TB Saracen UK Income Fund

Quarterly Review – June 2019

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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
Q2 2019	1.8%	3.1%	-1.3%

Performance Summary

After a solid start to 2019, the Fund lost a little relative ground during the second quarter with the shares rising by 1.8%, which lagged the 3.1% rise from the MSCI UK All Cap index and was in line with the increase of 1.8% in the IA UK Equity Income sector (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	Since launch*
TB Saracen UK Income B Acc	1.8%	-4.4%	44.4%	25.4%
MSCI UK All Cap Index (TR)	3.1%	0.3%	29.0%	29.2%
Sector Average	1.8%	-2.6%	23.2%	20.3%
Quartile Ranking	3	3	1	2

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

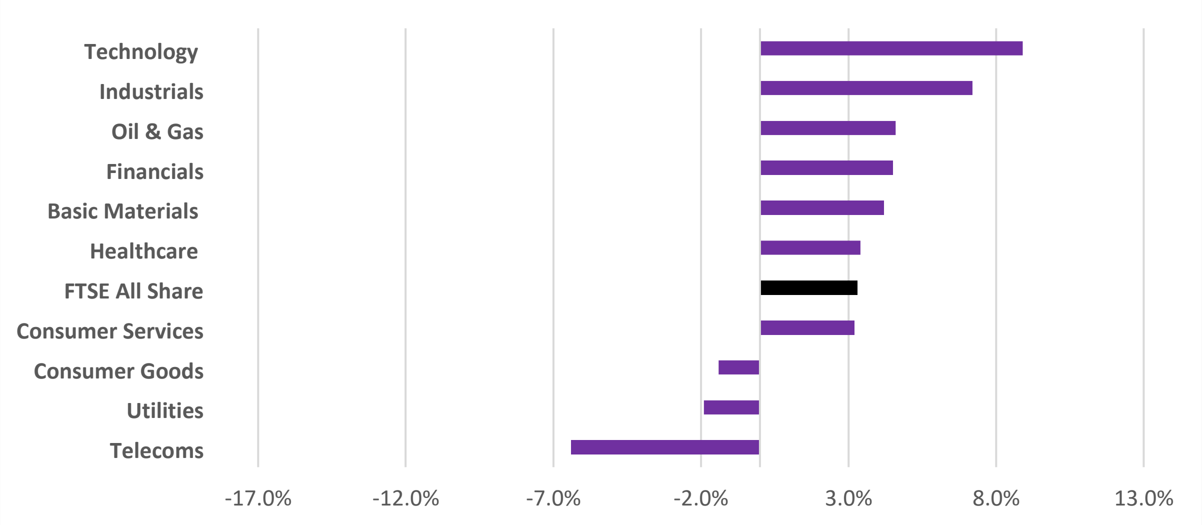
Market Overview

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 high 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 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. 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 the Fund has a high active share, with a current reading of 88%.

Positive Contributors

With equity markets continuing to make steady progress, our large weighting in financials was broadly helpful for the Fund's returns. Of particular note were our holdings in asset management businesses, all 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. **Jupiter Fund Management** continued its recovery and rose a further 17%, making it our biggest riser in 2019 so far.

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.

Although smaller companies lagged somewhat, we had several positive contributors in this segment with **Gateley** (legal services), **DiscoverIE** (electronic components) and **Kin & Carta** (marketing services) all making solid progress. These were all very stock specific returns.

Our final category of positive performers were across the broad theme of value and recovery. **WPP** rose 27% as investors focussed on its low rating and delivery of restructuring plans. **TI Fluid Systems** also rallied as they continue to deliver better returns than most in a difficult automotive sector. The flooring distributor **Headlam** rose 12% having had a solid start to the year and our recent purchase of **DS Smith** delivered good final results whilst announcing further positive margin guidance and strong dividend growth. The shares added 10%.

Negative Contributors

The lacklustre showing of the Fund during the period was dominated by the very weak performance of **Imperial Brands**, which fell 29% over the quarter and was one of the Fund's larger holdings. Whilst the interim results were broadly in line and guidance re-iterated, it is clear that the market does not trust management claims that cashflows and dividends will remain robust. Whilst we accept that demand for their products is in long term decline, we do not share others' certainty that profits and dividends will collapse. The low valuation of the shares is now at extreme levels in our view and we have recently added to the holding.

We had two holdings which were impacted by the gating of the Woodford fund, **NewRiver REIT** and **Eurocell**, which fell by 21% and 8% respectively. The Woodford portfolios hold large stakes in both companies which has led to selling pressure in each case. In the context of the Fund, however, they are relatively modest holdings and we see scope to increase our positions as and when the dust settles.

Several holdings which started 2019 well were impacted by profit taking, notably **Lloyds Banking**, **Alpha Financial Markets Consulting** 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 split of investment was 37% in largecap, 29% in midcap and 32% in smallcap/other. The Fund remains fully invested (post the recent XD on 1st July), reflecting the significant yield opportunities available from the UK equity market in general.

Purchases

There were no new stock purchases made during the quarter but we added to three companies, all of which had seen share price weakness during the period.

DS Smith has been derated significantly over the past year with analysts fretting about paper pricing and European economic slowdown. The results confirmed that their strategy of being 'paper light' and focussing on FMCG customers is the right one. The shares also have good dividend prospects as well as a high starting yield. **Galliford Try** have not had their troubles to seek of late but the news of a potential approach from Bovis could mark a turning point in so far as it highlights the extreme valuation discount that the shares currently trade on. Whilst talks have come to nothing initially, we believe that there is scope for a mutually beneficial transaction to be agreed which could deliver material shareholder value for both parties. As detailed previously, we have added to **Imperial Brands** on a dividend yield of 11%. We are strongly of the view that the company should stop increasing this dividend and execute a share buyback programme instead, as well as disposing of non core assets to reduce debt. If this can be done then the shares have considerable upside from here.

Sales

There were no holdings sold outright from the portfolio during the quarter.

We took some profit in two stocks which had served us well. **Discover IE** continues to deliver strong results and has admirably stretching medium term targets too but the yield on the shares has fallen considerably since our original purchase. **Alpha Financial Markets Consulting** has also performed well since our purchase in the IPO and we took the opportunity to scale back a fairly large position in the shares.

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

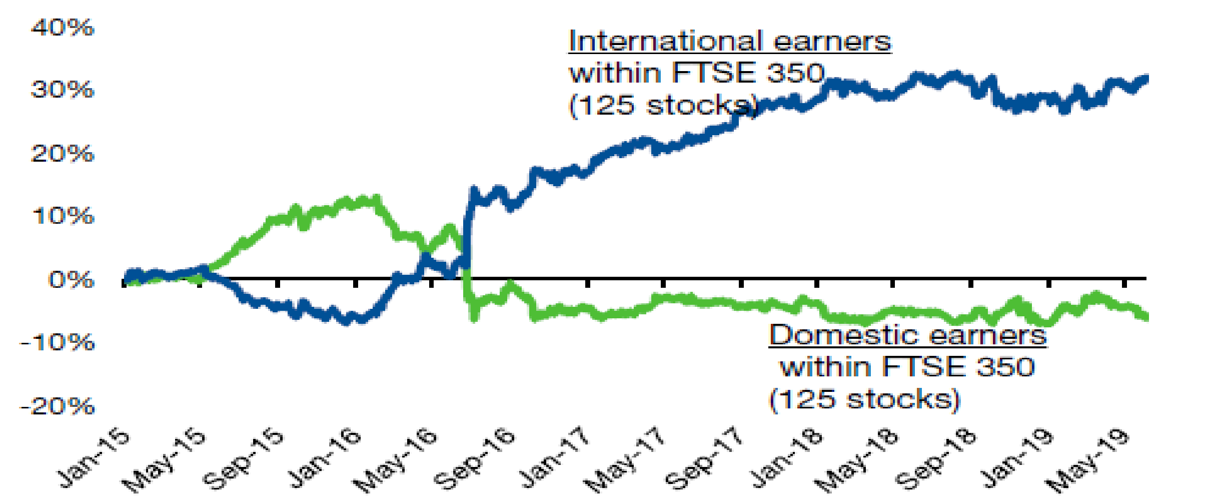
Source: Saracen Fund Managers as at 28.6.19

Our sector profile is largely unchanged. We continue to have over 30% of the fund held in financial sectors and see this segment as an important source of dividend income for the Fund, with dividend prospects across our holdings remaining robust. Even on a worst case scenario, we see only limited threats to current levels of income. Our investments 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 and the negative correlation with low bond yields doesn't help our cause. The holdings exposed to capital markets can be volatile and require careful monitoring, but recent share price performance has been more encouraging.

Our exposure in the industrial sectors is 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. The chart below demonstrates how domestic earners have struggled relative to international ones since the Brexit vote.

UK Domestic v International Earners



*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, we continue to avoid the ‘growth’ and ‘quality’ segments which we believe to be overvalued, in particular consumer staples where we see significant valuation risks and low underlying growth. The continued re-rating of such business 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.

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 dividend reductions are now beginning to materialise.

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 61% of the fund and large companies 37%, and the Fund has a policy of being 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 (49% 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 (51% 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 28.6.19, 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 continued to grow income during the first half of 2019 and we announced an interim dividend of 2.50p per income share which was marked 'XD' on 1st July 2019. This was an increase of 4% on the 2.40p paid in 2018. The historic yield of the Fund is currently 5.0%, based on the income share price of 104.1p as at 28th June 2019.

The forecast portfolio dividend yield based on our current expectations is 5.5%. This assumes growth in income from the portfolio over the next twelve months of 3%, which should be slightly ahead of inflation. The forecast dividend yield for the UK market as a whole is currently 4.6% with expected dividend growth of 3% (source: Bloomberg), albeit this number is quite sensitive to sterling rates. Only 14% 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 in general, 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

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 equities 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.

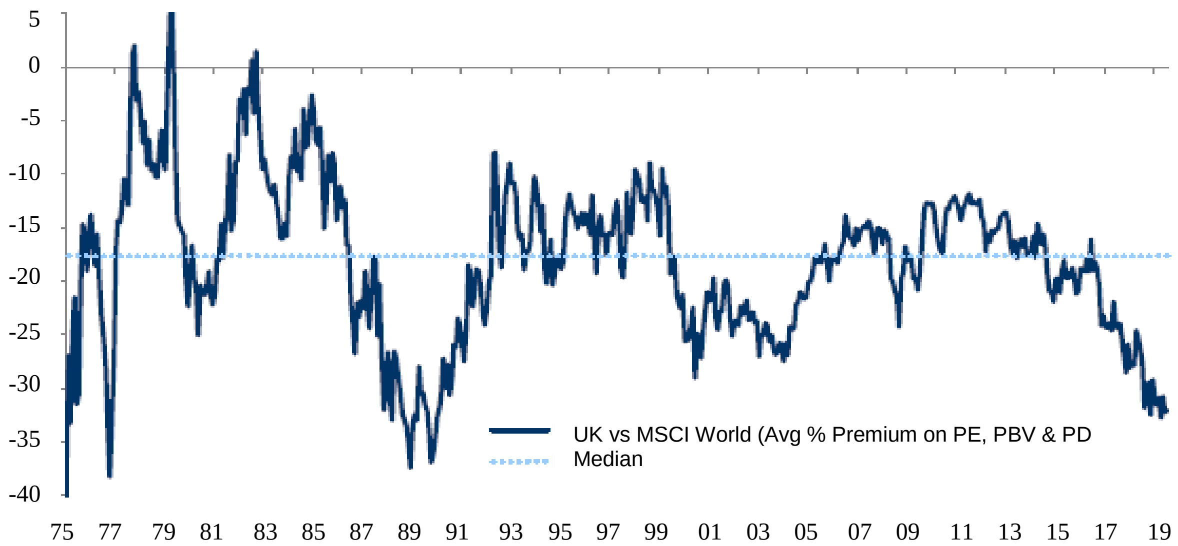
MSCI UK performance relative to MSCI World

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 <u>already</u> 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.

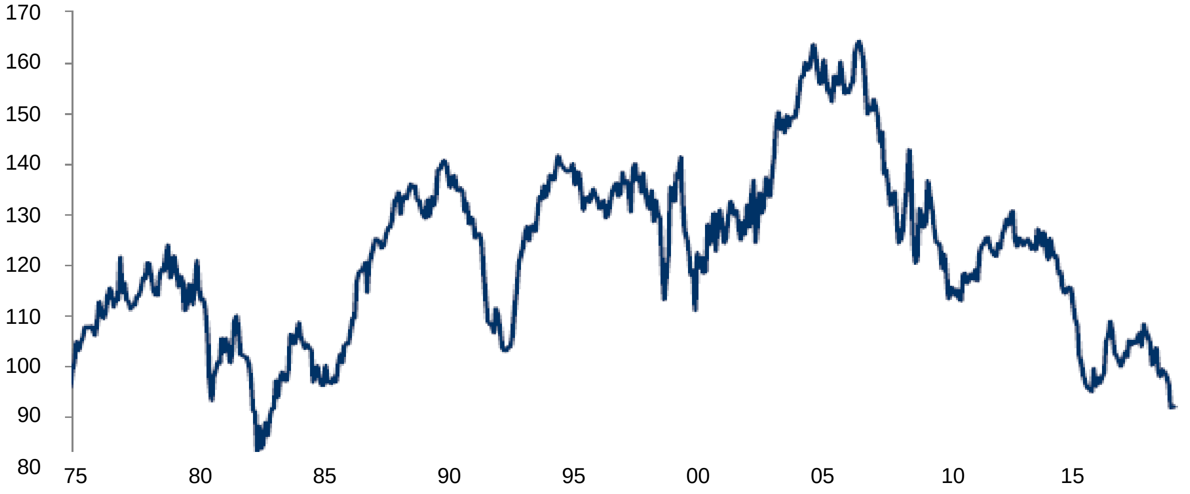
UK v MSCI World – Valuation Discount



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

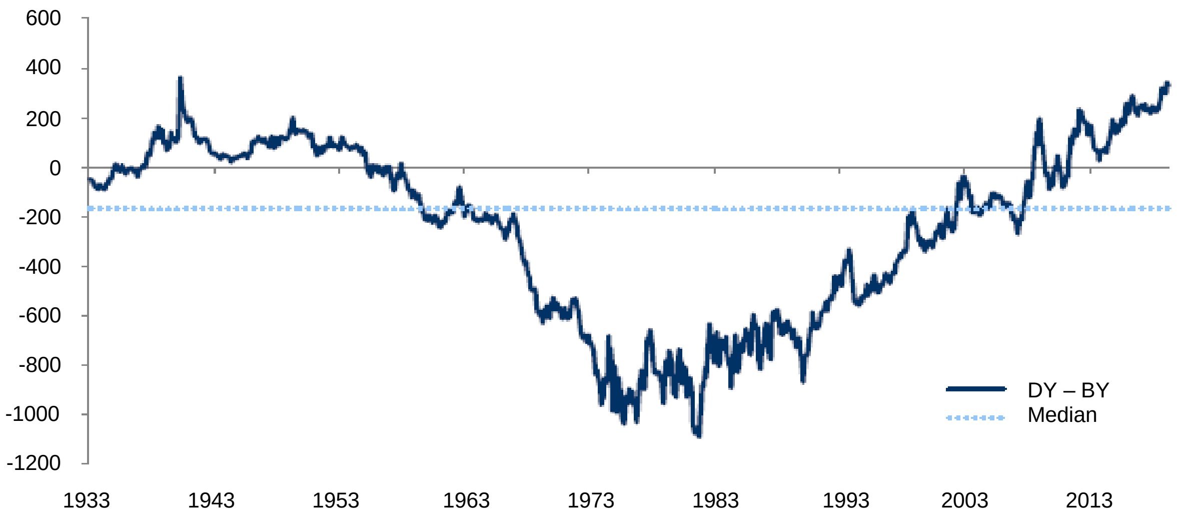
When one assesses the more recent style trends then the emergence of a 'quality' factor has been the key driver of market performance, again to the detriment of value factors. Recent Morgan Stanley research concluded that the top quintile of quality stocks had a valuation 2.2x that of the bottom quintile,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

Factor Performance – MSCI Europe

Source: Bloomberg

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 Income?

After a positive start to 2019 the Fund laboured somewhat during the second quarter as the huge disparity between value and growth/quality factors took its toll on our returns. As discussed above, we struggle to remember a time when there were so many extreme dislocations apparent across a range of asset classes, with the gap between the haves (US, technology, 'quality', growth, loss making 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 of late as investors have reduced exposure to a less liquid asset class where Brexit concerns are acutely concentrated. Our strategic commitment to investing in medium and smaller companies remains intact but we must be ever vigilant in minimising any disappointments here.

All of this adds up to a market environment which is currently pretty hostile towards our value based philosophy, an approach which remains heavily out of fashion. 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 we are comfortable being part of a lonely, minority group here. Unlike some, we do believe that valuation matters but we must be careful to avoid the 'value traps' which are all around us. We believe that there is significant potential value to be unlocked from many of our holdings and the current very high portfolio yield gives us cause for optimism in that respect, as do the recent early signs of takeover activity in the UK market (eg. BCA Marketplace, Merlin).

The dividend income on offer from UK shares remains highly attractive relative to current abnormally low gilt yields and the UK equity 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 upside potential to be under serious threat from here and those who await clarity tomorrow may well miss out on some outstanding investment opportunities today.

As always, 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 cash levels remain high and Brexit and trade war concerns look set to persist for now. We believe that our flexible 'multi-cap' approach, combined with a focus on a high and growing income, give us a good possibility of achieving positive real returns over the long term.

Scott McKenzie, Investment Director
5th July 2019

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