TB Saracen UK Alpha Fund

Quarterly Review – June 2019

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Fund Manager

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

	TB SUAF	MSCI UK All Cap (TR)	Relative
Q2 2019	3.3%	3.1%	+0.2%

Performance Summary

After a good start to 2019 the Fund delivered returns in line with the index during the second quarter with the shares rising by 3.3%, compared to a 3.1% rise from the MSCI UK All Cap index and an increase of 3.6% in the IA UK All Companies sector. With smaller companies in general lagging the main index the Fund slipped to third quartile against peers during the three-month period but remains first quartile over three and five years (source: FE Trustnet). A summary of performance is shown in the table below.

Cumulative Performance after all ongoing charges to 28th June 2019

	3 months	1 year	3 years	5 years
TB Saracen UK Alpha B Acc	3.3%	-4.8%	47.4%	47.6%
MSCI UK All Cap Index (TR)	3.1%	0.3%	29.0%	34.3%
Sector Average	3.6%	-2.3%	30.6%	34.0%
Quartile Ranking	3	4	1	1

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

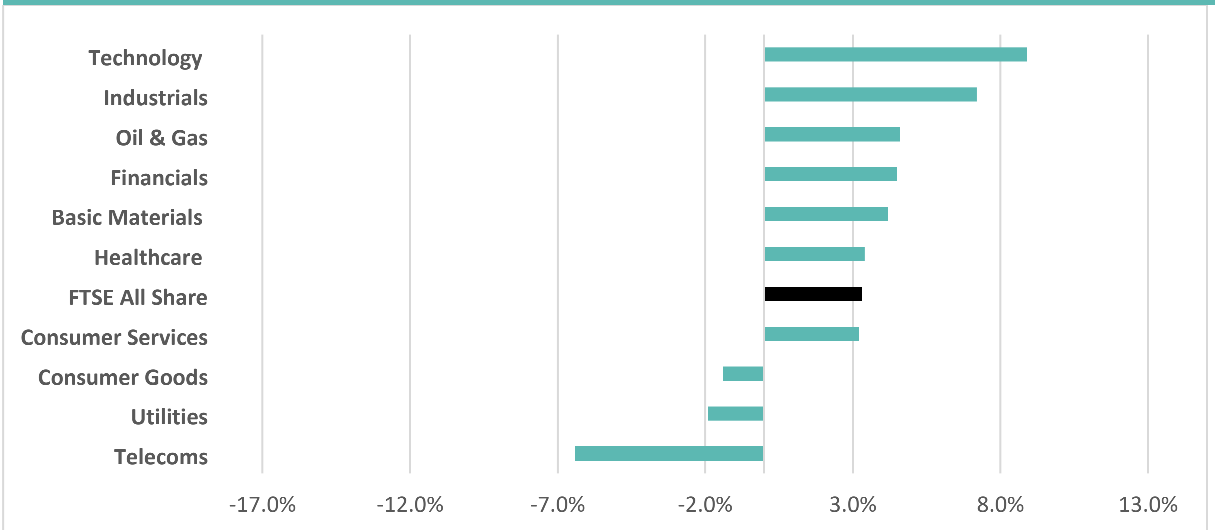
Market Overview

Over the period markets made solid progress, building on the strong recovery seen in the first quarter. However, as we got into June we saw notable underperformance from UK smaller companies, which was something of a headwind for the Fund in general.

Total returns by capitalisation: 3 months to 28th June 2019	
FTSE100	3.3%
FTSE Mid250	2.9%
FTSE Smallcap	2.9%

At a sector level, most industry groupings delivered positive returns, albeit within a fairly tight range. The clear leaders were technology (a very small sector in the UK) and industrials, which is a very diverse and heterogenous category. Once again telecoms and utilities saw declines with dividend cuts and political risks continuing to dominate sentiment. Consumer goods such as housebuilders and tobacco were weak whilst mining continued its strong run driven by rising metals prices and shareholder returns.

UK sector total returns: 3 months to 28th June 2019



Source: Bloomberg

The two key concerns for markets, Brexit and global trade, remain at the forefront of investors' thoughts. The ongoing prospect of a trade war between the US, Europe and China continues to cause great anxiety for investors, as global growth expectations slip and fears of recession intensify. These concerns have been amplified by dramatic falls in government bond yields globally with an inversion of yield curves which many commentators interpret as an ominous sign of global slowdown. Despite all of this, global markets have staged an impressive recovery during the first half of 2019 with the MSCI Global index returning 17% and the MSCI UK AllCap rising by 13%.

Investors are now looking towards lower shorter term interest rates again to support valuations and markets have continued to climb a 'wall of worry', with the recent BOAML fund managers' survey recording record levels of cash holdings amongst investors. Once again global returns have been driven by the US market and the technology sector, both of which have reached new highs recently. None of this feels very healthy and there is evidence of bubble-like behaviour in the IPO markets (Uber, Lyft, Beyond Meat), in private equity fundraising and in anything with the vaguest of ESG credentials.

For the third consecutive quarter bond returns were positive and yields fell sharply again in the key markets of the US, UK and Germany to 2.0%, 0.8% and -0.3% respectively. From our equity vantage point we find it inconceivable that investors would wish to lend to the UK government at such paltry rates. Bloomberg data estimates that over $13 trillion of global bonds now offer negative yields and even Greek government bonds yield only 2.2% now. These are unprecedented data points and defy any rational analysis in our view. By contrast many equity markets offer high and growing dividend streams.

From a UK perspective the Brexit shambles is now impacting the real world. Recent PMI survey data shows both manufacturing and construction veering towards recession with the services data not far behind. Indications are that Q2 GDP will be flat to down and the inversion of the yield curve now points towards a high chance of recession in the UK. To which we add the somewhat unedifying sideshow of the leadership election and the ongoing disintegration of the UK political system. All of this means that a satisfactory conclusion to the Brexit saga by the end of October is increasingly vital to future prosperity. All in all, a 'stasis' as the BCC recently commented. Given this highly uncertain and difficult background sterling weakened meaningfully over the quarter, falling 3% against the dollar and almost 5% 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 75% 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 as UK smaller companies have fallen out of favour to a degree whilst the larger, more multinational businesses in the FTSE100 have performed relatively well. This trend has continued during the first six months of 2019 but, despite this, the Fund produced a return of 14.2%, ahead of the MSCI UK AllCap gain of 13.1%. The Fund has no exposure to large, defensive sectors such as consumer staples and healthcare and this was detrimental during a period where bond yields fell and valuation gaps widened further. Offsetting this somewhat were our zero weightings in telecoms and utilities, both of which continued to fall. The focussed nature of the portfolio means that our results can often be quite different to the index and our active share is a measure of this, remaining at the high level of 93%.

Positive Contributors

With equity markets continuing to make steady progress our increased weighting in financials was broadly helpful for the Fund's returns.

Of particular note were our holdings in asset management businesses, two of which performed strongly. **Intermediate Capital** was the star of the show, rising 33% on strong results which confirmed huge growth in assets managed as well as a significant dividend increase. **Standard Life Aberdeen** also began to rehabilitate itself and rose 18%. Whilst they still face performance and fund outflow issues, investors are beginning to appreciate the deep value inherent in the company. Our large holding in **Prudential** rose by 12% as they progress with the planned demerger. Again, there is latent value here which should be unlocked as a result.

The Fund had a number of smaller growth stocks which made positive contributions. **Restore** continued to recover from an oversold position and rose by 17% whilst **Marlowe** successfully raised additional equity and rallied by 23%. **DiscoverIE** (electronic components) made further solid progress and the shares added 8%.

It was pleasing to see strong returns from some of our newer holdings with **Sanne** rising 32% as investors began to fully value its strong growth and repeat revenues. **Chemring** rose by 20% as they began to put the production problems of 2018 behind them. Again, revenue visibility is strong here.

Our final category of positive performers had a broad theme of value and recovery. **TI Fluid Systems** rallied by 10% as they continue to deliver better returns than most in a difficult automotive sector whilst **Kin & Carta** (marketing services) has begun to execute a major business transformation and went up by 15%.

Negative Contributors

The main negatives came from two domestic stocks. **U&I Group** fell 25% in response to ongoing investor aversion in the real estate sector and its relatively small size. It is very much in the wrong place at the wrong time and trades on a substantial discount to its asset value despite some decent progress in recent years. It is clear to us that something needs to be done to capture this value. **MJ Gleeson** fell 10% in response to the unexpected departure of the CEO who was held in high regard. This was one of the Fund's larger holdings and therefore unhelpful, but we are relaxed about the long term growth prospects for the business and have added to the holding.

In a generally better financial sector **Premier Asset Management** has been disappointing and fell 12% as previously strong fund inflows have dried up. Other smaller companies which drifted included **Eurocell**, which fell by 8% with the Woodford portfolios being a major investor in the business. Our large position in **Alpha Financial Markets Consulting** also saw some profit taking on results.

Several holdings which started 2019 well were impacted by profit taking, notably **Lloyds Banking** and **Greene King**. Other relative laggards included **Wood Group** which fell another 8%. However, the company did release a solid half year statement towards the end of June and the shares have begun to recover.

Portfolio Activity

The fund has 33 investments which are spread across a variety of market capitalisations. As at 28th June 2019, the breakdown of the portfolio by size was 19% in largecap, 24% in midcap and 54% in smallcap/other. The portfolio held 3% in cash at the period end.

Purchases

There were three purchases made during the quarter. All three are businesses which have had issues to overcome in recent years but where we can see tangible evidence of improving fortunes, hopefully leading to better returns in the future.

Equiniti provides complex administration and payment services supported by technology platforms to a wide range of large customers. These include shareholder registration, employee benefit scheme administration, pension administration and data analytics. While the variety of services, technology platforms and divisions make the group look complicated from the outside, the central focus is on building a portfolio of technology-enabled services and cross-selling them into its wide customer base. The company has a high quality core UK franchise and recently entered the US market with the acquisition of Wells Fargo's administration assets which offers a further strong platform for growth. The balance sheet is solid, and the de-rating of the shares post the Wells Fargo deal offered us an opportunity to buy a recurring revenue franchise at a low valuation.

Chemring is a global defence and security business, manufacturing high technology products such as countermeasures, flares and energetic devices as well as providing contracted R&D and security services for governments. The company suffered an accident at a UK factory last August resulting in one fatality, which prompted a full strategic review and some management change. This identified opportunities to restructure, simplify and build a stronger group. The company's balance sheet is strong and Chemring's recovery now appears to be well on track with the depressed share price giving us an attractive entry point.

Barclays Bank has shrunk its balance sheet considerably since the Global Financial Crisis, focussing more on costs than growth whilst reinvigorating its senior management. The strategy has been one of simplifying the group, building a robust capital base and shrinking or selling non-core activities. Despite this the shares are trading at a significant discount to tangible book value and remain friendless. While bad debts are likely to increase from here, litigation and conduct fines are now largely behind them. Whilst they remain in investment banking they do appear to be turning it around and the business has very little value in the current share price. This is an unloved business in an unloved sector with a rating which assumes the worst. We believe that Barclays has many strong franchises and the shares offer outstanding value.

We continued to build the holding in Melrose which we had begun in early 2019 and added to various holdings which had endured some share price weakness. These included **Galliford Try, MJ Gleeson** and **U&I Group**.

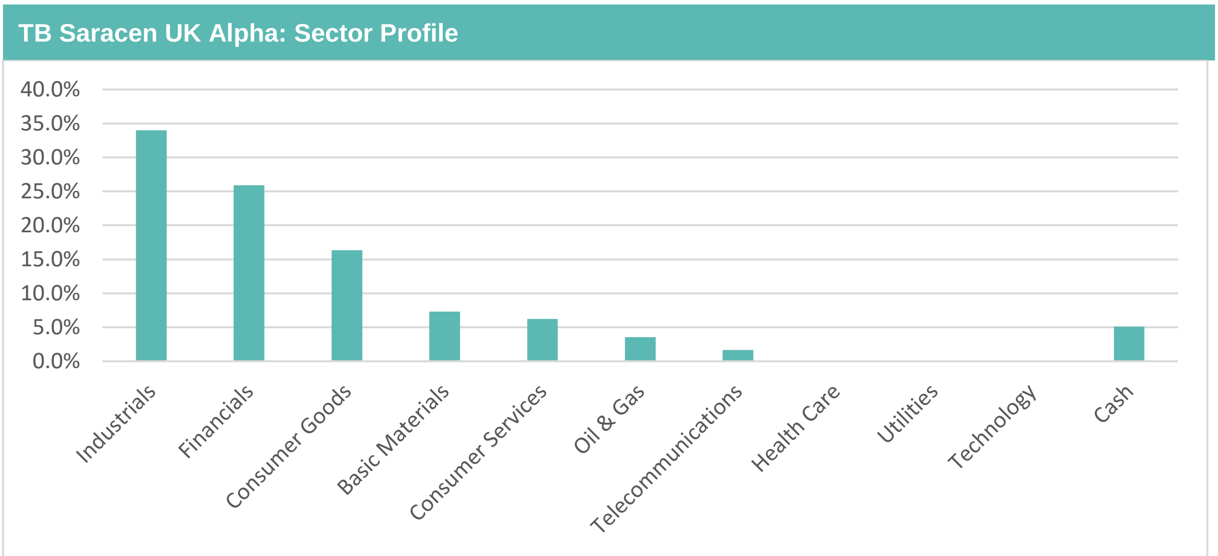
Sales

To fund the above purchases, we made three outright sales during the period. Two of them, **RPC Group** and **IFG Group**, had the fortunate circumstances of having been subject to takeover bids. We were happy to take the cash ahead of their final completion. The residual balance of **TalkTalk Telecom** was sold as it became clear that a meaningful earnings recovery remained somewhat elusive. Not one of our finest moments with some painful lessons learned regarding excessive debt and unrealistic expectations.

We reduced holdings in three other stocks. **Alpha Financial Markets Consulting** has performed well since our purchase in the IPO and we took the opportunity to scale back a fairly large position in the shares, whilst **Restore** has enjoyed a meaningful recovery from oversold levels in recent months. There was a long-overdue recovery in **Victoria** too and we took the opportunity to lower the holding.

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.



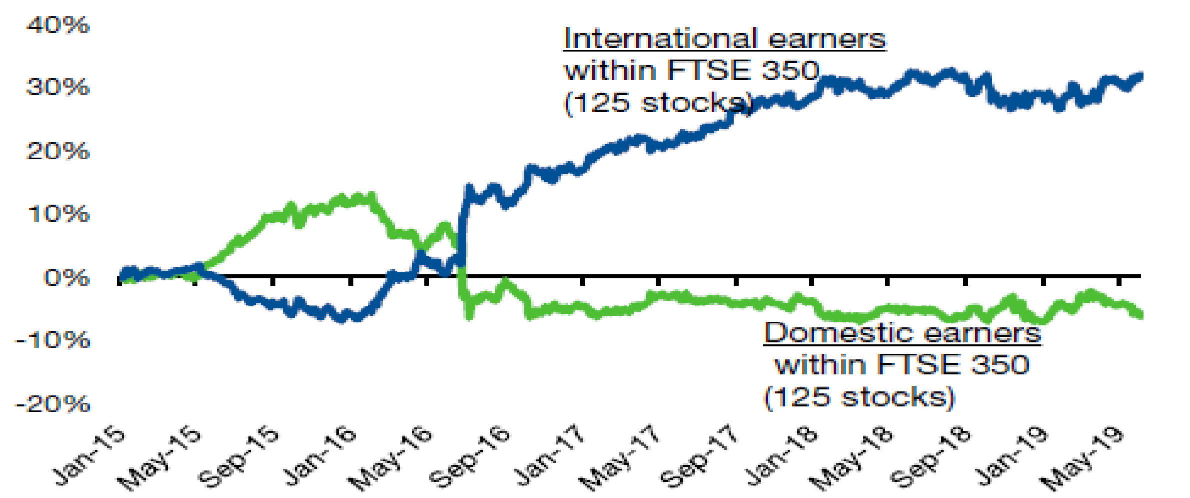
Source: Saracen Fund Managers as at 28.6.19

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.

At the end of 2018 we reported an increase in our holdings in the financials sector and we now have the highest financials weighting in the Fund for over a decade. Whilst the majority of our holdings are in smaller, growing businesses we recently added our first UK bank, Barclays, to the portfolio. We view it as an undervalued cyclical recovery stock.

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. The chart below demonstrates how domestic earners have struggled relative to international ones since the Brexit vote.

UK Domestic v International Earnings



*Source: Liberum, Datastream; *Relative to the FTSE 350*

Recent research from Liberum suggests that UK smaller companies derive more than 60% of profits from the UK economy compared to less than 30% for the FTSE100. Our current positioning is therefore reliant on some kind of satisfactory conclusion to Brexit. Should a 'no deal' scenario be avoided then we would expect to see strong results for the Fund driven by an increase in sterling and a re-rating of domestic earnings. If this scenario does not come to pass then at least we shall have a large margin for error in the valuations of many of our holdings.

In terms of sectors where we have low exposure, the structure of the portfolio is such that we tend to ignore 'deep value' sectors unless there are specific catalysts for recovery. We therefore have no investments in utilities or telecoms where a combination of high debt and increased political interference is now leading to dividend cuts and lower returns on capital as well as very low revenue growth.

We continue to avoid defensive sectors such as healthcare and consumer staples, where we see significant valuation risks and low underlying growth. The continued re-rating of such businesses feels pretty closely correlated to the bubbles that we see in government bonds and we are happy to sit on the side-lines. Fear of missing out (FOMO) does not trouble us here.

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 93%. 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 78% of the fund with large companies only 19%. We have a cash balance of 3% at present.

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 (45%* 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% in early 2018 due to the scarcity value and high ratings being applied to growth companies, which led us to take profits in various holdings.

Special situations (27%* 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 (25%* of portfolio assets)

The final group are good 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 28th June 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 far more potential investments emerging in the former category than the latter.

Outlook

From where we sit today we see an unprecedented amount of dislocations across asset classes, most of which have become significantly more stretched over the past three months. As relatively simple souls we struggle to understand or rationalise the following:

- $13 trillion of global bonds offering negative yields
- Unprecedented yield gaps between gilts and equities
- A 10 year bear market in value investing which worsens daily
- Bubbles in 'unicorn' businesses with no prospect of profit anytime soon
- Huge discounts to book value across real estate and banking equities
- All time high premiums being paid for 'quality' stocks
- Enormous sums of cash sitting in alternative assets and private equity

This list could indeed extend much further, all of which makes assessing the outlook even more difficult than usual. However, our guiding principles remain rooted in valuations, which we think matter all the more now, regardless of how unfashionable such an approach may currently be.

From our perspective as investors in UK companies there has rarely been a time when the market has been less loved. Since the Brexit vote in June 2016, both global and local investors have fled from UK equities, leading to material underperformance against the MSCI World index.

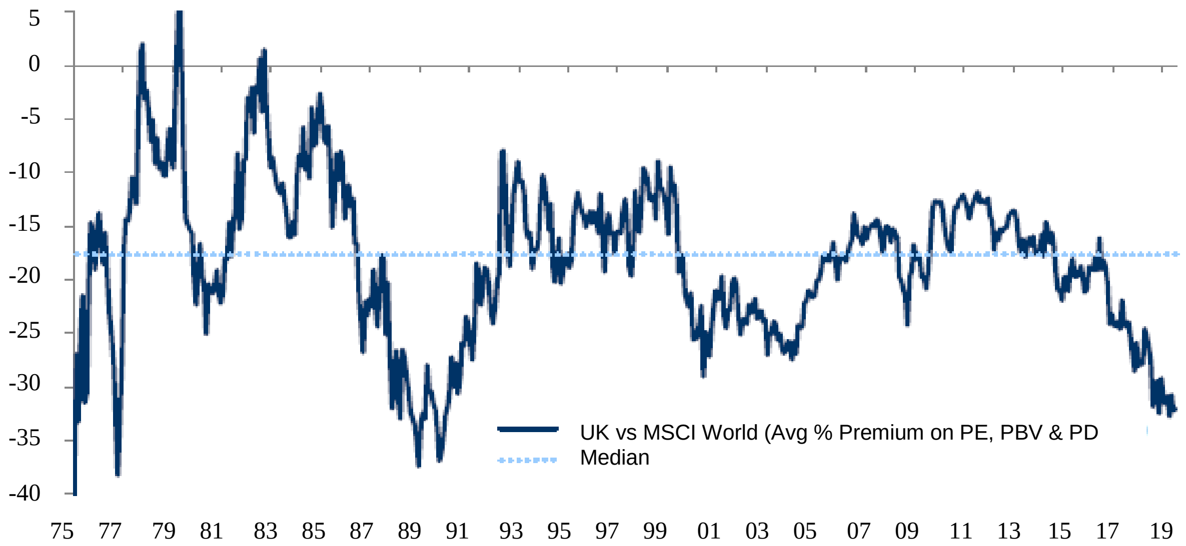
MSCI UK performance relative to MSCI World

Source: MSCI, IBES, Morgan Stanley

The recent BOAML Global Investor survey also confirmed that allocations to UK Equities remained heavily underweight, albeit the trend is showing some signs of bottoming now. This has manifest itself in fund outflows equating to almost 10% of UK equity assets under management in less than 4 years. Such findings demonstrate the damage that the Brexit fiasco has already done to investor perception (not to mention returns).

If we then consider the valuation of UK shares in a global context then a similarly extreme situation has evolved, with the valuation discount on UK shares now way in excess of any longer-term trend, despite considerable non-UK earnings in the FTSE100 in particular.

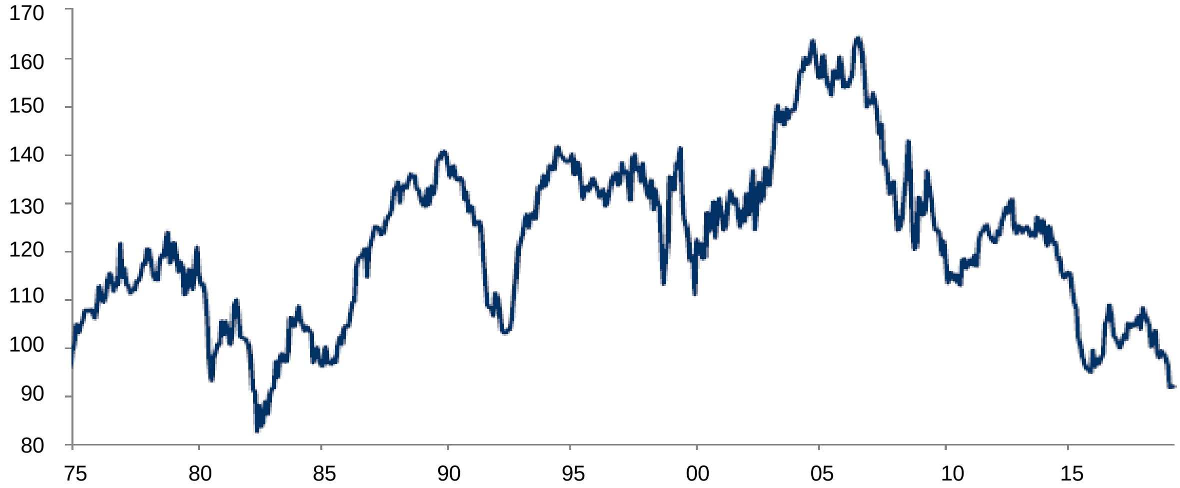
UK v MSCI World – Valuation Discount



Source: MSCI, IBES, Morgan Stanley

When one considers investment styles then the value investor is fast heading towards extinction with the past ten years in particular being a brutal battle for survival. Over the long run however, there is clear evidence that a value based approach does work, albeit it is now so long ago that many market participants may well have forgotten about it.

MSCI UK Value v Growth price performance



Source: MSCI, IBES, Morgan Stanley

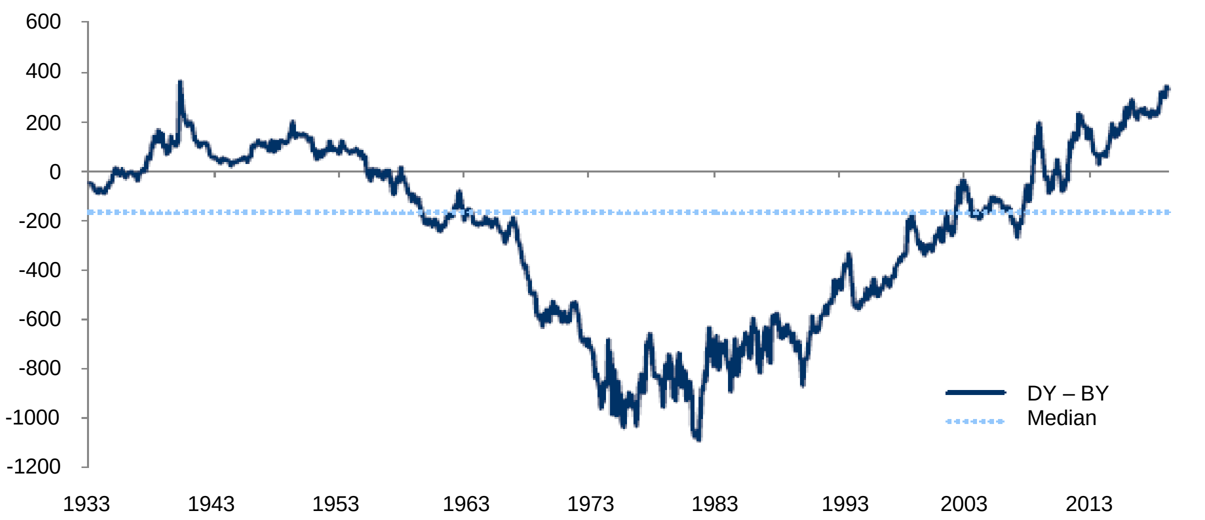
When one assesses the more recent style trends then the emergence of a 'quality' factor has been the key driver of market performance, again to the detriment of value factors. Recent Morgan Stanley research concluded that the top quintile of quality stocks had a valuation 2.2x that of the bottom quintile, a gap only reached once before, in the year 2000. We all know what happened subsequent to that.

Factor Performance – MSCI Europe

Source: Bloomberg

Although the Fund does not have any income objectives the yield gap between shares and UK gilts (now 3.7%, a post war high) makes the investment case for UK dividends 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 0.8%. This remains extreme when put into a historical context, all the more so when one considers the chaotic state of UK government likely under any current scenarios.

FTSE All-Share Dividend Yield – 10 Year Gilt Yield



Source: MSCI, IBES, Morgan Stanley

What does all of this mean for Saracen UK Alpha?

After a positive start to 2019 the Fund had a solid second quarter despite some ongoing underperformance from UK smaller companies. As discussed above, we struggle to remember a time when there were so many extreme dislocations apparent a [illegible] ge of asset classes, with the gap between the haves (US, technology, 'quality', gro [illegible] aking unicorns) and the have-nots (value, high dividends, banks, manufacturing, retail, UK) increasing by the day. We are often asked about the catalysts for these trends to reverse and struggle to give a clear answer but when it happens it is likely to be significant.

Having enjoyed strong returns from our positioning in mid and smallcap companies over the years, this part of the portfolio has found the going tougher over the past year or so as investors have reduced exposure to a less liquid asset class, where Brexit concerns are acutely concentrated. Post MIFID2 we see even greater potential for mispricing as 'sell side' research in this area diminishes. Therefore, our strategic commitment to investing in medium and smaller companies remains intact but we must be ever vigilant in ensuring that we minimise any disappointments here.

All of this adds up to a market environment which is currently pretty hostile towards any sort of valuation-based process. The key objective in the short term therefore is to keep our heads above water and deliver reasonable returns despite such headwinds.

The process and philosophy of the Fund will not change and unlike some, we do believe that valuation matters. We believe that there is significant potential value to be unlocked from many of our holdings and the recent early signs of takeover activity in the UK market (eg. BCA Marketplace, Merlin) give us some encouragement in that respect. We have had 5 portfolio companies receive takeover approaches over the past eighteen months and we believe that further corporate activity in some of our holdings may well be possible.

Whilst the Fund does not have specific dividend targets the 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 investors the world over. It would take a calamitous Brexit outcome or a synchronised global slowdown for this potential to be under serious threat from here and those who await clarity tomorrow may well miss out on some outstanding investment opportunities today.

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 cash levels remain high and Brexit and trade war concerns look set to persist for now. We believe that our flexible 'multi-cap' approach should serve us well over the long term.

Scott McKenzie, Investment Director
5th July 2019

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