TB Saracen UK Income Fund

Quarterly Review – September 2018

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Fund Manager

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

	TB SUIF	MSCI UK All Cap (TR)	Relative
Q3 2018	-0.3%	-0.8%%	+0.5%

Performance Summary

After a strong recovery in the second quarter, it was a lacklustre period with the Fund returning -0.3%, slightly ahead of the -0.8% decline in the MSCI UK All Cap index and the fall of -1.3% in the IA UK Equity Income sector. The Fund was top quartile ranked in this peer group during the three-month period and is also ranked top decile over six months, one year and since launch (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	Since launch*
TB Saracen UK Income B Acc	-0.3%	8.9%	31.9%	30.9%
MSCI UK All Cap Index (TR)	-0.8%	5.9%	38.8%	27.8%
Sector Average	-1.3%	3.4%	27.4%	21.9%
Quartile Ranking	1	1	2	1

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

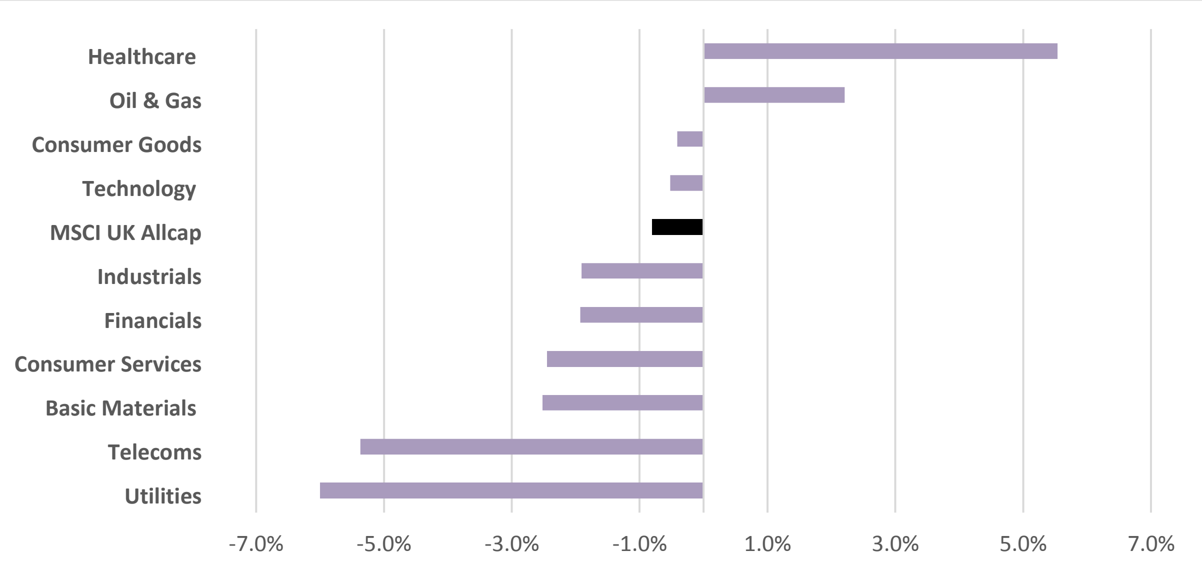
Market Overview

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 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 potentially negative correlation with rising bond yields.

Positive Contributors

In a quieter summer market we saw only four stocks make a double digit return over the period. In general, these 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. **Astra Zeneca** is also beginning to see light at the end of the tunnel, with several of its new drug therapies getting off to promising starts. The shares returned 15% during the quarter.

Our large holding in **Alpha Financial Markets Consulting** continued to progress, rising by another 6% despite a sparkling run previously. Also worthy of note was a 9% increase in **RPC Group**, which has received a tentative takeover approach. We await developments here with great interest.

Several previous stalwarts continued their upward marches. **Vitec** delivered strong results along with another sensible acquisition and the shares rose a further 8%. **Tyman** has made solid if quiet progress and rose by 7%. Finally, **Close Brothers** delivered another year of good results and went up 6%, at a time when most banking stocks struggled.

Negative Contributors

At the other end of the spectrum, we had five stocks which fell by more than 10% but there was no obvious sector trend amongst them. **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 **discoverIE** (-13%) and **STV Group** (-11%) were more reflective of profit taking after strong returns previously. Having met with both companies recently, we remain pleased with their progress and prospects.

Greene King struggles to convince investors that they can grow profits from here and despite a positive trading statement, they fell 11%. Of greater concern was a profit warning from **Low & Bonar**, which slipped 13% as a result. We have lost patience here and have taken a painful loss (see below).

In general, financial stocks remained in the doldrums, particularly asset managers, with both **Jupiter** and **Standard Life Aberdeen** seeing further falls after large declines already this year. **Lloyds Banking** and **Aviva** also slipped despite their attractive dividend prospects.

Stocks exposed to the UK consumer also continue to struggle in general, with the woes of the retail sector remaining headline news. Even a strong player such as **Next** saw its shares fall 8% over the quarter despite solid results and **Halfords** drifted on yet another strategic review under yet another CEO.

Portfolio Activity

The fund has 34 investments which are spread across a variety of market capitalisations. As at 28 September 2018, the split of investment was 33% in largecap, 32% in midcap and 31% in smallcap/other, with a cash balance of 4%.

Purchases

There was only one new investment made during the period, which was the global automotive supplier **TI Fluid Systems**. TIFS floated in Autumn 2017 and the shares have made no progress since then, being hindered by a very large private equity stake remaining 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.

During the quarter we increased our position sizes in the financials sector, an area of the market which has generally struggled during 2018 as investors fret about weaker investment markets and the spectre of Brexit impacting European financial institutions. We added to four stocks which had lagged considerably – **Aviva**, **Lloyds Bank**, **Palace Capital** and **Standard Life Aberdeen**. All of these businesses pay high and sustainable dividends in our view, and in each case offer good asset backing too.

We also added to two of our resources stocks, **Rio Tinto** and **Wood Group**. In the case of the latter, we believe that the Amec purchase in late 2017 could prove to be both timely and profitable. There were modest additions to the holdings in two consumer businesses, **Greene King** and **DFS Furniture**. Neither could exactly be described as market darlings at the moment and suffer from investor hostility towards anything exposed to the UK consumer. Finally, we increased the holding in **Gateley**, the legal firm. Gateley has delivered strong growth in profits and dividends since IPO and offers the portfolio good diversification benefits.

Sales

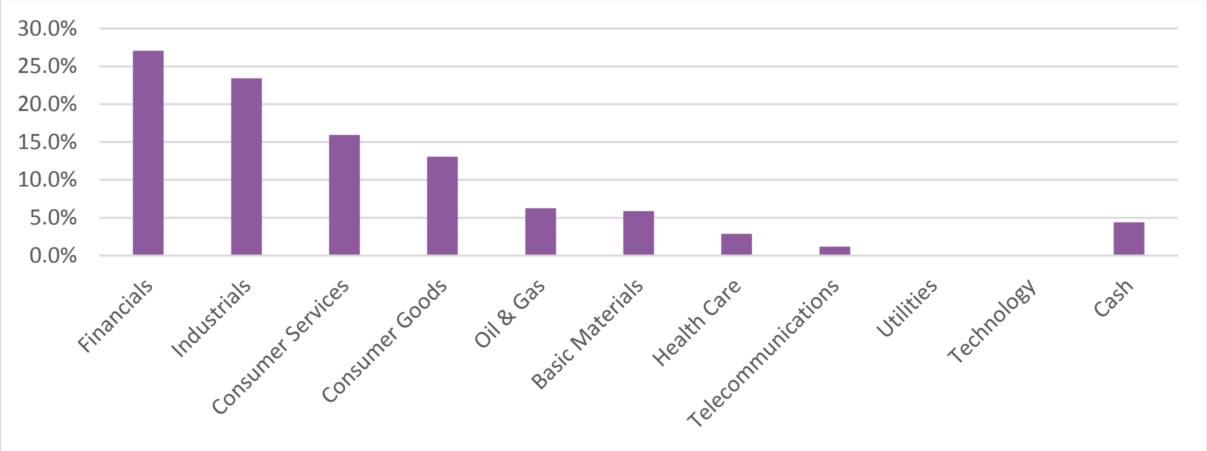
There was one sale to report and not for positive reasons. **Low & Bonar** has been a continual disappointment to the fund since it was purchased in early 2017 and has endured several profit warnings as well as unexpected management change. The recent warning led us to conclude that a large dividend cut is inevitable and with heavy hearts, we realised a fairly nasty loss and retired to lick our wounds.

On a happier note we took some profits in **Alpha FMC** after a significant re-rating in what is a large position for the fund. There was also a rare profit taken in a UK retailer as we reduced the holding in **Next**, which had substantially outperformed a very poor sector.

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 Income: Sector Profile



Source: Saracen Fund Managers as at 28.9.18

Our sector profile is largely unchanged. We have 27% 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.

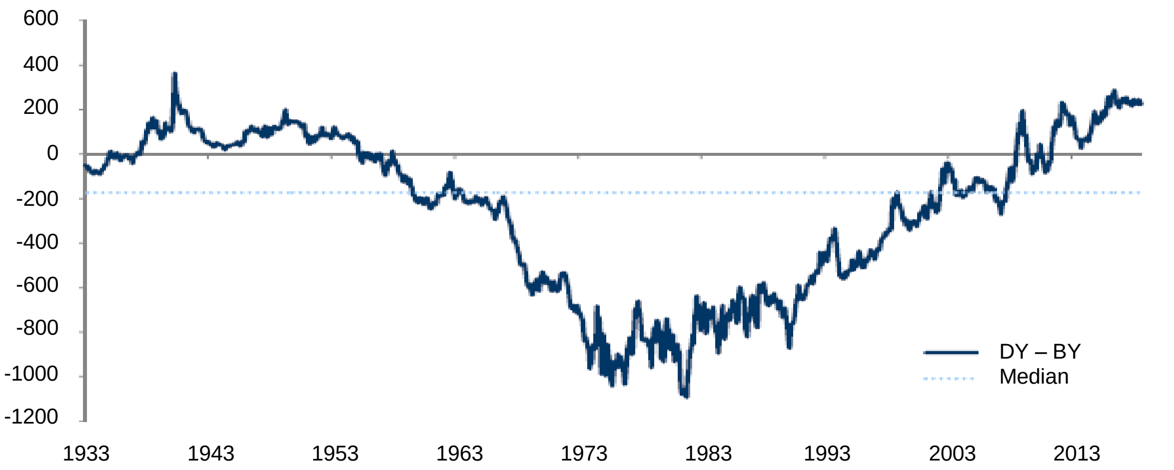
We continue to see the financial sector as an important source of dividend income for the Fund, with dividend prospects across the segment remaining robust. We do not expect any current payments to be under threat. A number of our holdings in life assurance and banks should benefit from higher interest rates and rising bond yields, whilst enjoying much improved cashflow and capital ratios. Despite this, financials sectors in general have struggled in 2018.

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 different 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.

The ongoing decline of UK equities against global equity markets and the yield gap between shares and UK gilts makes the investment case for a UK equity income strategy 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 – 10 Year Gilt Yield (Latest = 222bp)



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 is now leading to dividend cuts. Whilst the large telecoms companies offer high dividend yields and good value relative to history, we see them as having no real long-term attraction, being fairly indebted and with high ongoing capital requirements.

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 84%. 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 63% of the fund and large companies 33%, with cash held at 4%.

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 (46% 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 (50% 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 28.9.18, source Saracen Fund Managers*

To summarise, the 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

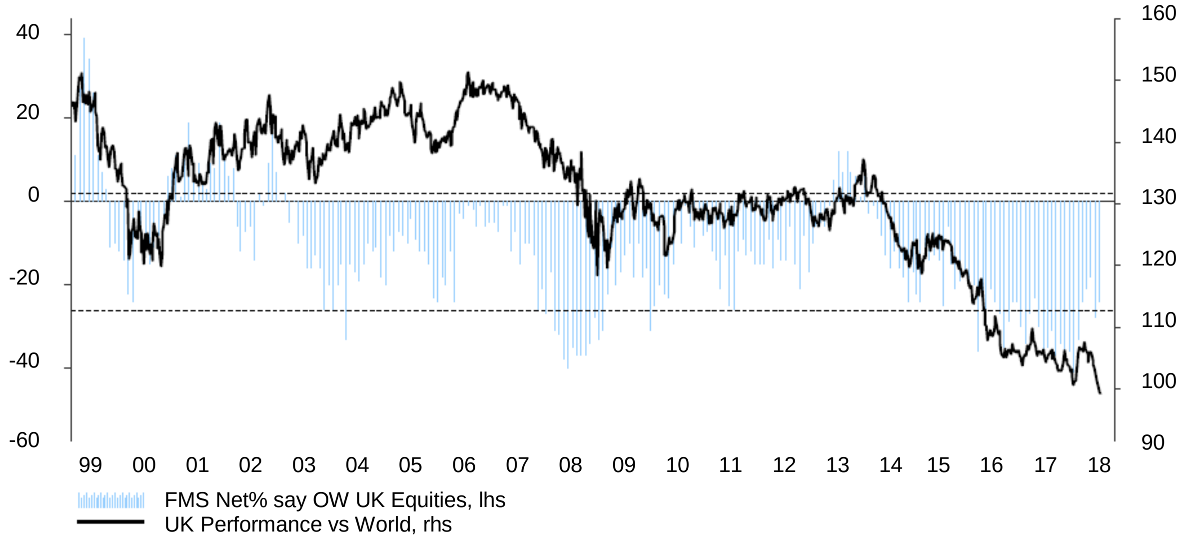
The forecast portfolio dividend yield based on our current expectations is 4.8%. This assumes growth in income from the portfolio over the next twelve months of 4%, which should be ahead of inflation. The forecast dividend yield for the UK market as a whole is currently 4.3% with expected dividend growth of 7% (source: Bloomberg). This reflects some recent sterling weakness too. Only 17% of the Fund's income is non-sterling denominated, significantly less than the index and most other equity income funds.

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

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 minus 24% of asset allocators positive on 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

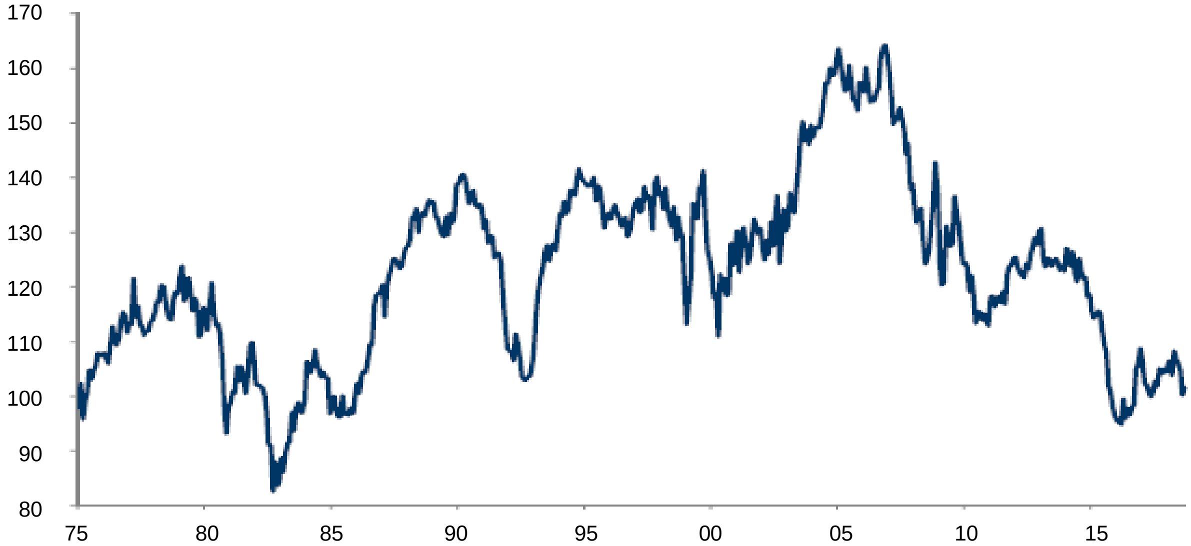
Within this context, it has been large cap investors who have borne the brunt of the pain, with the mid and smallcap indices materially outperforming over the past decade, and major UK sectors such as banks, oils and telecoms largely remaining in the doldrums. There are early signs that this long term 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 also meant it has been a miserable time for value investors globally, to the point where genuine value investors are almost an endangered species. Recent research by RWC and Bloomberg suggested that only 10% of UK equity funds by assets under management now employ a distinctive value style, and this in a market with a very small technology sector anyway. These type of reference points have strong parallels with the TMT bubble of 1999/2000 in our view.

MSCI UK Value vs Growth Price Performance



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 has delivered strong results in 2018 so far despite a pause for breath during this quarter. Saracen UK Income continues to produce 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 several years of good returns and higher valuations than before.

Despite the general robustness of the Fund's results recently we believe that there is still plenty of potential value to be unlocked from many of our holdings and the current high yield of the portfolio gives us cause for optimism in that respect. We will continue to invest where we see real 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 largely 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
5th October 2018

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