpha Fund

## Quarterly Review – September 2018

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*Fund Manager*

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

| | TB SUAF | MSCI UK All Cap (TR) | Relative |
|---|---|---|---|
| **Q3 2018** | 0.0% | -0.8% | +0.8% |

## Performance Summary

After a strong recovery in the second quarter, it was a lacklustre period with the Fund returning a spectacular 0.0%, slightly ahead of the -0.8% decline in the MSCI UK All Cap index and the fall of -1.2% in the IA UK All Companies sector.  The Fund was top quartile ranked in this peer group during the three-month period and is also ranked top quartile over one year, three years and five years (source: FE Trustnet).  A summary of overall performance is shown in the table below.

***Cumulative Performance after all ongoing charges to 28 September 2018***

| | 3 months | 1 year | 3 years | 5 years |
|---|---|---|---|---|
| **TB Saracen UK Alpha B Acc** | 0.0% | 14.0% | 45.2% | 74.5% |
| **MSCI UK All Cap Index (TR)** | -0.8% | 5.9% | 38.8% | 42.0% |
| **Sector Average** | -1.2% | 5.5% | 34.0% | 44.8% |
| **Quartile Ranking** | 1 | 1 | 1 | 1 |

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

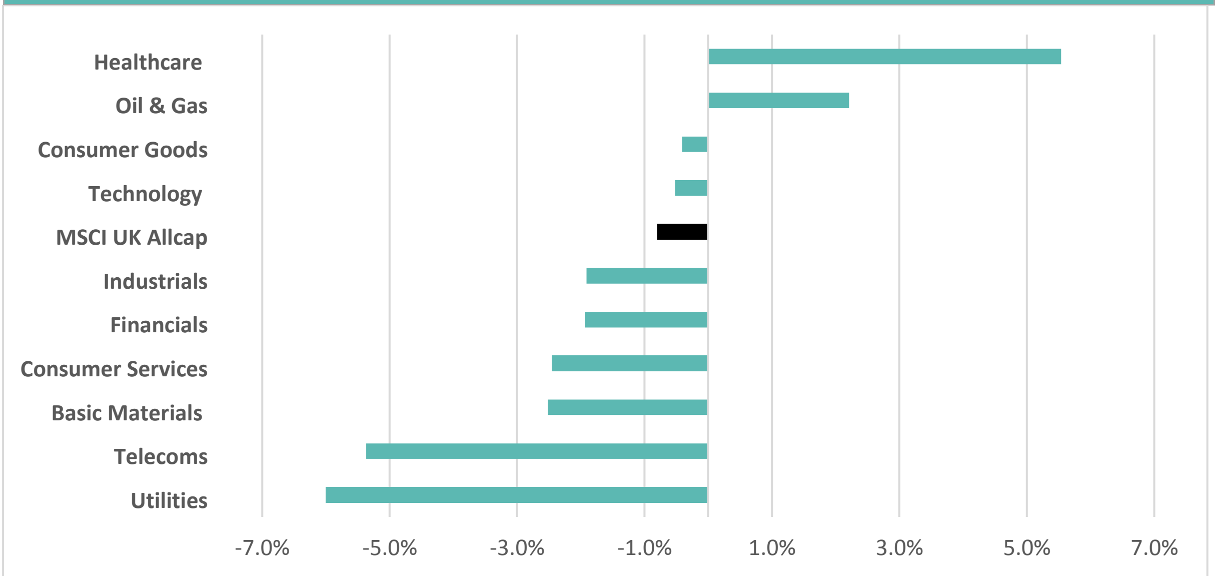
## Market Overview

Over the quarter there was very little differentiation at a market capitalisation level, with largecaps being broadly in line with the MSCI UK AllCap return, midcaps underperforming a little and smallcaps remaining broadly unchanged.

| Total returns by capitalisation : 3 months to 28 September 2018 | |
|---|---|
| **Largecap** | -0.7% |
| **Midcap** | -1.8% |
| **Smallcap** | -0.1% |

At a sector level, only two industry groupings delivered positive returns, oils and healthcare. This was the second quarter of positive returns from oils as the oil price recovery continued and dividends look more secure. Likewise, healthcare continued to recover after several years in the doldrums had left valuations relatively low. Given both sectors are predominantly largecap the Fund had low weightings to both, which proved to be a headwind overall. This was offset though by negative returns from utilities and telecoms, both areas where the Fund has very limited exposure and has done for some time.

**UK sector total returns: 3 months to 28 September 2018**




*Source: Bloomberg*

From a geopolitical perspective, there are 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 continuing to see a selloff as the US dollar strengthened further. Indeed, there were fully fledged currency crises in Turkey and Argentina, and weakness in a number of other countries. As a result, global growth expectations have generally been falling over the summer.

Closer to home, the Brexit negotiations rumble on with no obvious solution in sight. Mrs May seems incapable of uniting her government behind a common negotiating stance and, with time rapidly running out, it is hard to see a positive outcome emerging. The UK economy looks vulnerable to further disappointment as we go into 2019. Despite this impasse, it was an uneventful quarter for sterling, which fell only marginally during the period.

Bond investors globally had a tougher time of it with yields rising in the key markets of the US, UK and Germany to 3.1%, 1.6% and 0.5% respectively. Commentators are increasingly calling the end of the long bull market in government bonds. We would tend to agree.

## Portfolio Review

The portfolio has a 'multicap' structure with a large 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 negative correlation with rising bond yields. The Fund will also tend to have very limited exposure to largecap sectors such as oils, healthcare and telecoms.

## Positive Contributors

In a quieter summer market, we saw only three stocks make a double digit return over the period. All three were recovery stocks which had struggled previously and were making up some lost ground. **Wood Group** rose a further 24%, continuing their recent recovery as their markets appear to have finally bottomed and the benefits of the Amec acquisition become more apparent. **TalkTalk** bounced by 19% in a weak telecoms sector, albeit the recovery was from a very low base. **Galliford Try** is a business which has caused us some pain so far in 2018, so it was pleasing to see the stock rise by 16% as they delivered solid results and began to put their contracting woes behind them.

Two of our holdings are involved in bid situations at the moment and we saw a 9% increase in **RPC**, which recently received a tentative takeover approach. We await developments here with great interest. Our largest holding, **Shire**, rose another 9% as the previously large discount to the terms of the Takeda deal began to narrow.

Some other large holdings made good contributions. **Alpha Financial Markets Consulting** continued to progress, rising by another 6% despite a sparkling run previously. **Vitec** delivered strong results along with another sensible acquisition and the shares jumped a further 8%. **Tyman** has made solid if quiet progress and rose by 7% and **Dunelm** finally began to improve, rising 8% on results no worse than feared.

**Negative Contributors**

At the other end of the spectrum we had five stocks which fell by more than 10% including two damaging profit warnings. The worst culprit was **Hill & Smith** which fell 33% on unexpectedly poor results. This has been a successful business over the years, but its high rating and sudden trading downturn proved to be a toxic combination. Whilst our holding has been much reduced during 2018 it was nevertheless a painful blow. In a similar vein, **Clipper Logistics** fell 28% as its high growth expectations were impacted by unexpected costs in new contracts. Again, it was a highly rated stock which had a long way to fall. We hope that these setbacks will be temporary in nature.

**Palace Capital** fell 14% in a weak real estate sector, but this reflected illiquidity rather than any company specific concerns we believe. Likewise, the falls in **Victoria** (-15%) and **STV Group** (-11%) were more reflective of profit taking after strong returns previously. In the case of Victoria, there appears to be some indigestion after two equity issues and several large acquisitions during the past year.

Other stocks which saw profit taking and therefore negative contributions included **Avon Rubber** and **Premier Asset Management** whilst our new holdings in **Superdry** and **TI Fluid Systems** have yet to show a profit.

## Portfolio Activity

The fund has 30 investments which are spread across a variety of market capitalisations. As at 28 September 2018, the breakdown of the portfolio by size was 19% largecap, 29% midcap and 47% smallcap/other. The portfolio held 5% in cash at the period end.

**Purchases**

After disposing of several holdings in the second quarter, it was a busy summer and four new holdings were added to the portfolio.

**TI Fluid Systems** is a global automotive supplier which floated in Autumn 2017. The shares have made no progress since then, being hindered by a very large private equity stake in the business (currently 54%) as well as the large investment banks who sponsored the IPO losing interest, as they tend to do. We feel this has created an opportunity in a business which many UK investors have, with good reason, ignored up until now. TIFS is a global leader in the supply of fluid carrying systems to the light automotive industry and also has a fuel tank delivery division, with local operations in every major car production country, including a large business in China. The emergence of hybrid and electric vehicles represents both opportunity and threat for the business, but we believe that the group is well placed to be a winner, especially in hybrids. The business makes healthy returns and is well invested. The various uncertainties surrounding the global auto markets have left them very lowly valued indeed.

**Standard Life Aberdeen** has undergone dramatic change since the merger last summer, having sold its life and pensions business to Phoenix and floated its Indian life and asset management investments. The core asset management business has struggled with integration issues along with some significant client losses, including the £100bn Lloyds account, due to go in 2019. The shares have been miserable performers despite significant value being created in some of the above transactions. This leaves the business as a deep value, special situation in our view, trading at a material discount to its component parts.

**Superdry** is a global fashion brand operating owned stores in 11 countries and franchised stores worldwide, with a total reach of 157 countries. Global brand revenues are now only 29% in the UK, with Europe over 50% and promising early stage positions in the US and China. Like many fashion businesses it is undergoing radical changes in distribution, with store sales declining whilst online and wholesale rise. The shares had fallen sharply recently in response to slowing growth, but we believe that they have better long term prospects than other more UK-centric retailers given their growing international brand and low valuation.

**Marlowe** is a small business which has been set up as a provider of critical asset maintenance services to offices, in areas such as fire, security, water and air treatment. These are highly fragmented markets at present but offer considerable consolidation potential as well as significant cross-selling opportunities as Marlow grows in scale. We would expect Marlowe to be an acquisitive business as they look to execute this strategy and become a much larger group over time. However, they are paying very modest prices for such deals and earnings growth therefore could be substantial.

In general, we have added to businesses where we see value but where short term trends have been more challenging. These included **Dunelm**, **Clipper Logistics** and **IFG Group**. During August there were timely additions to **RPC** and **Wood Group**, with both stocks now beginning to recover. In September, we bought more **Premier Asset Management** and **Victoria**, both of which had seen significant profit taking in the preceding months.

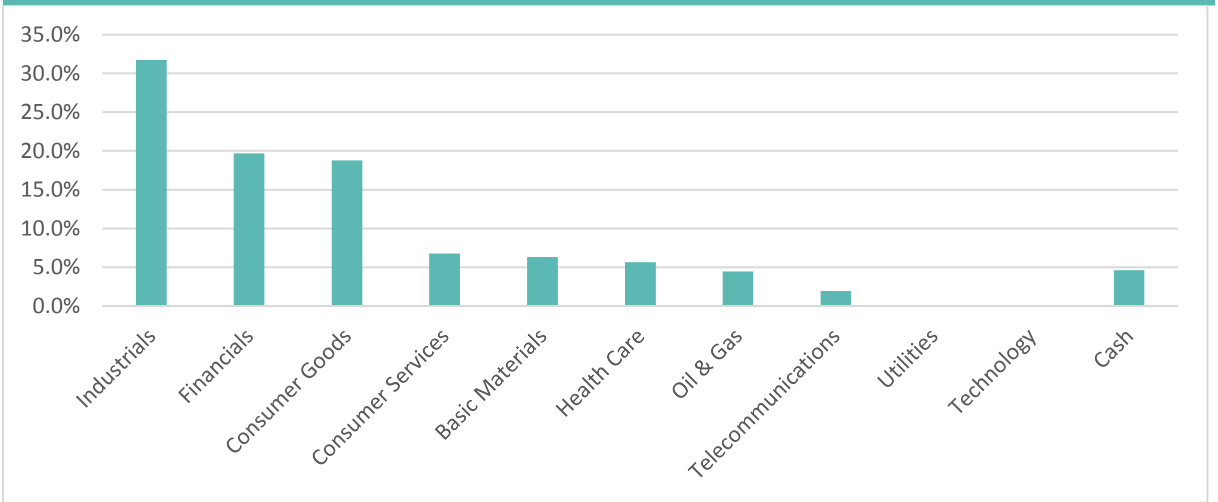
## Sales

There were no outright sales made during the period although we did take some further profit in **Alpha FMC** which had enjoyed a very strong run and was at that point the fund's largest holding.

## 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 Managers as at 28.9.18*

Our holdings in the industrial sectors are mainly in smaller companies with strong global market positions and positive long-term growth drivers.  They are a wide and varied group of businesses and overall they have proven to be a good antidote to the domestic exposure and generally offer significant diversification in overseas markets.

Unlike many investors at the moment, we are not scared to have exposure to the UK consumer, but must be conscious that consumers face an increasingly tough environment as the Brexit negotiations intensify.  Economic disappointments are possible, which may lead 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.

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 catalysts for recovery.  Whilst sectors such as tobacco and oil producers 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 30 quoted UK companies making up a 'best ideas' fund with a very high active share, currently at 93%. 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 76% of the fund with large companies only 19%. We have a cash balance of 5% 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 (42%* 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 four 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 (25%* of portfolio assets)**

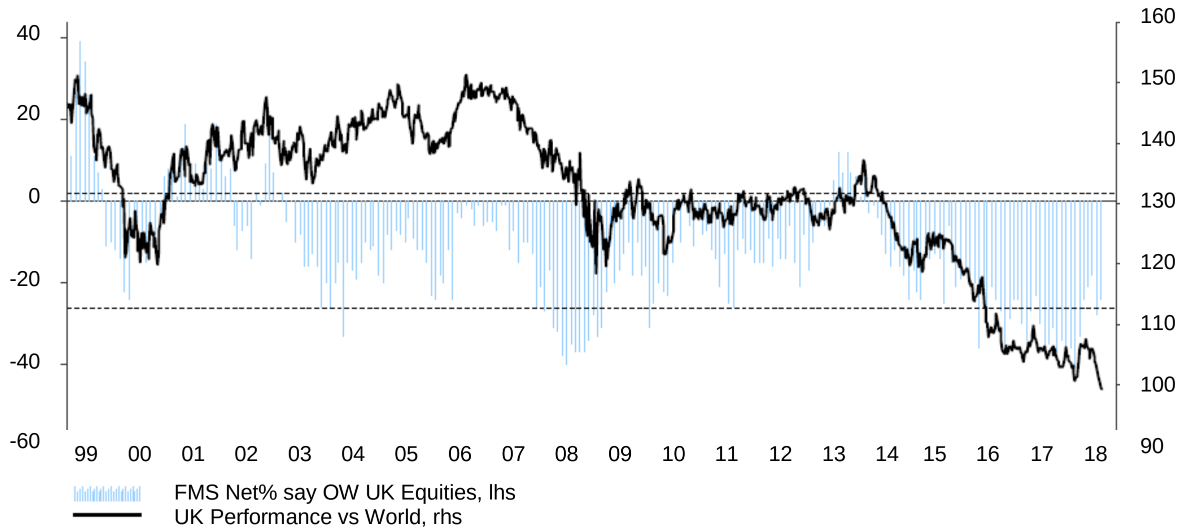
The final group are high quality, cyclical businesses where we recognise that economic conditions may not always be ideal but the company has sufficient strength of management and balance sheet to justify an investment.

**asset mix shown as at 28.9.18, source Saracen Fund Managers*

## Outlook

The UK stock market remains unloved 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 -24% of asset allocators overweight UK shares. In the survey, UK equities are the second least favoured asset class relative to their history with emerging markets being the most out of favour.

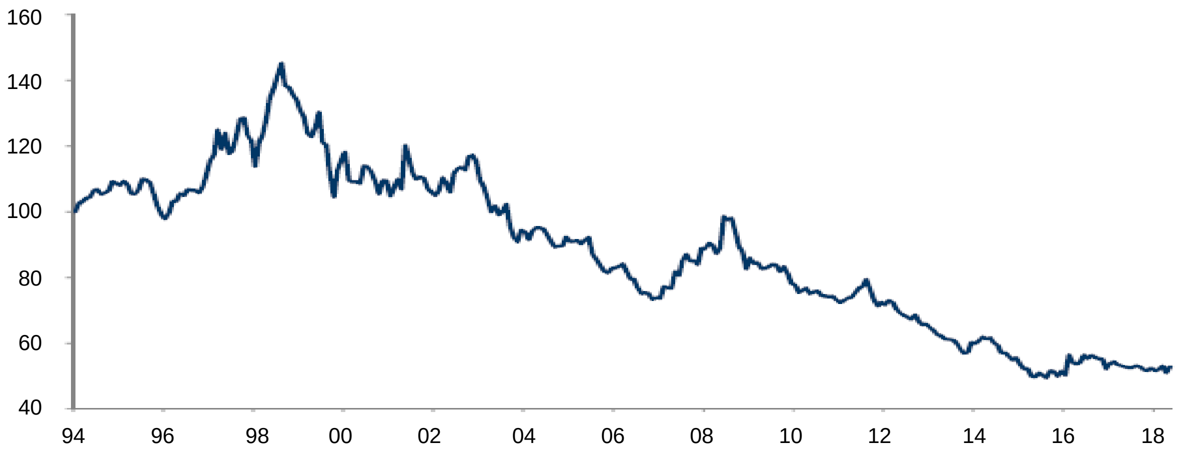
**BOAML Survey – Net % Asset Allocation Overweight UK Equities (current -24%)**




*Source: BofA Merrill Lynch Global Fund Manager Survey*

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. There are early signs that this long term trend is now bottoming out.

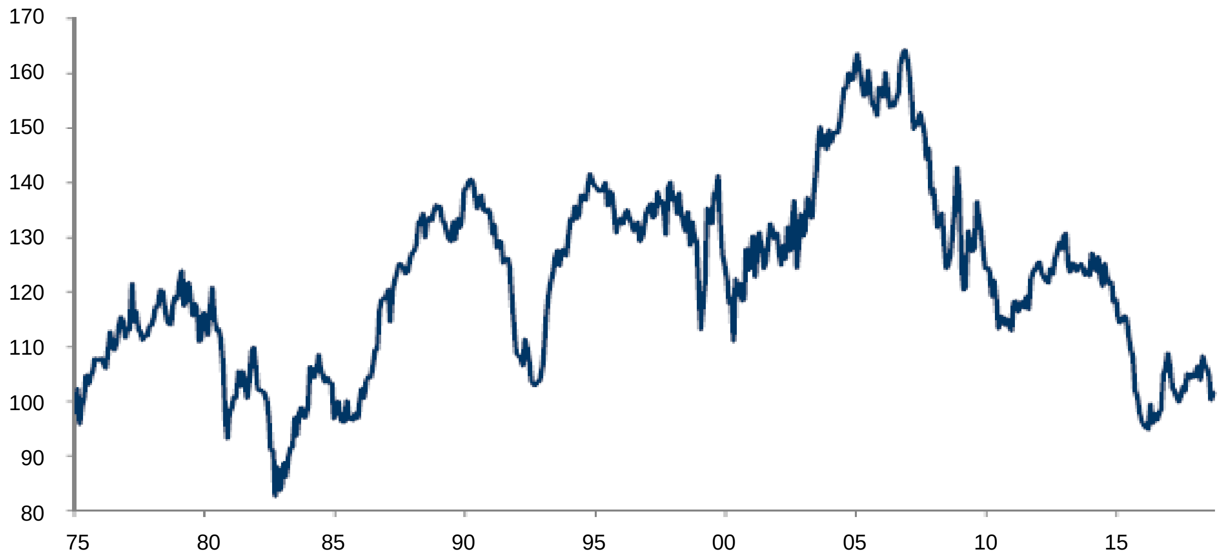
**UK MSCI Large vs Small & Mid Caps Price Performance**




*Source: MSCI, IBES, Morgan Stanley*

The astonishing dominance of the technology sector in recent years has meant that it has been a miserable time for value investors globally, although it is worth noting that value strategies in the UK have begun to stabilise, helped by the absence of tech in the index.

**MSCI UK Value vs Growth Price Performance**




*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 are now proceeding 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.

As a result, recently the Fund has become more focussed on finding value and special situations, where returns are less market dependent.

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**
**5th October 2018**

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