# TB Saracen UK Income Fund

## Quarterly Review – December 2018

SARACEN
share success

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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 |
|---|---|---|---|
| **Q4 2018** | -14.7% | -10.6%% | -4.1% |
| **Calendar 2018** | -8.9% | -9.8% | +0.9% |

## Performance Summary

It was a dismal end to 2018 for the Fund with the shares falling 14.7% during the final quarter, well behind the 10.6% decline in the MSCI UK All Cap index and the fall of 10.9% in the IA UK Equity Income 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 | Since launch* |
|---|---|---|---|---|
| **TB Saracen UK Income B Acc** | -14.7% | -8.9% | 13.4% | 11.6% |
| **MSCI UK All Cap Index (TR)** | -10.6% | -9.8% | 19.7% | 14.2% |
| **Sector Average** | -10.9% | -10.5% | 8.4% | 8.7% |
| **Quartile Ranking** | 4 | 2 | 1 | 2 |

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

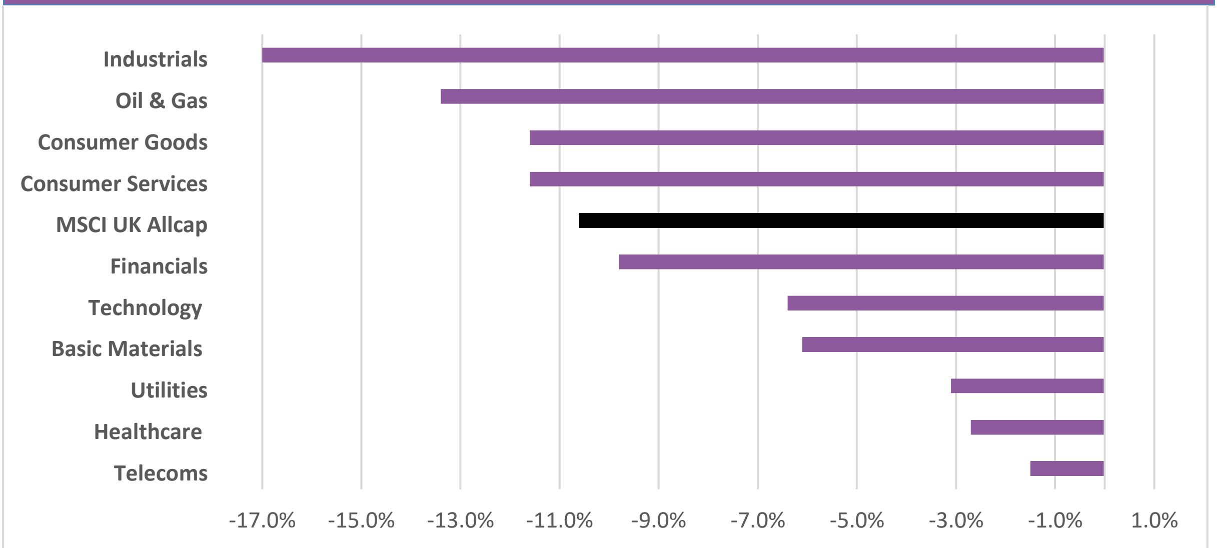
## Market Overview

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 over 60% 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 financial, industrial and consumer sectors, all 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 key 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 sold from the portfolio during the period – **Next** and **TalkTalk** – both of which fell after their sale.

Of the existing holdings, only **Palace Capital** (+7%) and **Greene King** (+10%) were in positive territory, with both stocks producing positive updates despite operating in challenging sectors. It was pleasing to see Greene King finally show some resilience after their poor showing in recent years.

### Negative Contributors

In such difficult circumstances, it is hard to know where to begin and the Fund had nine 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 damaging profit warnings from Superdry and WPP and further fund outflows at Jupiter. **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. **WPP** has also proven to be a value trap since purchase and they had a torrid year in 2018, dismissing their long-standing CEO, reducing guidance and then unveiling a major profit warning in October. This was topped off with a strategic review in December which majored on cost and debt reduction. The shares fell 23%. **Jupiter** has had a terrible 2018 after a strong 2017 and has managed to lose all the assets gained the previous year in one fell swoop. The shares halved in 2018 and lost 27% in the final quarter. The one saving grace is that they have a very strong balance sheet and will continue to pay high dividends even in tough times.

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** has been 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% in 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 dividend prospects but whose shares have suffered varying degrees of de-rating. Our thoughts on these are as follows:

**Phoenix (-17%)**: post the Standard Life deal, Phoenix produced a very positive trading update and we believe that the current 8% dividend yield is sustainable for many years to come.

**Gateley (-23%):** despite a strong trading statement this illiquid share has continued to fall. We see it as very lowly rated with excellent dividend prospects and a conservative strategy.

**Aviva (-23%)**: caught in the crossfire of a general weakness in the financials sector. The business is very lowly valued and has been de-risked significantly whilst increasing its returns to shareholders in a steady and sustainable fashion.

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. **Imperial Brands** shares suffered from tobacco market concerns despite them producing a solid set of final results and another increased dividend.

## Portfolio Activity

The fund has 32 investments which are spread across a variety of market capitalisations. As at 31st December 2018, the split of investment was 36% in largecap, 32% in midcap and 31% in smallcap/other, with a cash balance of only 1%.

### Purchases

There were three new investments made during the period, one of which ran into trouble almost immediately.

**Superdry** probably takes the prize as the worst investment we have made since the inception of the Fund. Having sold our Next holding at a significant profit, our analysis suggested that Superdry had increasingly global reach and reasonable growth prospects at a modest valuation, with a strong balance sheet. The shares had already fallen substantially prior to purchase but, with hindsight, this was a massive red flag and the stock delivered two large profit warnings in the final quarter, the first only days after our purchase. 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 changed dramatically and need further reassessment before we can consider adding to the position.

**Clipper Logistics** was another business exposed to the retail sector which we bought in October after a wobble over the summer. Unlike Superdry, we believe that Clipper is a growth business, with a major competitive advantage in online retail in particular. The shares have de-rated heavily as it became clear that the very high growth rates of the past were not sustainable. However, despite the overall challenges of retail, Clipper operates in some real sweet spots and has been unfairly tarred by sector issues. The shares offer a high and growing dividend yield with long term growth prospects which we do not believe are currently priced in. We added to the holding in December as retail sector concerns escalated.

**Greencore** is a food producer specialising in ‘ready to go’ products, predominantly for food retailers. The company announced the surprise sale of their US business at a very attractive price but, despite this, the shares fell and we dusted down our models. Our conclusion was that we were able to invest in a business with solid, defensive growth prospects and a balance sheet which will be transformed by the disposal. The business is very well invested with a dominant market share in UK food retail and trades at a low rating with much improved dividend prospects.

In October, we increased our position sizes in the financials sector, an area of the market which struggled in 2018 as weaker investment markets and the spectre of Brexit took their toll. We added to four stocks – **Aviva**, **Lloyds Bank**, **Jupiter** and **Standard Life Aberdeen**. Whilst these purchases have yet to bear fruit, all of these businesses pay high and sustainable dividends in our view, and in each case offer good asset backing too. We acknowledge that currently this is akin to catching falling knives but all could offer substantial upside from here, particularly if Brexit clouds clear in 2019 (a big ‘if’, we admit).

Overall, we have continued to add to existing positions whose share prices have been caught in the market crossfires. These include **Gateley** and **discoverIE**, two small companies which are still delivering strong results. In December, we added to **Wood Group** and **Tyman**, more cyclical stocks which had been hit hard by collapsing oil prices and concerns over US economic slowdown respectively. Time will tell if these fears are overdone or not but their very low current valuations offer us good prospects of positive returns in the future.

**Sales**

There were a number of sales made as we focussed the Fund further on the value opportunities which became apparent as markets unravelled towards the end of the year. As a result, we took profits in several businesses which had served us well in recent years. **Vitec** had doubled in value since we identified the business as a value stock with improving prospects. Their growth drivers are now more widely understood by investors. In a similar vein **Astra Zeneca's** strong product pipeline is now better appreciated and expectations going into 2019 are high, whilst the dividend remains static and the yield far lower than it was.

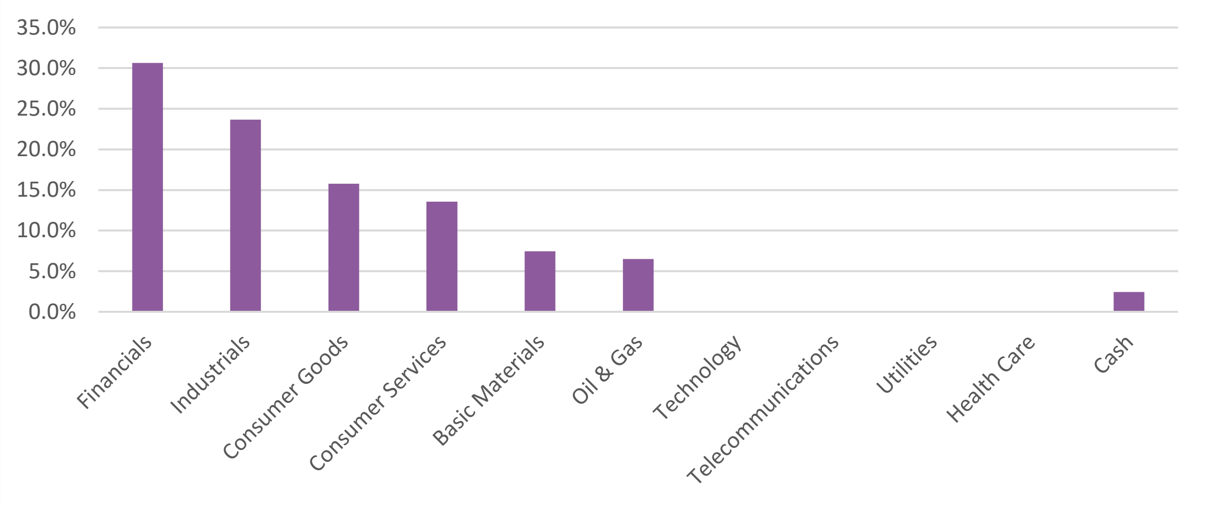
As detailed above, our recent forays into retail have not gone well but we did sell two investments at a profit, **Next** and **DFS Furniture**, both of which subsequently fell in value. Next remains a high quality business in a troubled sector and after recent falls, will remain on our watchlist going into 2019. DFS was sold after several years of declining profitability had left the dividend cover stretched. Despite this the shares had held up reasonably well. Sadly, though our subsequent purchases of Superdry and Clipper took us straight from the frying pan into the fire.

The final balance of **TalkTalk** was sold as it became clear that dividends would not be high on the agenda in the foreseeable future. Not one of our finest moments with some painful lessons learned regarding excessive debt and unrealistic expectations.

## 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**



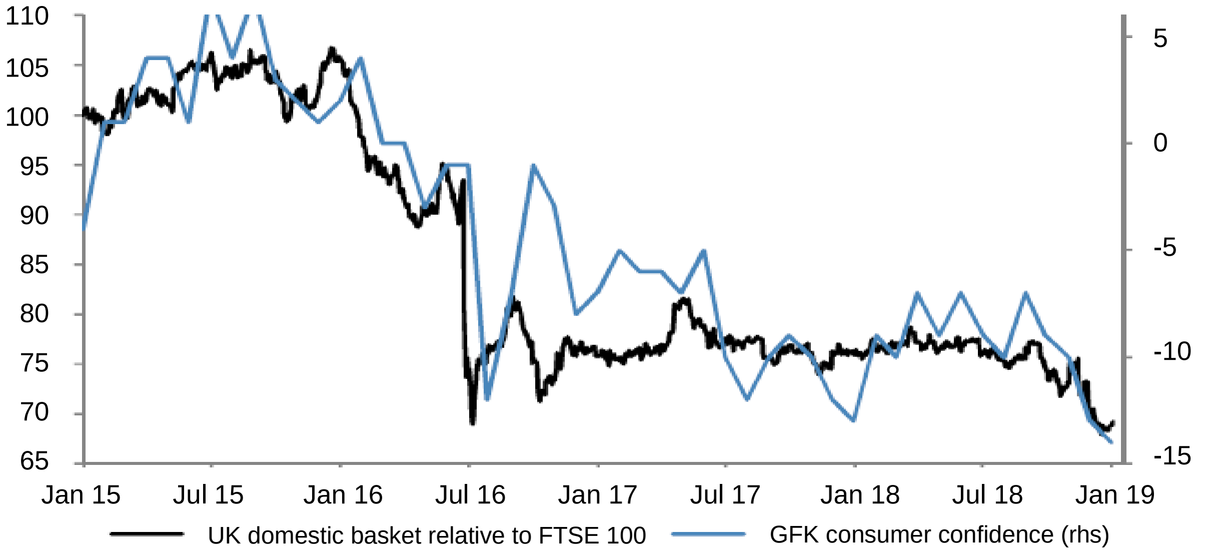

*Source: Saracen Fund Managers as at 31.12.18*

Our sector profile is largely unchanged. We now have over 30% of the fund held in financial sectors which is the highest level since the fund launch. 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. Even on a worst case scenario we see only limited threats to current levels of income. Our holdings in life assurance and banks should benefit from higher interest rates and rising bond yields, should they materialise, and are showing much improved cashflow and capital ratios. Despite broad improvement in their finances these sectors have continued to struggle since the dark days of the 2007-08 crisis.

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 the main feature of late.

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. We have around 20% of the Fund invested in companies directly exposed to UK consumer 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 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 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, 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. With the recent sale of Astra Zeneca, 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 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 88%. 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 36%, with cash held only 1%.

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 either of the following categories:

**High Yield (51% 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 (49% 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 31.12.18, 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

Despite a highly disappointing end to 2018 the Fund delivered strong growth in income during the year with a final dividend announced of 2.84p per distribution share, making a total of 5.24p for the year. **This was an increase of 9%** on the 4.80p paid in 2017 and represents a yield of 5.5% based on the distribution share price of 95.6p as at 31st December

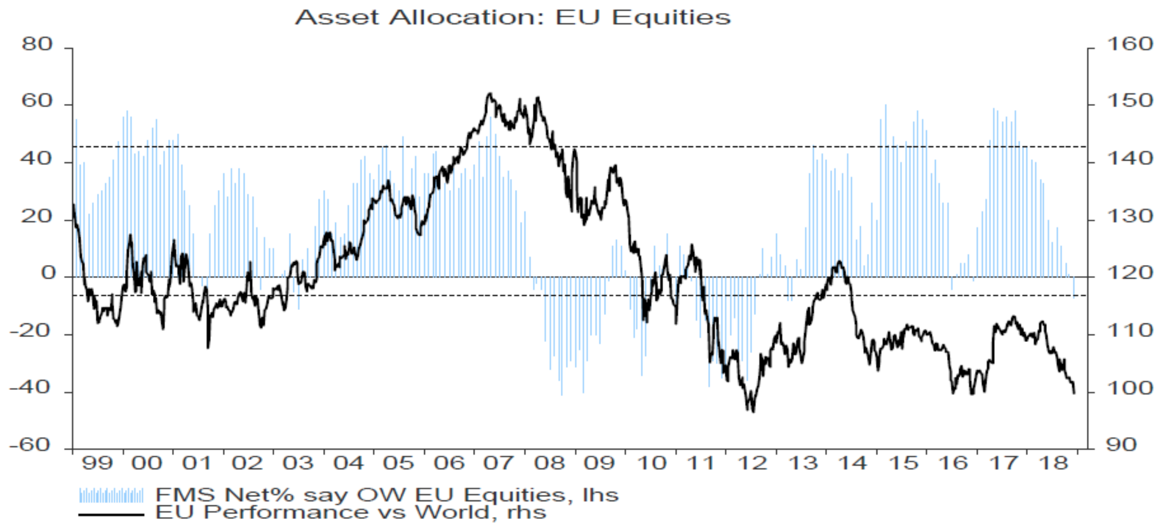
The forecast portfolio dividend yield based on our current expectations is 5.8%. This assumes growth in income from the portfolio over the next twelve months of 4%, which should be ahead of inflation. The forecast dividend yield for the UK market as a whole is currently 5.1% with expected dividend growth 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.

Given the already high payout ratio and significant dividend yield on offer from UK shares we would expect overall dividend growth to slow in the years ahead. However, it is our firm intention to grow underlying dividends per share ahead of inflation again in 2019, assuming a fairly stable market environment and some sort of resolution to the current Brexit impasse.

## 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.

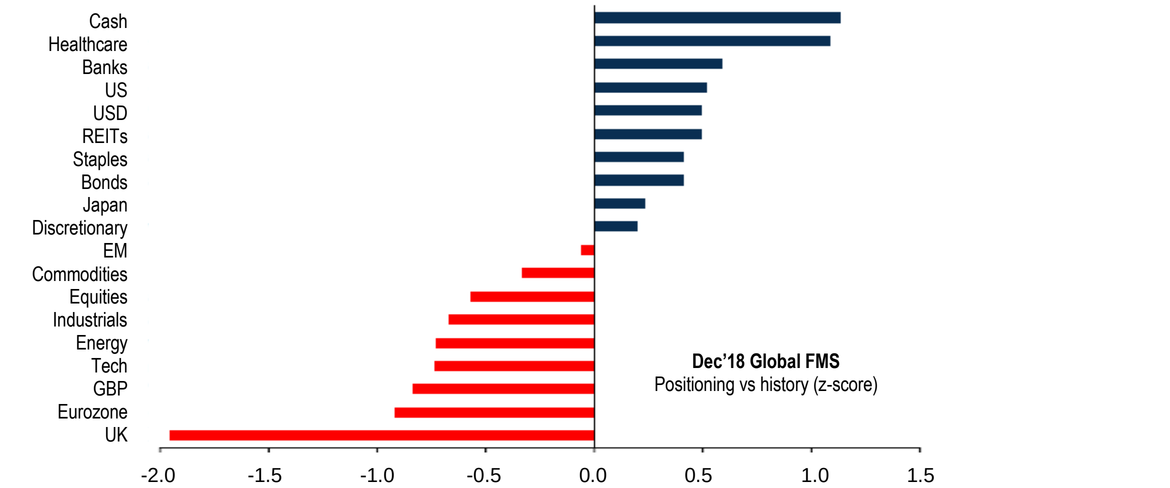
**BOAML Survey – Net % Asset Allocation Overweight Uk Equities (current -39%)**




*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***

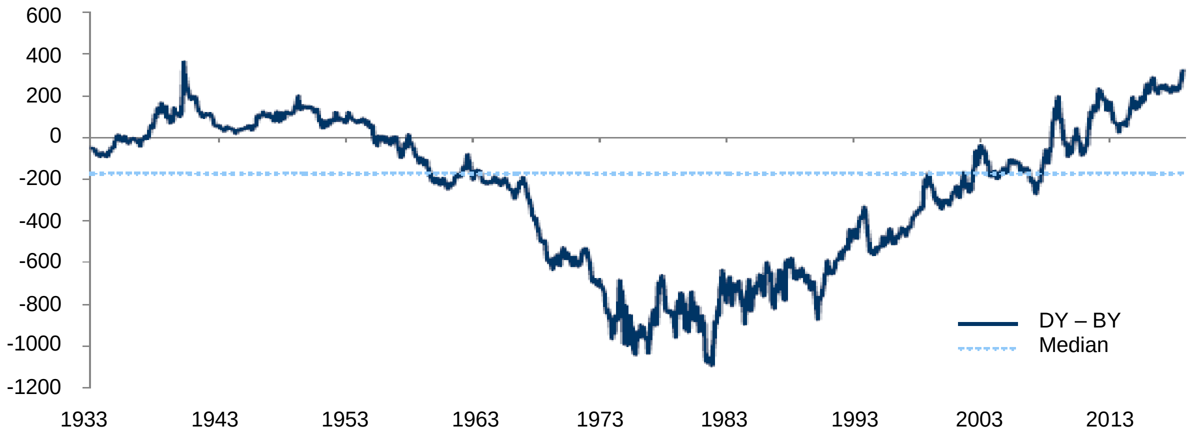



*Source: BofA Merrill Lynch Global Fund Manager Survey. *data since 2006 for commodities & real estate; since 2001 for all others*

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.

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 and we find it hard to rationalise this 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.

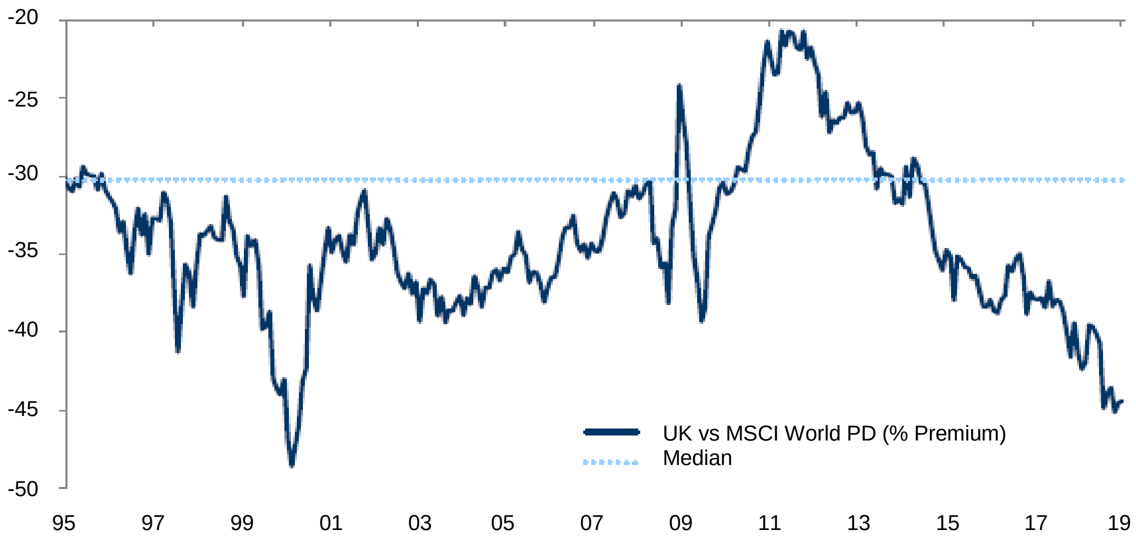
**FTSE All-Share Dividend Yield – Bond Yield (latest: 322bp)**




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

If we then consider the income available from UK shares in a global context then a similarly extreme situation has evolved, with the yield on UK shares now almost 50% greater than the yield on the MSCI World index, way above the longer term median.

**UK vs MSCI World Price to Dividends**




*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. In general, the fund is positioned to benefit from any recovery in value styles and an increase in bond yields and we view the UK market in general as an attractive proposition for income investors at current high yields.

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

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 Income produced better relative returns than the average peer group fund in 2018 this was a hollow victory given where the Fund had been previously. The only item of consolation was that the Fund managed to increase shareholder dividends by 9%, the third consecutive year where we grew income well ahead of inflation since our launch in 2015.

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 and the current abnormally high portfolio yield gives us cause for optimism in that respect. The dividend 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. It would take a calamitous Brexit outcome or significant global slowdown for this potential to be under serious threat from where we sit today.

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. 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.

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

**Regulatory Status:**
**FCA Recognised: Yes**
**Scheme Type: OEIC**
**Issue date – 31st December 2018**