# TB Saracen UK Alpha Fund

## Quarterly Review – December 2018

**Scott McKenzie**
*Fund Manager*

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

| | TB SUAF | MSCI UK All Cap (TR) | Relative |
|---|---|---|---|
| **Q4 2018** | -16.7% | -10.6% | -6.1% |
| **Calendar 2018** | -9.7% | -9.8% | +0.1% |

## Performance Summary

It was a dismal end to 2018 for the Fund with the shares falling 16.7% during the final quarter, well behind the 10.6% decline in the MSCI UK All Cap index and the fall of 12.5% in the IA UK All Companies sector. This was all the more disappointing when we consider the positive returns the Fund had delivered in the previous nine months of the year. As a result, the Fund was bottom quartile against peers during the three-month period and slipped to second quartile for 2018 overall (source: FE Trustnet). A summary of performance is shown in the table below.

***Cumulative Performance after all ongoing charges to 31st December 2018***

| | 3 months | 1 year | 3 years | 5 years |
|---|---|---|---|---|
| **TB Saracen UK Alpha B Acc** | -16.7% | -9.7% | 14.9% | 30.6% |
| **MSCI UK All Cap Index (TR)** | -10.6% | -9.8% | 19.7% | 20.3% |
| **Sector Average** | -12.5% | -11.2% | 12.2% | 18.4% |
| **Quartile Ranking** | 4 | 2 | 2 | 1 |

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

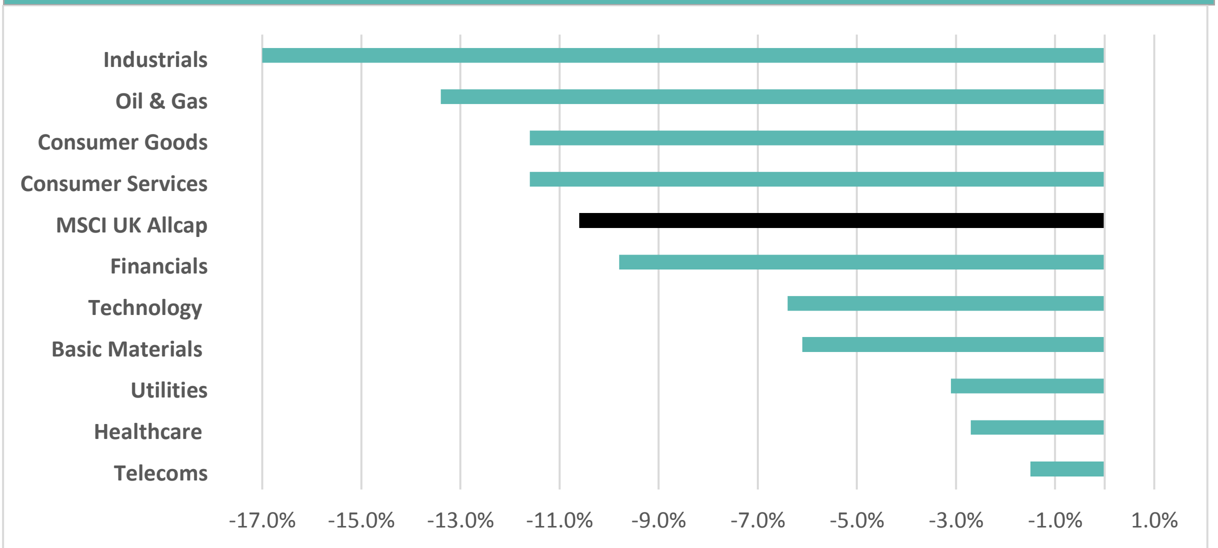
## Market Overview

Over the quarter, the mid and smallcap indices bore the brunt of the market declines and this was decidedly unhelpful for the Fund which has 80% of its investments here. However, in general there were precious few hiding places with all market capitalisations seeing significant declines and every major global equity market also falling materially, including the S&P 500 which fell 13.5% and the MSCI World (£) which was down by 11.3%.

| Total returns by capitalisation : 3 months to 31st December 2018 | |
|---|---|
| **Largecap** | -9.6% |
| **Midcap** | -13.4% |
| **Smallcap** | -10.3% |

At a sector level, every industry grouping delivered negative returns, albeit losses were limited in more traditionally defensive segments such as telecoms, utilities and healthcare. Given such sectors are predominantly largecap the Fund had low weightings to all, which proved to be a relative headwind. More problematic however were the large exposures to industrial and consumer sectors, both of which proved to be significant negative factors for performance.

**UK sector total returns: 3 months to 31st December 2018**




*Source: Bloomberg*

From a geopolitical perspective, two of the ongoing concerns for markets, Brexit and global trade, remain omnipresent and more worrying now than they were previously. The increasing prospect of a trade war between the US, Europe and China has brought ever greater nervousness to global markets, with industrial and financial sectors falling sharply worldwide as global growth expectations continue to fall and fears of recession intensify. A further ongoing depressant is increased quantitative tightening, with interest rates now rising and an end to the global easing programmes we have seen over the past decade.

In the closing months of 2018, falling bond yields and rapidly inverting yield curves have heightened such concerns, leading to an overall sense of investor panic. This has seen the US stockmarket finally crack after a long period of relative strength. In a reversal of the trend seen in the first nine months of 2018 bond returns were positive with yields falling sharply in the key markets of the US, UK and Germany to 2.7%, 1.3% and 0.2% respectively.

Closer to home, the Brexit negotiations have gone from bad to worse with no obvious end in sight and time rapidly running out. Having survived a leadership challenge, Mrs May limps on doggedly but with parliament in chaos as we write, it is hard to see a positive outcome emerging. The UK economy looks vulnerable to further disappointment as we go into 2019 and it now feels that a 'no deal' crash out of the EU would be highly damaging in both the short and long term. As a result, sterling continued to slip, falling 2% against the dollar and 1% against the Euro and investors remain highly negative about the prospects for UK shares.

## 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 in recent years as well as offering considerable long-term flexibility. However, this structure did us no favours during the quarter, not helped by some specifically poor stock selection in sectors such as industrials and consumer discretionary where exposure was high. The focussed nature of the portfolio means that there is nowhere to hide when our stock selection falters and this was painfully apparent in the latter part of 2018. The Fund also had a low allocation to large, defensive sectors such as utilities, healthcare and telecoms which was unhelpful during a period where bond yields fell.

### Positive Contributors

Against this difficult background our winners were few and far between, with only a handful of investments in positive territory over the quarter. Of these two were businesses we had added to the portfolio during the period with **Kin & Carta** rising 12% and **discoverIE** rising by 4% - we discuss both companies in more detail in our review of activity.

There was a 17% recovery in **Hill & Smith** and we took the opportunity to exit. Of the existing holdings, only **Palace Capital** (+7%) and **Dunelm** (+2%) were in positive territory, with both stocks producing positive updates despite operating in challenging sectors.

### Negative Contributors

In such difficult circumstances it is hard to know where to begin and the Fund had no less than twelve holdings which fell by more than 20% during the period. It is important to differentiate between those whose results have deteriorated already, those which are deemed cyclical and therefore at risk and those where long term prospects appear largely unchanged but whose shares have been heavily de-rated.
In the first category there were two highly damaging profit warnings from Superdry and Victoria. **Superdry** is probably the worst investment we have made in the Fund in recent

years.  The shares had already fallen substantially prior to our purchase but, with hindsight, this was a major red flag and the stock delivered two large profit warnings in the final quarter. The shares have halved in response and there is potential management change to come. Whilst current valuation metrics do point to an extremely oversold position, prospects have faded dramatically and need further reassessment before we can consider adding to the position. **Victoria** had been a successful investment for the Fund in 2017 but has unravelled of late. Whilst we do not believe the business is broken, management credibility has been severely damaged post a spate of acquisitions and they now require a period of sober delivery of results leading to reduced debt levels. The shares fell 33%.

In the cyclical category, there were several shares where investors have taken a view that prospects will deteriorate markedly going into 2019. **Wood Group** fell 33% mainly in response to very weak oil prices. We believe that the purchase of Amec will prove to be a good one and expect improved results from here, despite a tough background. **TI Fluid Systems** is a fairly recent purchase which has proven to be ill-timed, coming against a crisis of confidence amongst global auto companies and various profit warnings. TIFS has delivered solid results so far but the shares are discounting a savage downturn going forward, having fallen 33% over the quarter. **Tyman** also fell by 33% despite a solid trading statement. The CEO is retiring in 2019 and the business has a large exposure to US housing markets where there are concerns about economic prospects. **Galliford Try** has had a torrid 2018, having raised equity post the fall of Carillion only to see another price fall of 34% in response to a badly received and sudden rights issue from Kier, another contracting business. The ongoing saga of the Aberdeen bypass needs to be resolved and put behind them as soon as possible.

The final category of fallers are companies which we believe have solid growth prospects but whose shares have suffered substantial de-rating. Our thoughts on these are as follows:

**Clipper Logistics (-23%)**: the previous high rating has now gone and whilst the retail outlook is cloudy, Clipper has exposure to structural growth in online retail and is pursuing significant new business opportunities.

**Restore (-34%):** no longer on a premium rating but a company with high repeat business and strong visibility. The CEO is retiring which was a surprise but the main consolidation in their market is now largely done. Very lowly rated for the quality of earnings.

**Synthomer (-34%)**: caught in the crossfire of a very weak chemicals sector. The business continues to trade well and acquisition opportunities are now more likely for them, with management having been patient so far.

**Premier Asset Management (-28%):** Premier had the misfortune of having a September year end which co-incided with the peak of investment markets. As such they will struggle to deliver meaningful asset growth this year if current weak markets persist. We very much view this as a blip and take encouragement from their strong balance sheet, defensive product portfolio and modest fund sizes.

We have added to each of the stocks above during this period of market turbulence.
Other negative contributors included **RPC Group**, where we still await news on a possible takeover bid (due in January) and **Standard Life**, where weak markets and fund outflows

remain a toxic cocktail. **Prudential** shares suffered from market concerns as well as their exposure to emerging markets but we believe that there is now a lot of value to be unlocked from the shares and have bought more.

## Portfolio Activity

The fund has 32 investments which are spread across a variety of market capitalisations. As at 31st December 2018, the breakdown of the portfolio by size was 18% largecap, 24% midcap and 55% smallcap/other. The portfolio held 3% in cash at the period end.

### Purchases

There were four purchases made, all businesses which we had followed closely in recent years and where significant buying opportunities had emerged as markets retreated.

**Kin & Carta** is a digital marketing business, a hybrid of the big advertising agencies and the consultancy firms, but on a smaller scale. Formerly known as St Ives, it has a new CEO who has just announced a major strategic repositioning. Debt has been drastically reduced and they now look to the future with confidence. They have some genuinely blue chip customers and K&C looks like an investment with high potential, being lowly rated, operating in growth markets and with new targets which suggest that a re-rating could be possible.

**discoverIE** is a small electronic components business, designing, manufacturing and distributing specialist, customised assemblies to a wide array of industrial customers, predominantly in Europe. They have a number of secular growth markets with strong positions in medical, transport, connectivity and renewables. Whilst the company is acquisitive they operate in genuine niche segments where competition is limited and they have potential to become a much larger company in the long run whilst delivering solid organic growth.

**Mattioli Woods** is one of the UK's leading providers of wealth management and employee benefits services, advising over 10,000 clients with assets under advice of almost £9bn across 10 UK offices. Unlike traditional wealth managers, the majority of client assets are pensions linked. The business has grown substantially over the past five years and has ambitious targets for future growth. Having previously enjoyed a high rating, the shares have sold off sharply recently and are now trading on a sensible valuation, backed by large amounts of cash on the balance sheet.

**Intermediate Capital** is an alternative asset manager specialising in various forms of mezzanine debt, real estate and credit funding in private markets. The client base is now both global and institutional, with their asset classes becoming more mainstream and offering good diversification away from public markets. Unlike most asset managers, ICG has a significant competitive advantage by virtue of its longevity and track record, its skill sets and the closed end nature of their funds, giving them secure revenue streams in attractive niche markets, even in times of stock market turbulence.

As detailed previously, we have added to businesses where the shares have been heavily de-rated but where long term prospects remain attractive - these include **Clipper Logistics, Restore, Synthomer, Prudential** and **Premier Asset Management**. Amongst the more cyclical stocks, we have increased our exposure to **Wood Group** and **Tyman**.

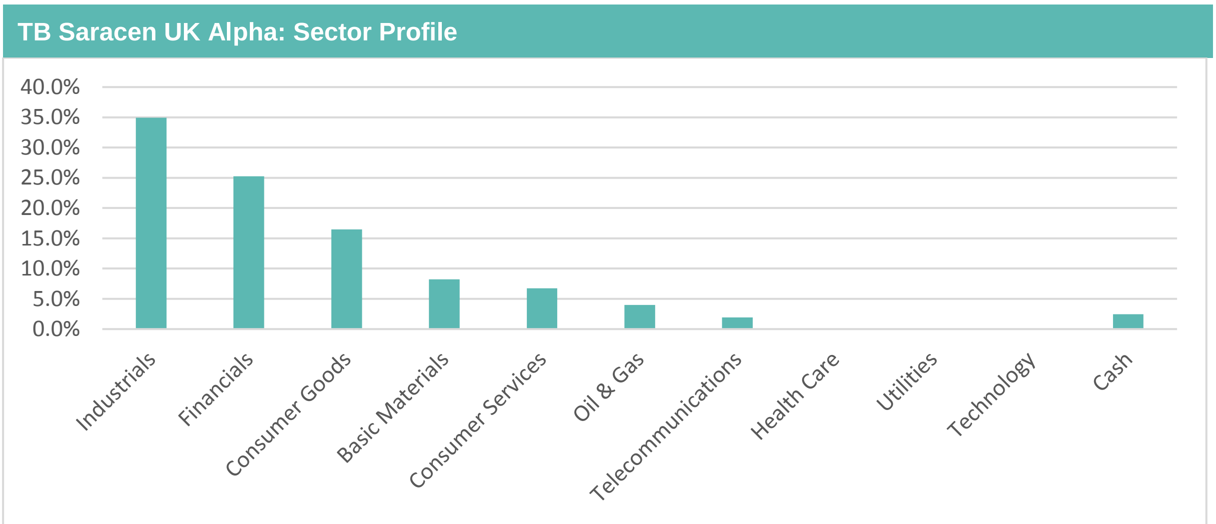
**Sales**

There were two outright sales made during the period, both for quite different reasons.

We were happy to conclude the sale of **Shire** as the year ended, ahead of the conclusion of the Takeda takeover bid. The shares returned 16% during 2018 and were the largest holding in the Fund for most of the year. On a more sober note, we sold the holding in **Hill and Smith** which had suffered a shock profit warning in August. Thankfully the shares had enjoyed some recovery from the lower levels and we took the opportunity to exit after this bounce.

## 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.



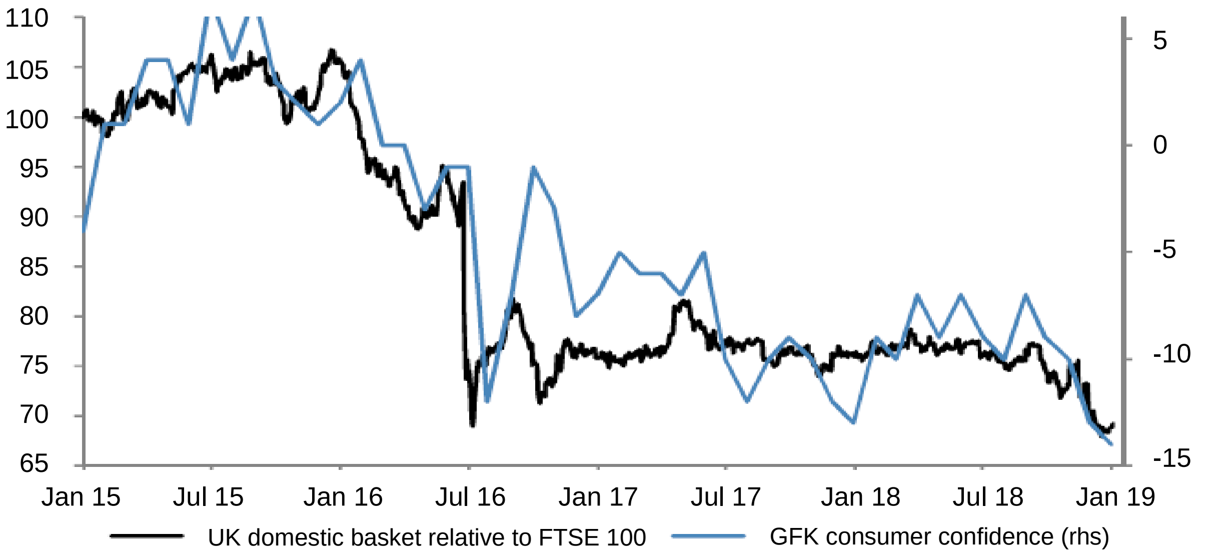

*Source: Saracen Fund Managers as at 31.12.18*

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 should prove to be a good antidote to the domestic exposure held elsewhere in the Fund. However, in general this group has suffered badly during the recent selloff, with derating rather than declining earnings power being a notable feature of late.
The main change to report since our previous review is an increase in our holdings in the financials sector. In broad terms, share prices in UK financials businesses have suffered from a combination of weak equity markets, Brexit uncertainty and more recently falling bond yields.

We have used this period of uncertainty to buy two good businesses, Intermediate Capital and Mattioli Woods, whilst increasing exposure to some existing holdings. This has resulted in the fund having its highest financials weighting for over a decade.

Given our high exposure to medium and smaller companies, in general we remain long sterling assets and short overseas earners compared to a broad UK benchmark. This has clearly been a 'top down' headwind for the fund more recently, with consumer related stocks particularly badly impacted, but we have no plans to change this positioning and should we get a remotely satisfactory conclusion to Brexit this segment of the fund could recover significantly. The chart below highlights the material underperformance of UK 'domestic' businesses against the FTSE100 in recent years and its correlation to weaker consumer confidence.

**UK Domestic basket relative and consumer confidence**




*Source: Bloomberg, JP Morgan*

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 also continue to hold nothing in consumer staples or utilities where we see limited valuation support and weak underlying growth. With the sale of Shire we now have no exposure to healthcare either, which was ranked as the most overowned sector relative to its history in the recent BOAML investor survey.

## Investment Approach

The TB Saracen UK Alpha Fund's investment objective is to achieve a long-term total return above the total return of the MSCI UK All Cap Index.

We have a focussed portfolio of 32 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 79% of the fund with large companies only 18%. We have a cash balance of 3% 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. Valuation is key in every decision we make.

We spend very little time responding to what is in the news or analysing economic data. Most macro factors are unpredictable and volatile in our experience. 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 being applied to growth companies, which led us to take profits in various holdings.

**Special situations (30%* 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. During 2018, we saw 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)**

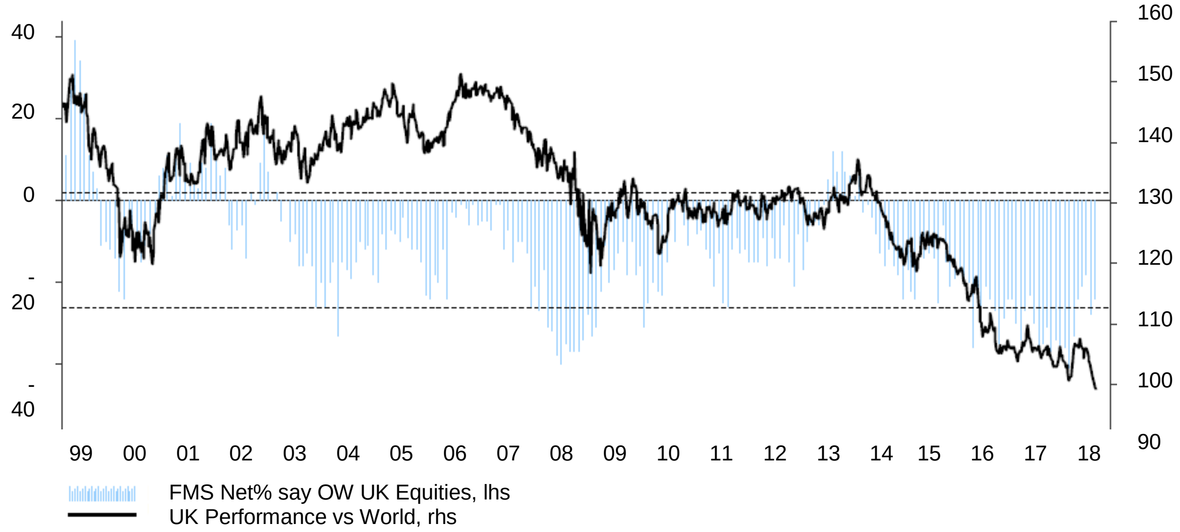
The final group are high quality, cyclical businesses where we recognise that economic conditions may not always be ideal but the company has sufficient strength of management and balance sheet to justify an investment.

**asset mix shown as at 31.12.18, source Saracen Fund Managers*

## Outlook

The UK stock market remains loathed 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 39% of asset allocators underweight UK shares, one of its weakest ever readings.

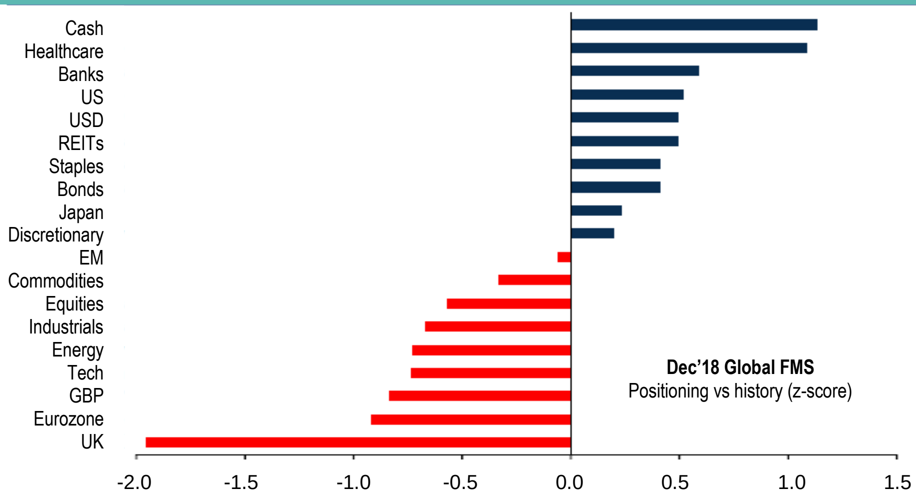
**BOAML Survey – Net % Asset Allocation Overweight UK Equities (current -39%)**




*Source: BofA Merrill Lynch Global Fund Manager Survey*

In the same study, UK equities are also the least favoured asset class relative to the survey history by a considerable margin whilst sterling also remains heavily out of favour.

**The Long & Shorts, relative to Global FMS history***

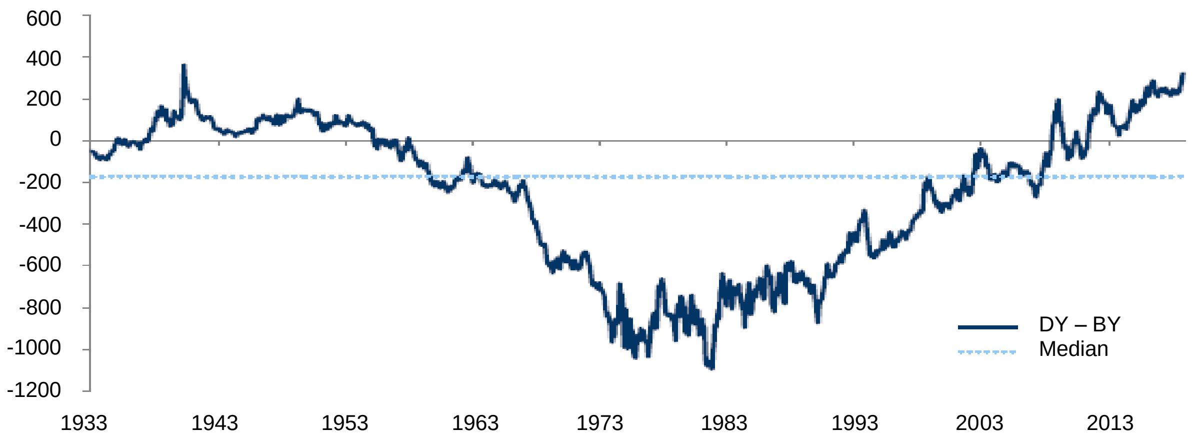



*Source: BofA Merrill Lynch Global Fund Manager Survey. *data since 2006 for commodities & real estate; since 2001 for all others*

These findings demonstrate the damage that the Brexit has already done to investor perception (not to mention returns) and how little confidence there is in a positive resolution being achieved in the months ahead.

If one then considers the alternatives we find it hard to rationalise the enormous yield gap which has emerged between UK equities and gilts, a situation which has worsened over the past quarter. This can only be described as extreme and almost unprecedented in a historical context, all the more so when one considers the risks of a UK government credit downgrade and the large overseas earnings component driving UK dividend payments. We therefore make no apologies for featuring the chart below again.

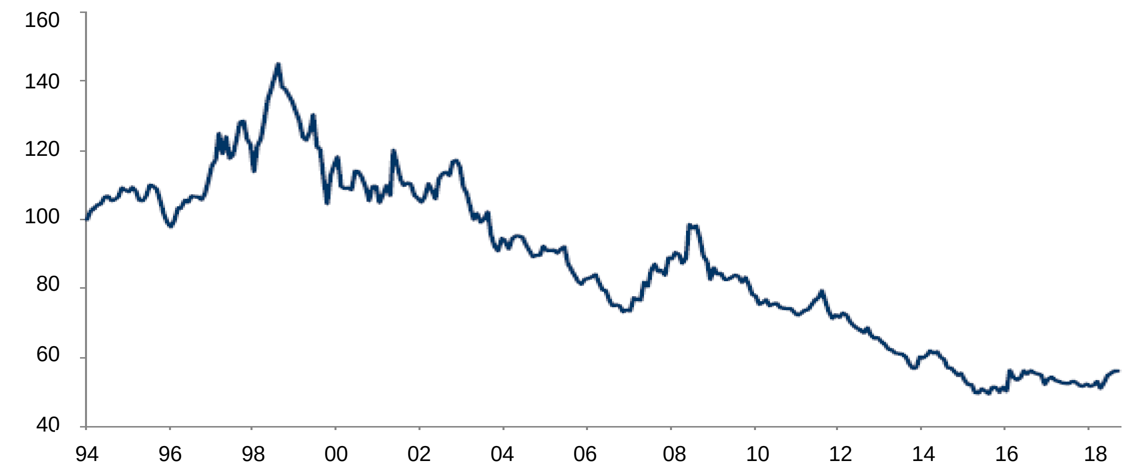
**FTSE All-Share Dividend Yield – Bond Yield (latest: 322bp)**




*Source: MSCI, iBoxx, Global FinancialData, Datastream, Morgan Stanley*

Despite the profit taking we saw towards the end of 2018, particularly in midcap, it is worth noting the need for some caution, given that our fund strategy favours a large allocation to mid and smallcap investments. Over the past decade it has been large cap investors who have borne the brunt of poor returns, with the mid and smallcap indices materially outperforming, and major UK sectors such as banks, oils and telecoms remaining in the doldrums. There is now evidence that this trend has bottomed out which is a potential headwind for UK Alpha.

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




*Source: MSCI, IBES, Morgan Stanley*

We spoke in our previous review about the various threats to markets and the overvaluation in high growth areas such as technology as well as the vulnerability of the US market. Whilst these concerns have now materialised we have been surprised by the intensity of the downturn in other, supposedly cheaper markets across Europe and emerging markets. The UK continues to bear the brunt of such trends, all the more so when the current Brexit-induced paralysis is considered.

## What does all of this mean for Saracen UK Alpha?

After a strong first nine months The Fund had a very poor end to 2018 and fell substantially during the final quarter, leading to negative returns for the year as a whole. Although Saracen UK Alpha produced better relative returns than the average peer group fund in 2018 this was a hollow victory given where the Fund had been previously.

Having enjoyed strong returns from our positioning in mid and smallcap companies in recent years this strategy struggled somewhat in the final part of 2018 as investors took flight in what is an illiquid asset class. Our strategic commitment to investing in medium and smaller companies remains. With much of the previous exuberance in this segment of the market now much diminished numerous valuation anomalies are becoming apparent. After recent market declines there are far better opportunities to buy good businesses at bargain prices and we must retain the discipline and confidence to do so. Having had our fingers burned of late we will work even harder to steer clear of the value traps which are all around us.

Given the weakness of the past few months we believe that there is significant potential value to be unlocked from many of our holdings. It would take a calamitous Brexit outcome or significant global slowdown for this potential to be under serious threat from where we sit today. We will therefore continue to invest where long term valuations are compelling.

Whilst the Fund does not have specific dividend objectives, in general the income on offer from UK shares remains highly attractive relative to gilt yields and the market remains hugely out of favour with global asset allocators.

As we enter 2019, our priority is to improve shareholder returns after the setbacks of recent months and to remain focussed on value whilst ignoring 'noise'. We therefore approach the year ahead with some optimism given our belief that global equity markets are now heavily oversold. When a lot of bad news is priced in then investing boldly now should tilt the odds in your favour.

'Be fearful when others are greedy and greedy when others are fearful'. Warren Buffet

**Scott McKenzie, Investment Director**
**9th January 2019**

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**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.**

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

**Regulatory Status:**
**FCA Recognised: Yes**
**Scheme Type: OEIC**

**Issue date – 31st December 2018**