TB Saracen UK Income Fund

Quarterly Review – March 2019

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
Q1 2019	10.4%	9.7%	+0.7%

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 10.4%, which was ahead of the 9.7% rise from the MSCI UK All Cap index and an increase of 8.7% in the IA UK Equity Income sector. It was pleasing to show good improvement from the previously depressed position and the Fund was placed in the top quartile against peers during the three-month period. It also remains first quartile over all other cumulative time periods since launch (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	Since launch*
TB Saracen UK Income B Acc	10.4%	5.7%	27.5%	23.2%
MSCI UK All Cap Index (TR)	9.7%	6.3%	31.5%	25.2%
Sector Average	8.7%	3.6%	19.6%	18.2%
Quartile Ranking	1	1	1	1

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

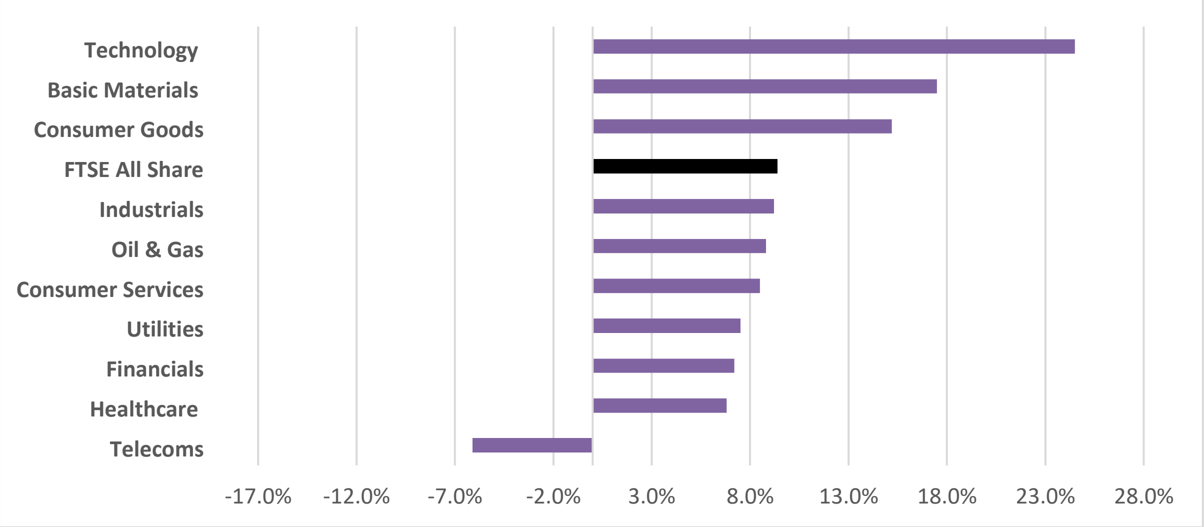
Market Overview

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 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 60% of the portfolio. This strategic positioning has been beneficial to our results in recent 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. The Fund also had a low allocation to large, defensive sectors such as consumer staples which was unhelpful during a period where bond yields fell but, despite this, our returns were creditable. The focussed nature of the portfolio means that our results can often be quite different to the broader index and our high active share is a measure of this, with a current reading of 88%.

Positive Contributors

The strong recovery in markets led to a number of positive performances and we had 16 stocks which rose by more than 10% in the period, in stark contrast to the previous quarter.

A key driver of overall returns was a significant recovery in a number of our financials holdings, which in total comprise just over 30% of the Fund. Having suffered badly towards the end of 2018 this segment in general bounced back strongly. There were three particularly material contributors – **Jupiter Fund Management** (+30%), **Phoenix Group** (+24%) and **Lloyds Bank** (+20%). Our smaller positions in **NewRiver REIT** and **Intermediate Capital** also rallied nicely from depressed levels.

Our long-held positions in the mining sector continued to pay off despite concerns about global growth. Both **Rio Tinto** (+29%) and **BHP** (+20%) benefitted from strong iron ore prices as well increasingly robust balance sheets which have led to significant shareholder returns.

We finally received two bids for **RPC Group** which rose by 21%. The final price achieved by RPC management is far from ideal, but it is now time to move on and the holding was sold to make way for better ideas.

Having written at length in our previous review about various small and midcap holdings which we believed had been unfairly de-rated it is pleasing to report strong recoveries in a number of them. Highlights included **Gateley** (+22%), **Clipper Logistics** (+18%) and **Greencore** (+15%), all of which we had added to in late 2018.

For the second quarter in a row **Greene King** delivered positive returns, rising by 26% as it continues to put some difficult years behind it.

Negative Contributors

Thankfully the recovery in the Fund's portfolio during the quarter meant that the impact of any weaker holdings was much diminished, with only 4 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 **Halfords** which issued a poor Christmas trading statement, with the new CEO downgrading expectations for the next two years as he reinvests in the business. The shares fell 9% over the quarter. Another ongoing sore was **WPP** which fell 4%, having already performed poorly in both 2017 and 2018. Again, expectations have been lowered by a new CEO who has outlined a detailed recovery plan for the group.

In a rather nervous and illiquid market for smallcaps in general several holdings drifted somewhat including **Kin & Carta** and **Palace Capital**. Palace fell in response to ongoing investor aversion in its sector. Brexit concerns and the woes of the retail sector have kept real estate stocks highly subdued. Very little has changed in both cases and we added to the Kin & Carta holding recently.

Other relative laggards included **Wood Group** where progress on debt reduction has been slow and **Galliford Try**, who lost their CEO unexpectedly.

Portfolio Activity

The fund has 33 investments which are spread across a variety of market capitalisations. As at 29th March 2019, the split of investment was 36% in largecap, 31% in midcap and 33% in smallcap/other. The Fund remains fully invested with no cash balances.

Purchases

There were two new stock purchases made during the quarter.

DS Smith is a leading corrugated packaging company providing packaging solutions throughout Europe as well as having a modest but growing presence in the US. It has been an acquisitive group over the years and the pace has accelerated in the past 18 months with the 2017 acquisition of Interstate in the US for £820m and another major European deal, the purchase of Europac for £1.7bn in 2018. The core of the group is supply to FMCG companies and the company has a clear strategy to grow with a focus on three structural drivers – increased e-commerce, multi-channel retail formats and environmental substitution, mainly from plastics. Like many acquisitive companies the shares have been heavily de-rated of late and offer a high dividend yield and solid growth prospects.

Synthomer is a global specialty chemicals company, active in polymer markets such as health & protection, carpets, foam, construction and paper. More than half of group sales come from Western Europe where they have strong market niches but relatively modest growth. Over 30% comes from a nitriles gloves business in Asia which has strong growth prospects after significant recent investments. We have admired the business and its management for a while and the recent share price weakness provided an attractive entry point for the Fund. It also has the potential to make acquisitions which, if executed well, could make a material difference to its earnings prospects. So far, they have been admirably patient with regard to taking bigger steps.

We continue to add to smaller companies which offer highly attractive valuations and have increased our exposure to **Kin & Carta** and **Tyman** in the believe that both offer considerable upside potential from here.

Sales

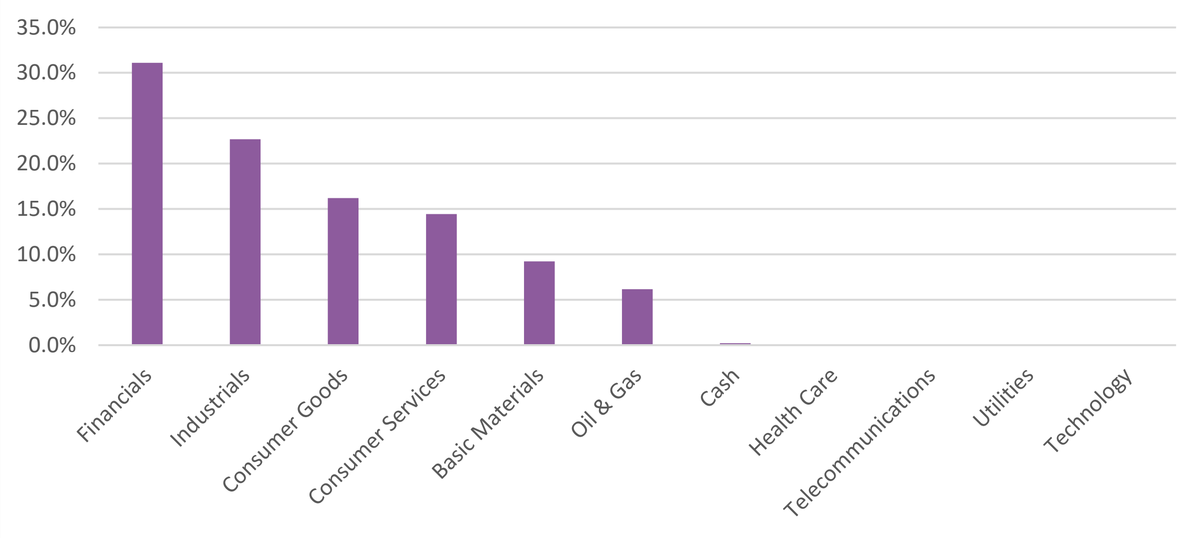
There was only one sale made during the period, which was the packaging company **RPC Group**. Having patiently waited on the takeover bid we sold the holding when it became apparent that a better price was unlikely and there were better uses for the funds.

We also took some profits in three other stocks which had served us well. 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 seen strong performances from both in recent months we reduced the large position sizes in **Gateley** and **Greene King** to more normal portfolio holdings.

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 29.3.19

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's 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 are now showing much improved levels of cashflow and capital ratios leading to consistent dividend growth. Despite broad improvement in their finances these sectors have continued to struggle since the 2007-2008 crisis. The holdings exposed to capital markets are by definition more volatile and require careful monitoring, but recent share price performance has been encouraging.

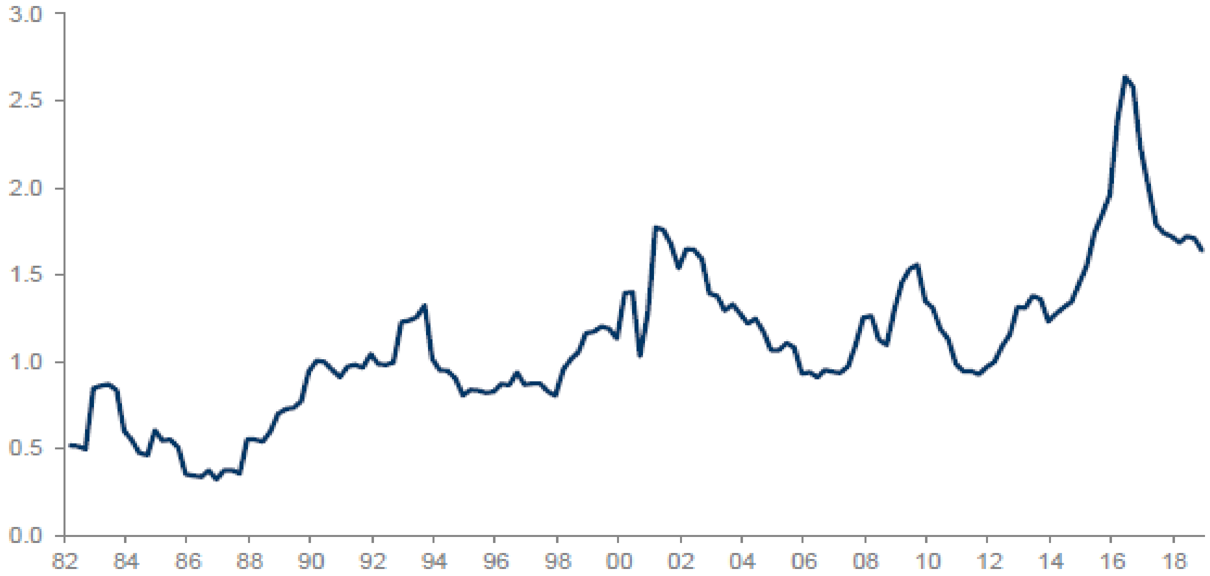
Our holdings in the industrial sectors are mainly in smaller companies with strong global market positions and positive long-term growth drivers. They are a wide and varied group of businesses and should prove to be a good antidote to the domestic exposure held elsewhere in the Fund.

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. We have around 20% of the Fund directly exposed to the UK consumer. Whilst this positioning is dependent on a remotely satisfactory conclusion to Brexit, this part of the fund offers deep value characteristics 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 some 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. In 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, we continue to avoid a number of the more 'expensive defensive' sectors which we believe to be overvalued, including 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 and the same would apply to the large telecoms companies where we see dividend reductions as inevitable.

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 a total return 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 64% of the fund and large companies 36%, and the Fund is fully invested.

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 (52% 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 (48% 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.

** as at 29.3.19, 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 Fund delivered strong growth in income during 2018, paying a total of 5.24p per income share for the year. This was an increase of 9% on the 4.80p paid in 2017 and represents a yield of 5.1% based on the income share price of 102.4p as at 29th March 2019.

The forecast portfolio dividend yield based on our current expectations is 5.3%. 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 4.7% with expected dividend growth of 4% (source: Bloomberg). This reflects some recent sterling recovery. Only 15% 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.

Outlook

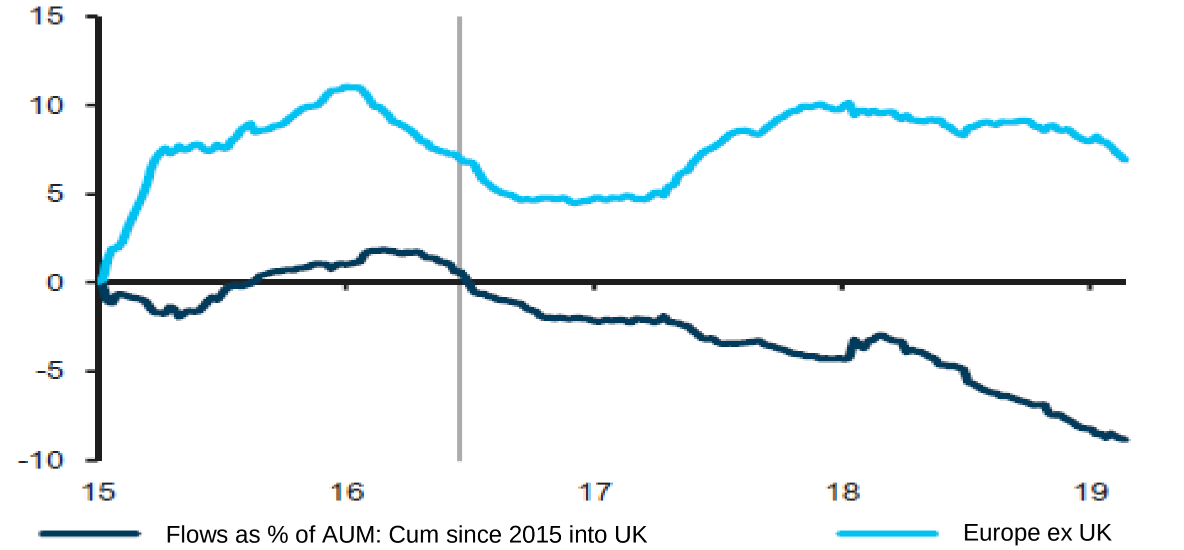
The UK stock market remains heavily out of favour and since the Brexit vote in June 2016, global investors have fled from UK equities, leading to material underperformance against the MSCI World index.

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

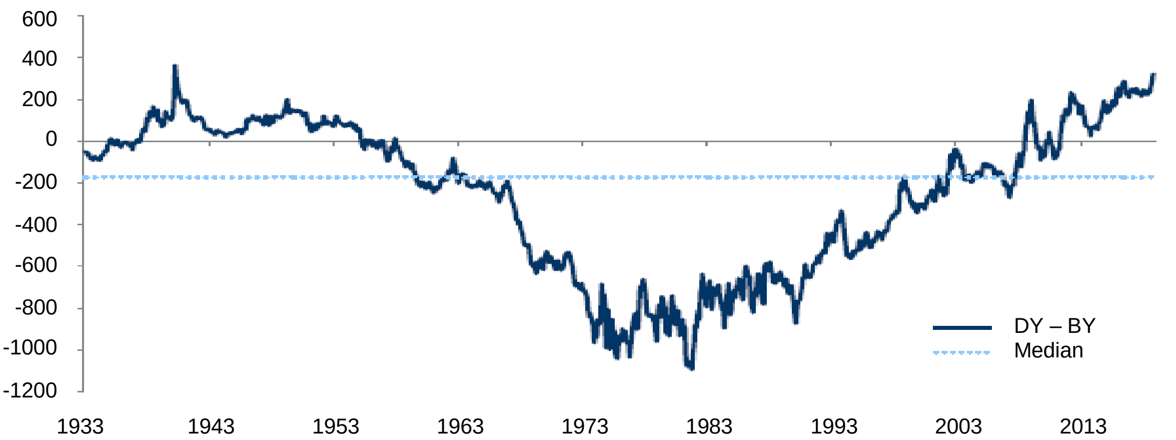


Source : EPFR, Barclays Research

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 a UK income strategy 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.

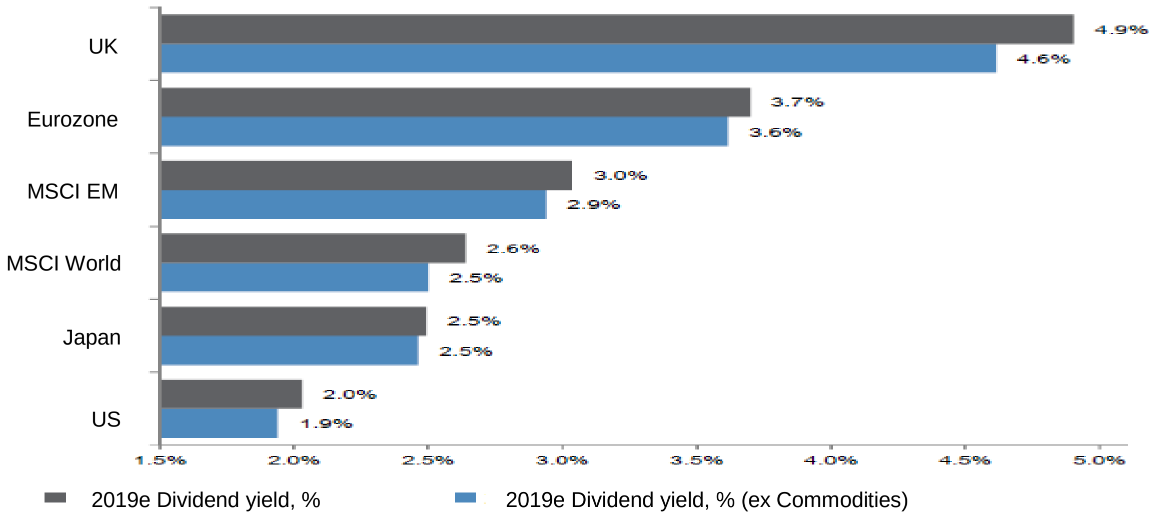
FTSE All-Share Dividend Yield – 10 Year Gilt Yield



Source: MSCI, IBES, Morgan Stanley

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 double the yield on the MSCI World index, again way above any longer-term trend.

Global Markets – Forecast Dividend Yields



Source: Datastream

What does all of this mean for Saracen UK Income?

After a difficult end to 2018 the Fund has started 2019 in more robust form and continues to produce better returns than the average peer group fund in the UK Equity Income sector. 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. It is particularly encouraging to note the ongoing strength of dividend payments pretty much across the board.

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. 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. Our value based philosophy remains heavily out of fashion and we must be careful to avoid the 'value traps' which are all around us. However, this philosophy will not change and we are comfortable being part of a minority group here. Unlike some, we do believe that valuation matters.

Despite a solid start to 2019 we believe that there is significant potential value to be unlocked from many of our holdings and the current high portfolio yield gives us cause for optimism in that respect. The dividend income on offer from UK shares remains highly attractive relative to current abnormally low gilt yields and the market remains hugely out of favour with global asset allocators. It would take a calamitous Brexit outcome or a synchronised global slowdown for this potential to be under serious threat from where we sit today.

Our priority is to maximise shareholder returns by remaining focussed on value and ignoring 'noise' as best we can. 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, combined with a focus on a high and growing income, should serve us well over the long term.

Scott McKenzie, Investment Director
9th April 2019

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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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