# TB Saracen UK Alpha Fund

## Quarterly Review – March 2019

**Scott McKenzie**
*Fund Manager*

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

| | TB SUAF | MSCI UK All Cap (TR) | Relative |
|---|---|---|---|
| **Q1 2019** | 10.6% | 9.7% | +0.9% |

## Performance Summary

After a difficult end to 2018 the Fund enjoyed a good recovery during the first quarter of 2019 with the shares rising by 10.6%, which was ahead of the 9.7% rise from the MSCI UK All Cap index and an increase of 9.0% in the IA UK All Companies sector. It was pleasing to show good improvement from the previously depressed position and this was achieved despite smaller companies in general lagging the main index. As a result, the Fund was top quartile against peers during the three-month period and remains either first or second quartile over other cumulative time periods (source: FE Trustnet). A summary of performance is shown in the table below.

***Cumulative Performance after all ongoing charges to 29th March 2019***

| | 3 months | 1 year | 3 years | 5 years |
|---|---|---|---|---|
| **TB Saracen UK Alpha B Acc** | 10.6% | 4.4% | 29.3% | 36.5% |
| **MSCI UK All Cap Index (TR)** | 9.7% | 6.3% | 31.5% | 33.1% |
| **Sector Average** | 9.0% | 2.9% | 24.5% | 28.6% |
| **Quartile Ranking** | 1 | 2 | 2 | 1 |

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

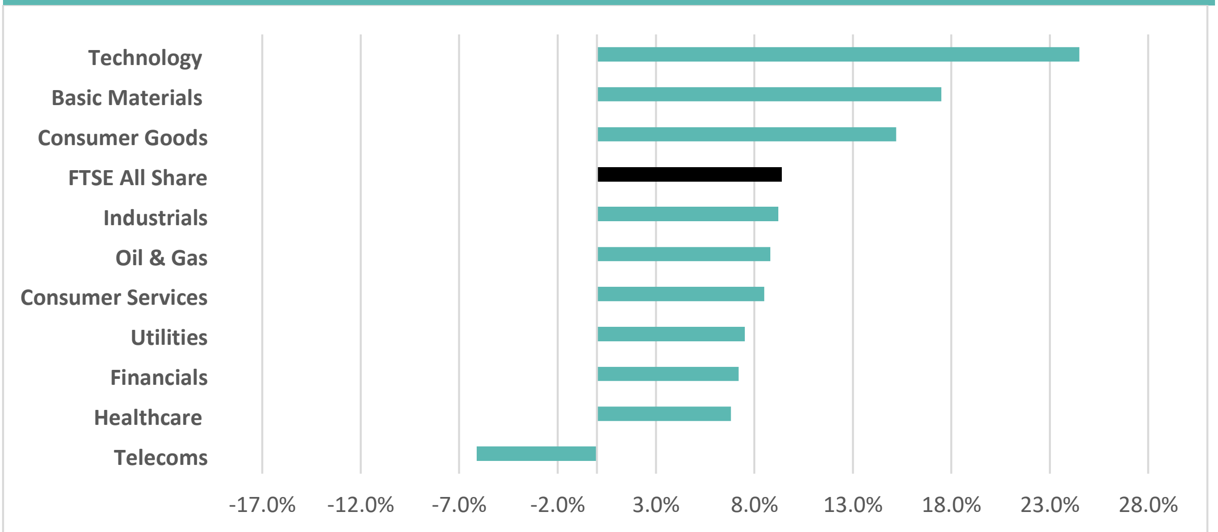
## Market Overview

Over the quarter all boats were lifted by a rising tide, not just in the UK but globally. Key market returns included the S&P500 up 13.7% and the MSCI World (£) rising by 9.8%, whilst China and Hong Kong also rose materially from low levels. However, it was notable that smaller companies in the UK underperformed, which was something of a headwind for the Fund in general.

| Total returns by capitalisation : 3 months to 29th March 2019 | |
|---|---|
| **FTSE100** | 9.5% |
| **FTSE Mid250** | 9.7% |
| **FTSE Smallcap** | 6.2% |

At a sector level, every industry grouping delivered positive returns apart from telecoms. Many of the domestic consumer goods sectors such as retail, food retail and construction rebounded sharply whilst tobacco recovered from highly oversold levels. Mining continued its strong run in recent years driven by rising metals prices and shareholder returns. Whilst many financials stocks improved markedly banks continued to underperform in response to lower bond yields, and telecoms were hampered by ongoing cash and dividend concerns.

**UK sector total returns: 3 months to 29th March 2019**




*Source: Bloomberg*

From a geopolitical perspective, two of the key concerns for markets, Brexit and global trade, remain omnipresent and are as worrying now as they were previously. The ongoing prospect of a trade war between the US, Europe and China continues to cause great anxiety for markets, as global growth expectations slip and fears of recession intensify. These concerns have been amplified by dramatic falls in government bond yields, particularly during March, along with an inversion of yield curves which many commentators interpret as an ominous sign of global slowdown. There has also been a material shift in policy with regard to shorter term interest rates with the Fed effectively reversing its previous tightening bias.

For the second consecutive quarter bond returns were positive and yields fell sharply again in the key markets of the US, UK and Germany to 2.4%, 1.0% and negative respectively. From a UK perspective we find it inconceivable that investors would wish to lend to the Treasury at such paltry rates for the next ten years but these are indeed unprecedented times.

Closer to home, the Brexit negotiations have gone from chaos to farce with no obvious end in sight and timescales remain hugely uncertain. This is now having a profoundly negative impact on the UK's standing internationally as well as affecting the real economy, with sectors such as travel and automotive seeing sharp declines. It is inevitable that Mrs May will go but with parliament in chaos as we write, it is hard to see a clear or positive outcome emerging. It feels like the democratic foundations of the UK have permanently shifted and, as such, political risks have risen. It is, to paraphrase Malcolm Tucker from The Thick Of It, an 'omnishambles'. The UK economy therefore looks vulnerable to further disappointment with official data being held up mainly by Brexit-related stockbuilding. Despite all of this sterling actually strengthened over the quarter, rising 2% against the dollar and 4% against the Euro.

## Portfolio Review

The portfolio has a 'multicap' structure with a large exposure to small and mid cap companies, which make up over 80% of the portfolio. This strategic positioning has been beneficial to our results over many years as well as offering considerable long-term flexibility. However, this structure has proven to be a headwind during the past year or so as UK smaller companies have fallen out of favour whilst the larger, more multinational businesses in the FTSE100 have performed relatively well. This trend has continued in the early months of 2019 but, despite this, the Fund produced decent returns with takeover activity helping performance as it did in 2018. The focussed nature of the portfolio means that our results can often be quite different to the broader index and our active share is a measure of this, remaining at the high level of 94%.

### Positive Contributors

The strong recovery in markets led to a number of positive performances and we had 14 stocks which rose by more than 10% in the period, in stark contrast to the previous quarter. Two holdings in particular delivered significantly positive returns. **Dunelm** rose by over 60% and the shares have gone from zero to hero in a very short period. Having struggled for much of 2018 trading improved markedly over Christmas. Dunelm is a case study in not losing one's nerve in what is a fundamentally sound business. However, just as the shares previously offered deep value they now feel extremely overbought and our holding has been sold.

**IFG Group** received an agreed cash takeover bid in March highlighting the clear value that was inherent in their two strong operating businesses and the shares rose by 45%. Again, patience has been rewarded in holding a company which has not always been an easy ride for investors and the new management deserve credit for delivering shareholder value here.

Whilst on the topic of takeover activity we have finally received two bids for **RPC Group** which rose by 21%. In contrast to the efforts at IFG the final price achieved by RPC management is far from ideal. It is now time to move on however, and the remaining holding will be sold.

Having written at length in our previous review about various holdings which we believed had been unfairly de-rated it is pleasing to report strong recoveries for a number of them. Highlights include **Premier Asset Management** (+26%), **Clipper Logistics** (+18%) and **Greencore** (+15%), all of which we had added to in late 2018. The increased exposure to the financials sector, which we actioned in December, has delivered good results with our new holdings in **Intermediate Capital** (+14%) and **Mattioli Woods** (+19%) both getting off to positive starts.

A number of large holdings which the Fund has held for many years also came good with strong contributions from **Rio Tinto** (+29%), **MJ Gleeson** (+27%) and **Prudential** (+12%).

### Negative Contributors

Thankfully the recovery in the Fund's portfolio during the quarter meant that the impact of any weaker holdings was diminished, with 7 holdings in negative territory overall. A large number of portfolio companies produced results during the period and there were only a handful of businesses which delivered disappointing updates.

The latter category included two ongoing laggards, **TalkTalk Telecom** and **Victoria**, where expectations for the current year were reduced once again. The stocks fell by 3% and 8% respectively. Victoria actually saw significant director buying into the weaker statement which helped limit the damage somewhat.

In a rather nervous and illiquid market for smallcaps in general several holdings drifted somewhat including **Kin & Carta**, **Vitec** and **Marlowe**. Very little has changed in each case and we have added to the Kin & Carta holding recently.

Finally, our two small property companies, **Palace Capital** and **U&I Group**, fell in response to ongoing investor aversion in that sector. Brexit concerns and the woes of the retail sector have kept real estate stocks highly subdued but again we have no company specific concerns. We think that both happen to be in the wrong place at the wrong time for now.

## Portfolio Activity

The fund has 33 investments which are spread across a variety of market capitalisations. As at 29th March 2019, the breakdown of the portfolio by size was 13% largecap, 23% midcap and 58% smallcap/other. The portfolio held 5% in cash at the period end.

### Purchases

There were two purchases made during the quarter.

**Melrose Industries** is an industrial conglomerate run along the lines of a private equity firm. It's strategy is simple – buy, improve, sell. Over a fifteen-year period it has done this spectacularly well, with an annual compound growth in shareholder value of 22%. In early 2018 Melrose did the biggest deal in their history, taking on GKN in a hostile bid. As a former GKN shareholder that business is well known to us. Melrose shares have been heavily derated since the acquisition, losing the premium rating they once enjoyed. Expectations are now fairly low, and the valuation is attractive. We believe that they will significantly improve GKN from here.

**Sanne Group** is a global provider of fund and corporate services to alternative asset managers, covering asset classes such as debt, real estate, private equity and hedge funds. From its origins in Jersey, Sanne has acquired steadily since IPO in 2015 and now operates from a global network of offices servicing a sophisticated client network, with regulation an increasing driver of new business growth. It is a business with strong long-term growth prospects which we have monitored for a while and the recent share price weakness provided an attractive entry point for the Fund.

We continued to add to businesses where the shares had been de-rated but where long-term prospects remain attractive - these included **Restore, Kin & Carta, Mattioli Woods** and **Intermediate Capital**. Amongst the more cyclical stocks, we have increased our exposure to **Synthomer** and **Tyman** and believe that both offer considerable upside from here.

**Sales**

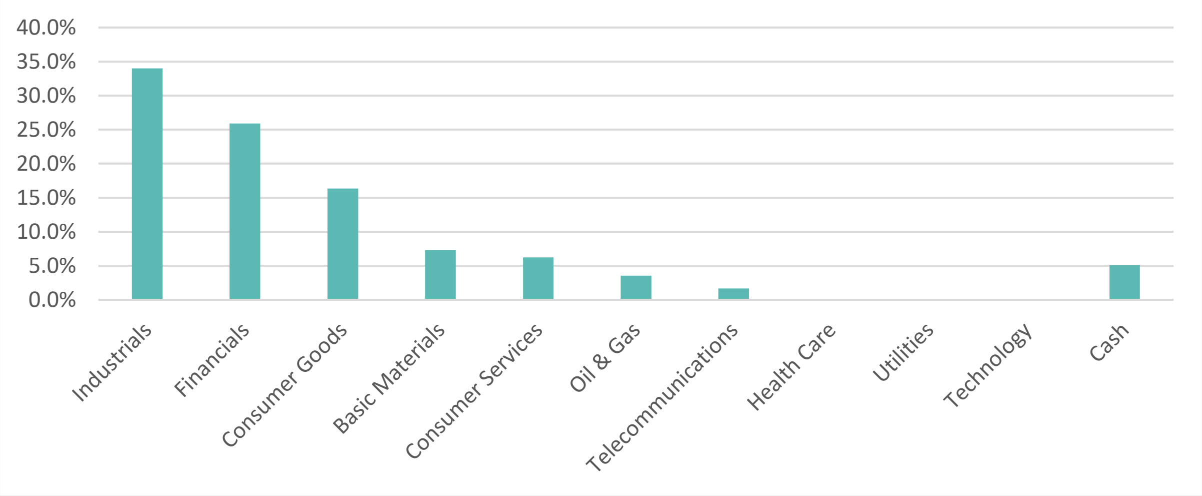
There was only one sale made during the period, which was the retailer **Dunelm** where we enjoyed a share price rise of over 60% amidst a dramatic reappraisal of its prospects.

We also took profits in two other stocks which had been large positions. Having bought **Rio Tinto** a few years ago when profits and dividends were depressed we began reducing our position in response to high dividend payments and a portfolio restructuring which is now complete. Having patiently waited on the takeover bid we reduced the holding in **RPC Group** which has now received a counter offer, albeit at a very modest premium to the first one.

## 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 29.3.19*

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.

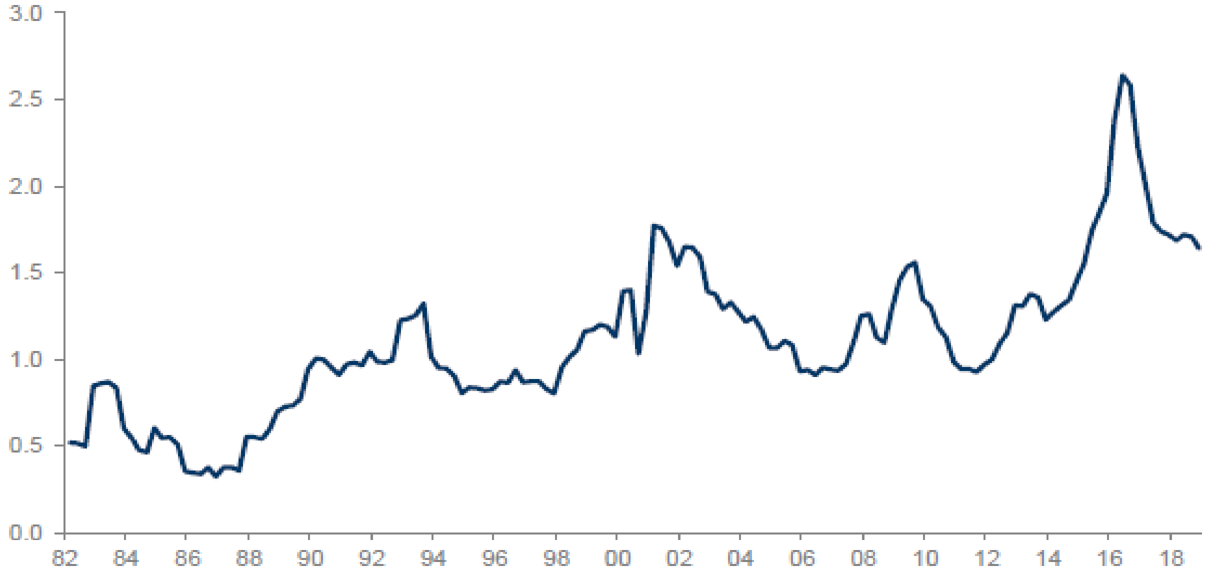
In our previous review we reported an increase in our holdings in the financials sector and this has resulted in the fund having its highest financials weighting for over a decade. However, it is important to note that our holdings are mainly in smaller, growing businesses – we have no exposure to UK banks for example. This strategy is already helping our returns with new holdings in Intermediate Capital and Mattioli Woods contributing well and the recent takeover approach for IFG Group highlighting a significant amount of hidden value.

Given our high (and growing) exposure to medium and smaller companies, in general we remain long sterling assets and short overseas earners compared to a broad UK benchmark. Our allocation to smaller companies is now almost 60%, the highest it has been for over ten years. Whilst this positioning is dependent on a remotely satisfactory conclusion to Brexit, this part of the fund offers attractive valuation metrics despite some recovery so far in 2019. Should Brexit be resolved then this structure should deliver good results for the Fund coupled with an increase in sterling which would make the largest overseas earners relatively less attractive. If this scenario does not happen then at least we shall have a large margin for error in the valuations of many of our holdings.

Another theme which has become increasingly prominent in recent months is the extreme aversion to debt amongst investors in public companies. The portfolio has not been immune to this change of focus and balance sheet analysis is becoming ever-more important, particularly in smaller companies where fortunes can turn quickly. In a variety of recent meetings we have had with companies many CFOs have lamented the declines in their equity valuations linked to what they had assumed were manageable levels of debt. This is a theme which crosses all sectors and may well lead to opportunity.

The chart below highlights that overall levels of debt to EBITDA in the UK index have been reducing of late. We would expect this to continue. The comparable ratios in the US are considerably higher.

**MSCI UK (ex Financials) Net Debt / EBITDA**




*Source: Morgan Stanley*

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 telecoms 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. Post the takeover of Shire we now have no exposure to healthcare either.

## 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 33 quoted UK companies making up a 'best ideas' fund with a very high active share, currently at 94%. 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 82% of the fund with large companies only 13%. We have a cash balance of 5% at present.

We expect modest levels of turnover in the fund and 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 (29%* 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 bids for four portfolio companies and we have already had one in 2019, IFG Group. 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.

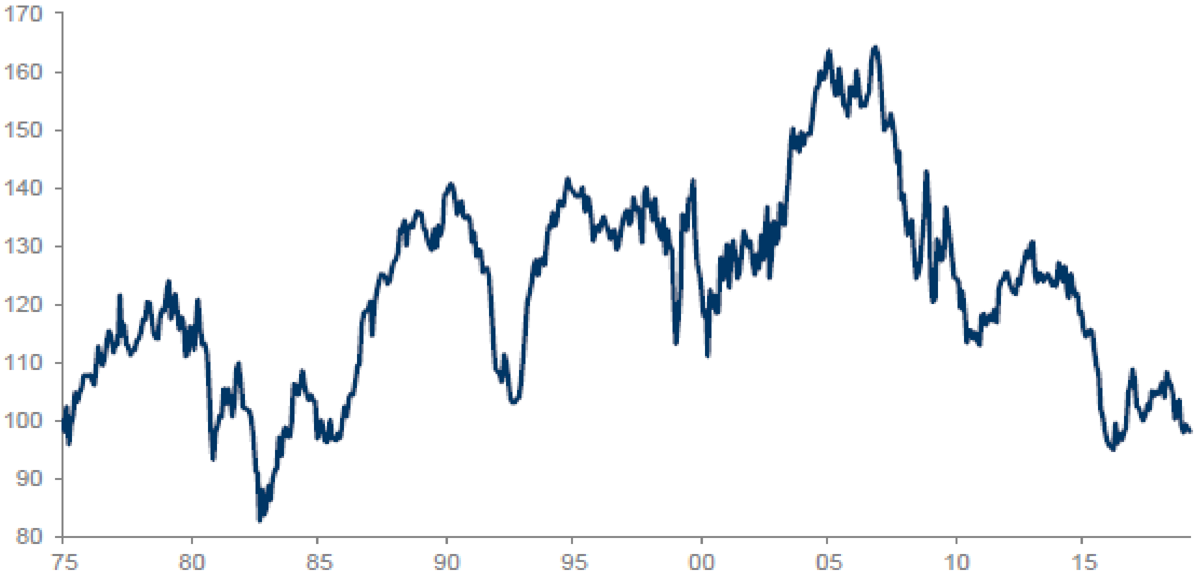
**Cyclical recovery (24%* of portfolio assets)**

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 29th March 2019, source Saracen Fund Managers*

With this structure in place the Fund is designed to be style agnostic and is able to take advantage of both 'value' and 'growth' opportunities when they arise. At this point in time there are more potential investments emerging in the former group than the latter with the chart below outlining the hard time value investment styles have endured in the UK in recent years. The relationship is even more stretched in the US where technology dominates.

**UK Value v Growth price performance**




*Source: MSCI, IBES, Morgan Stanley*

## Outlook

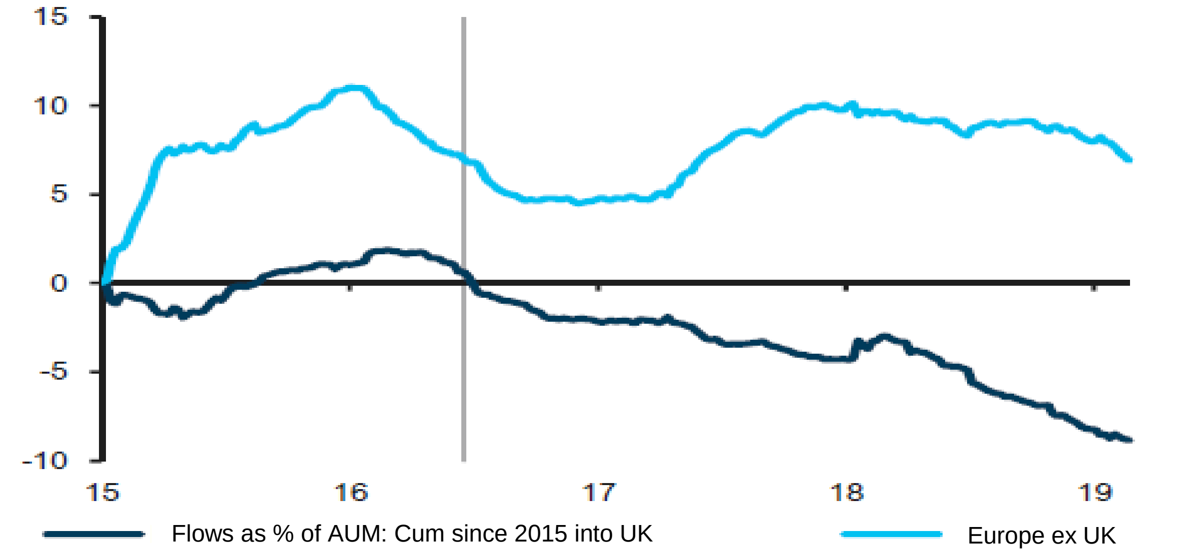
The UK stock market remains heavily out of favour and since the Brexit vote in June 2016, global investors have fled from UK equities, leading to material underperformance against the MSCI World index.

**MSCI UK performance relative to MSCI World**


*Source: Datastream*

This underperformance is put sharply into context by the significant outflows we have seen in UK equities since the Brexit referendum, as detailed below.

**UK and European Equity Fund Flows**

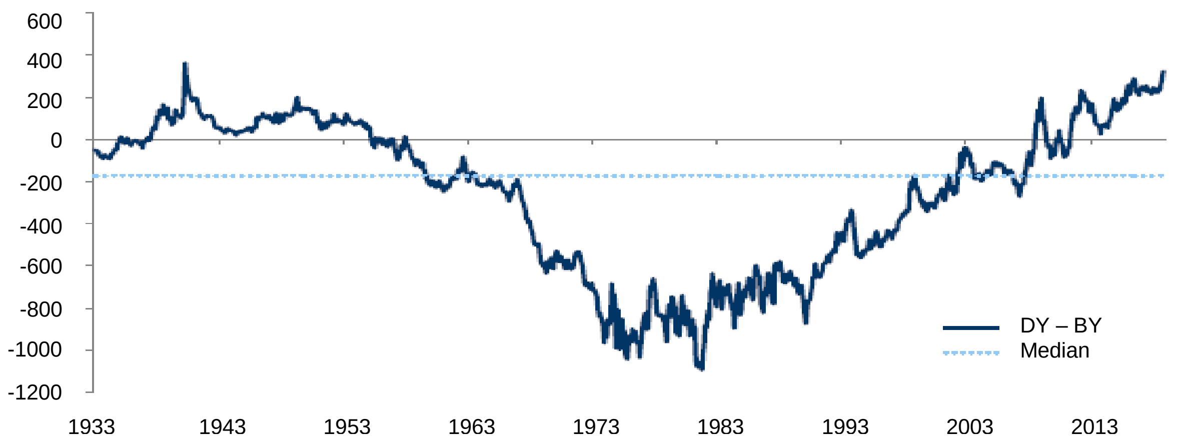



*Source : EPFR, Barclays Research*

These outflows equate to almost 10% of assets under management in less than 4 years. Such 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 yield gap between shares and UK gilts (now more than 3.5%, a post war high) makes the investment case for UK equities in general fairly compelling in our view and we find it hard to rationalise this situation, which has worsened again over the past quarter as gilt yields have fallen to only 1%. This remains extreme when put into a historical context, all the more so when one considers the risks of a UK government collapse.

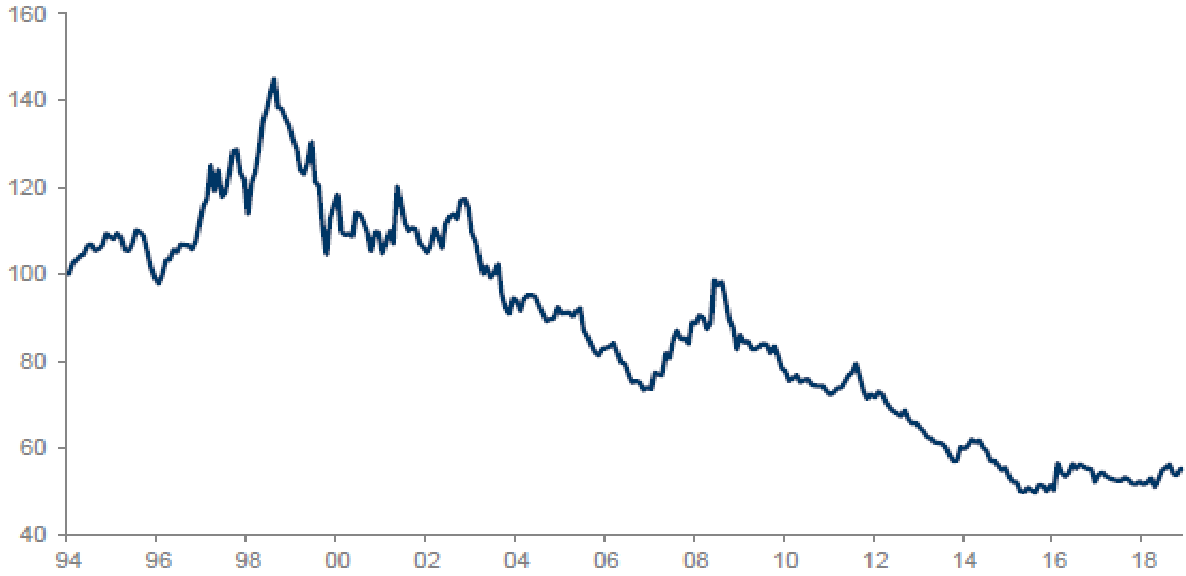
**FTSE All-Share Dividend Yield – 10 Year Gilt Yield**




*Source: MSCI, IBES, Morgan Stanley*

We have continued to steadily increase our allocation to smaller companies in the Fund but it is worth noting some general caution towards this segment of the UK market. For almost twenty years now the mid and smallcap indices have materially outperformed largecap but over the past three years this trend has bottomed out. Whilst this is a potential headwind for UK Alpha the focussed nature of the Fund means that our portfolio does not tend to reflect the market for smaller companies in general. Post MIFID2 we see even greater potential for mispricing as 'sell side' research in this area diminishes.

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




*Source: MSCI, IBES, Morgan Stanley*

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

After a difficult end to 2018 the Fund has had a positive start to 2019 and continues to produce better returns than the average peer group fund across all cumulative time periods. A large number of our portfolio companies have produced results so far in 2019 and, by and large, these have gone at least as well as we would have expected.

Having enjoyed strong returns from our positioning in mid and smallcap companies in recent years, this strategy has been challenged recently as investors have reduced exposure to a less liquid asset class where Brexit concerns are more concentrated. Our strategic commitment to investing in medium and smaller companies remains intact and is growing if anything. With much of the previous exuberance in this segment of the market now diminished, numerous valuation anomalies are becoming apparent. There are currently opportunities to buy good businesses at bargain prices and we must retain the discipline and confidence to do so. Unlike some, we do believe that valuation matters

Despite some recovery in recent 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.

Our priority is to maximise shareholder returns by remaining focussed but open minded in our approach. There has been some welcome recovery in equity markets so far this year, but we detect an ongoing nervousness and caution amongst investors in general. We believe that our flexible 'multi-cap' approach should serve us well over the long term.

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

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