TB Saracen UK Income Fund

Quarterly Review – September 2019

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FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

	TB SUIF	MSCI UK All Cap (TR)	Relative
Q3 2019	-0.2%	0.9%	-1.1%

Performance Summary

It was a difficult summer for our strategy and, despite a good recovery in September, the Fund lost a little relative ground during the third quarter with the shares falling by -0.2%, which lagged the 0.9% rise from the MSCI UK All Cap index. This was also behind the increase of 1.1% 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 30th September 2019

	3 months	1 year	3 years	Since launch*
TB Saracen UK Income B Acc	-0.3%	-4.4%	26.4%	25.1%
MSCI UK All Cap Index (TR)	0.9%	2.0%	20.8%	30.3%
Sector Average	1.1%	-0.1%	14.3%	21.8%
Quartile Ranking	4	4	1	2

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

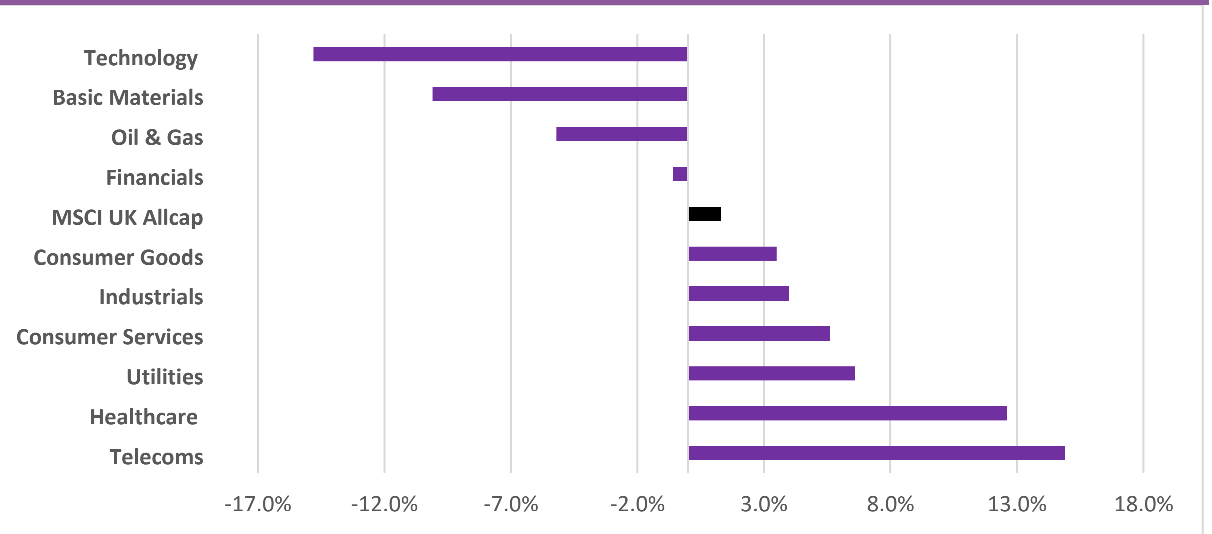
Market Overview

Whilst the UK market eked out a small positive return during the quarter the underlying pattern was a volatile one, with notable weakness in August offset by a good recovery during September. This pattern was repeated globally, with the MSCI World index returning 0.5%. There remains an ongoing tussle between growth and value styles, with growth investors having enjoyed over a decade of superior returns now. Closer to home we saw further underperformance from UK smaller companies, which remains a headwind for the Fund.

Total returns by capitalisation: 3 months to 30th September 2019	
FTSE100	1.0%
FTSE Mid250	3.3%
FTSE Smallcap	-1.0%

At a sector level, it was a very mixed bag, with a number of extreme variances. The leaders were generally defensive in nature, with healthcare continuing its run of form and both telecoms and utilities recovering from long periods of underperformance. By contrast, the bull run in basic materials such as mining began to unwind in response to the intensifying US/China trade war and the financials sectors in general laboured once again, under further pressure from ever-decreasing bond yields. Despite the Saudi attacks the oil sector drifted as oil prices remained depressed and investors turned up the heat on ESG concerns.

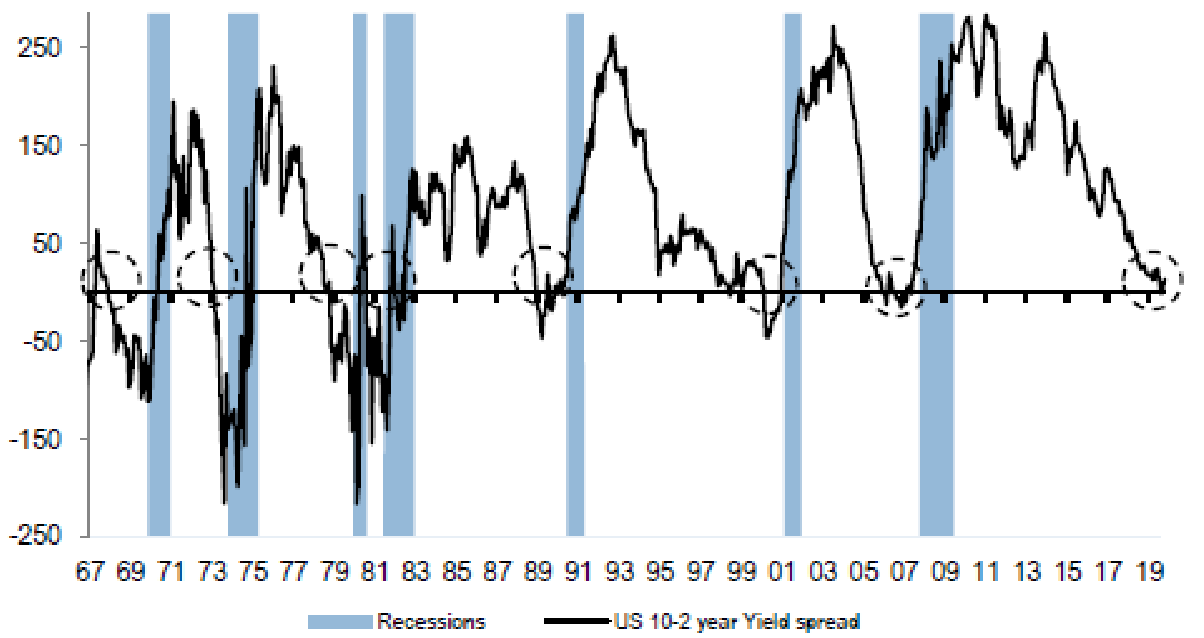
UK sector total returns: 3 months to 28th June 2019



Source: Bloomberg

As before, Brexit and global trade disputes remain huge concerns for investors, with both situations going from bad to worse, leaving the outlook particularly uncertain and difficult to navigate. The dramatic falls we have seen in government bond yields globally have continued, with inverted yield curves everywhere historically serving as an early warning of global recession. This has been compounded by weak survey data, with the recent very poor ISM manufacturing data from the US causing alarm across global markets.

US Yield Curves & Recessions



Source: Datastream, NBER, JP Morgan

For the fourth consecutive quarter, bond returns were positive and yields fell again in the key markets of the US, UK and Germany to 1.7%, 0.5% and -0.6% respectively. We have to acknowledge that we are something of a stuck record on this point, but the idea of investors lending to any of the current crop of political leaders in the UK at such rates gives us a cold sweat. Bloomberg currently estimates that around $15 trillion of global bonds now offer negative yields. There are far cleverer souls than us who can explain and rationalise such a phenomenon, but we struggle to see plunging economic growth and negligible inflation persisting for a long enough time period for the buyers of such assets today to get a positive return. By contrast, many equity markets offer high and growing dividend streams, something which, in the long run, should not be ignored.

Despite a wave of negative commentary the US market remains close to it's all time highs. However, there are early signs of sanity prevailing and valuation beginning to take centre stage again. This has manifest itself in the postponement of the WeWork IPO along with the miserable post listing performance of loss making 'unicorns' such as Uber, Lyft and Slack. In the UK market we have seen similarly troubled new issues such as Amigo, Funding Circle and Aston Martin Lagonda, all of which have collapsed in value shortly after floating. A number of highly rated market darlings such as Netflix, Fevertree and ASOS have also come back to earth somewhat, all of which suggests some signs of rationality returning to public markets

However, we must acknowledge the deteriorating economic trends all around us. From a UK perspective, the Brexit saga and ongoing political crisis is now having a negative impact on the real world. Recent PMI survey data shows that the crucial services sector reading is now indicating negative economic growth prospects, joining the already weak manufacturing and construction indicators. It feels like there is now a high chance of recession in the UK.

All of this means that a satisfactory conclusion to the Brexit saga is increasingly vital to future prosperity, but it is hard to see a clear and positive way forward, both politically and economically. Given this highly uncertain and difficult background, sterling weakened a further 3.5% against the dollar over the quarter but was flat against the Euro, perhaps a reflection on the damage that both Brexit and weakening world trade are doing to Europe's prospects, with Germany in particular now showing signs of economic strain.

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 over the 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 whilst the larger, more multinational businesses in the FTSE100 have performed relatively well. The Fund has no exposure to defensive sectors such as telecoms, utilities and healthcare and this was detrimental again during a period where bond yields fell to new lows. Lack of exposure to these three sectors accounted for all of the Fund's underperformance against the MSCI UK Allcap index during the quarter and offset good returns from the consumer sectors and some of our financials holdings. The focussed nature of the portfolio means that the Fund has a high active share, currently 88%.

Positive Contributors

Despite the ongoing Brexit fiasco our exposure to the UK consumer was, for once, a positive for the Fund, none more so than in **Greene King**, where we saw a return of 42% over the quarter in response to a takeover bid at 850p per share. **STV Group** also performed well, rising 12% despite ongoing concerns in the broader TV industry. During the period we added to our UK construction exposure with new holdings in **Bovis Homes** and **Ibstock**, and those have risen by 8% and 12% respectively since purchase. The proposed merger of the housebuilding assets of Bovis and **Galliford Try** also had a positive effect on the latter, which rose by 6% during the quarter.

During the summer we steadily increased exposure to UK real estate, adding to **NewRiver REIT** and buying a new position in **U&I Group**. Both stocks have begun to show signs of life, rising by 9% and 15%, and we see considerable potential for corporate activity in this unloved sector. Despite the ongoing headwind of falling bond yields there were some positives in our financials holdings with **Intermediate Capital** continuing its strong momentum and **Close Brothers** and **Standard Life Aberdeen** rallying towards the end of the period.

For the second successive quarter **WPP**, **National Express** and **DiscoverIE** made further progress and we have now sold the latter holding on yield grounds.

Negative Contributors

The lacklustre showing of the Fund during the period was dominated by some weak small company stock selection and our lack of exposure to certain sectors which delivered positive returns. Having no exposure to healthcare (mainly Astra Zeneca), telecoms (Vodafone) and utilities was costly to our relative performance, but we have no plans to change this positioning.

Of more fundamental concern was weakness in **Kin & Carta**, which had a disappointing profit warning, highlighting the period of transition the business is currently in. The shares fell by 22%. A delay to the results from **Clipper Logistics** caused great alarm and the shares fell 20%. We have bitten the bullet here and exited at a loss. Whilst we have modest exposure to retailing overall the two small companies we own remain in the doghouse, with **Halfords** falling 20% as poor trading continues and **Superdry** losing a further 10% in response to significant management change and future uncertainty. In general, it has been a difficult environment for our smallcap portfolio with larger positions in **Alpha Financial Markets Consulting** and **Palace Capital** also continuing to drift**.**

Our holdings in the resources sectors were lacklustre with **Rio Tinto** and **BHP** seeing profit taking in response to weaker commodity prices and the ongoing US/Chinese trade wars. Both stocks fell by 10% during the period. Finally, **Wood Group** continues to be dogged by high levels of debt and somewhat complex reporting of results as well as considerable short selling. The company has much to prove going into 2020 and the shares fell a further 14%.

Portfolio Activity

The fund has 32 investments which are spread across a variety of market capitalisations. As at 30th September 2019, the split of investment was 38% in largecap, 30% in midcap and 31% in smallcap/other, leaving only 1% in cash. The Fund remains fully invested, reflecting the significant yield opportunities available from the UK equity market in general.

Purchases

There were three new stock purchases made during the quarter, all of which had a UK-centric flavour to them, with two construction businesses and one real estate company added to the portfolio.

Ibstock is one of the three leading UK brick manufacturers. We are very optimistic on margin expansion for the company, given the strong pricing power they enjoy as well as positive fundamentals in UK new-build construction, driven by continued cross-party support for the industry. The brick market has consolidated in recent years and this means that margins and returns are not at risk from new competition, whilst weak sterling makes imports less attractive. Strong cash generation will support its bolt-on acquisition strategy and increase the likelihood of further shareholder returns. Ibstock's shares trade at a discount to the UK construction sector and we believe that this discount is unjustified.

Bovis Homes is a mid-size UK housebuilder, primarily focussed on southern England with no exposure to London. Although margin pressure is expected across the wider housebuilding industry over the next couple of years, Bovis still represents a clear turnaround story in the sector, with potential for improved returns. The company has launched a bid for the housebuilding assets of Galliford Try which will widen their geographic scope and diversify their product mix by adding a leading partnership business. We believe this to be an excellent deal for both parties if concluded but, even without this, Bovis is an attractive stand alone investment.

U&I is a small real estate business with significant development assets in the UK (London, the South and Manchester) and Ireland (Dublin). It is a leader in mixed use regeneration schemes and is active in a number of large, multi year projects. It also has an investment portfolio which allows it to pay a meaningful dividend to shareholders going forward. The shares trade on a substantial discount to the value of their assets and offer considerable upside from here.

We also increased exposure to a number of existing holdings post some of the sharp declines we saw in valuations over the summer. These included the financials businesses **NewRiver** and **Close Brothers** as well as more cyclical recovery names such as **Synthomer**, **WPP**, **DS Smith** and **Superdry**. All of these positions began to recover during September.

Sales

There were four holdings sold outright from the portfolio during the quarter.

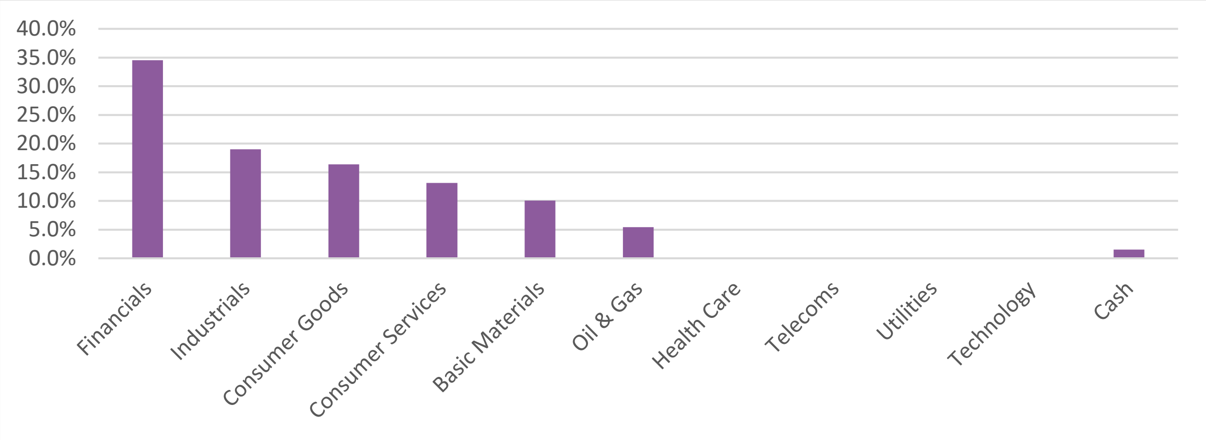
We realised healthy profits in two stocks which had served us well. **Discover IE** continues to deliver strong results and has admirably stretching medium term targets too, but the yield on the shares had fallen considerably since our original purchase. **Greencore** has enjoyed a re-appraisal of its prospects since the sale of its US business last year and we now believe that much of the value opportunity in the shares has been realised. The sale of **Clipper Logistics** was done with a heavy heart, but the late arrival of the final results and generally poor investor communication led us to conclude that we were no longer comfortable as shareholders. The final sale was for happier reasons, with the bid approach for **Greene King** at a meaningful premium allowing us to exit the shares at a full and proper valuation for the business.

In addition to this we reduced the positions in **Jupiter** and **Tyman** after some good recovery was seen in both.

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, the ongoing impact of weak sterling and low bond yields have been major headwinds for the Fund during the past year.

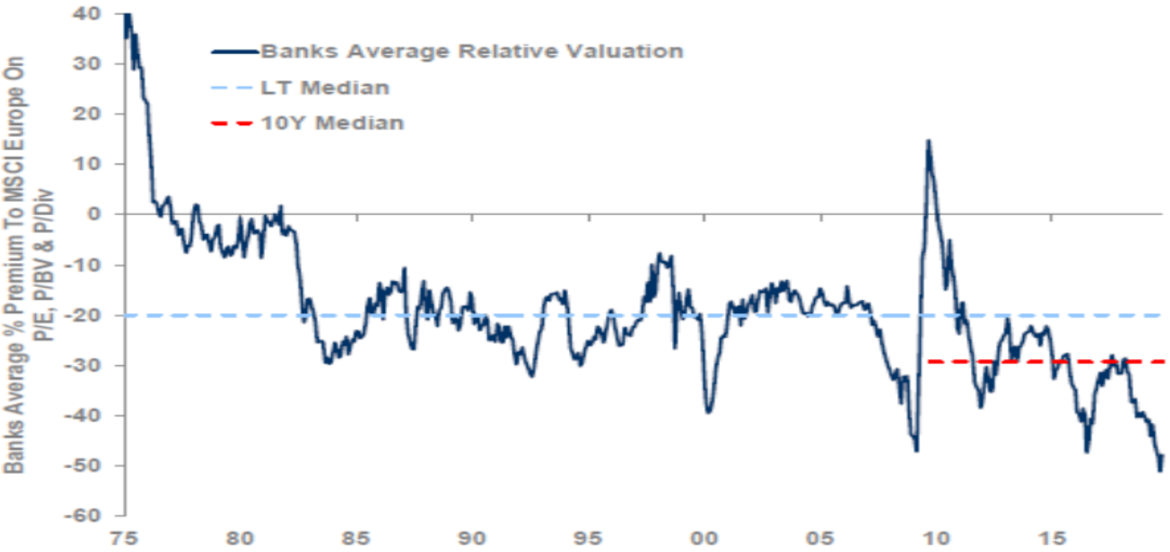
TB Saracen UK Income: Sector Profile



Source: Saracen Fund Managers as at 30.9.19

Our sector profile remains pretty much as before. We continue to have well over 30% of the portfolio in the financial sectors and see this segment as an important source of dividend income for the Fund. We have done a fair bit of stress testing in this sector of late but we still see only limited threats to current levels of income, assuming no Brexit-related disasters. Our investments in life assurance and banks are producing solid levels of cashflow and capital ratios which should underpin dividend payments. Despite broad improvement in their finances, these sectors have continued to struggle since the 2007-2008 crisis and the ongoing negative correlation with low bond yields has left them firmly out of favour.

European Bank valuations

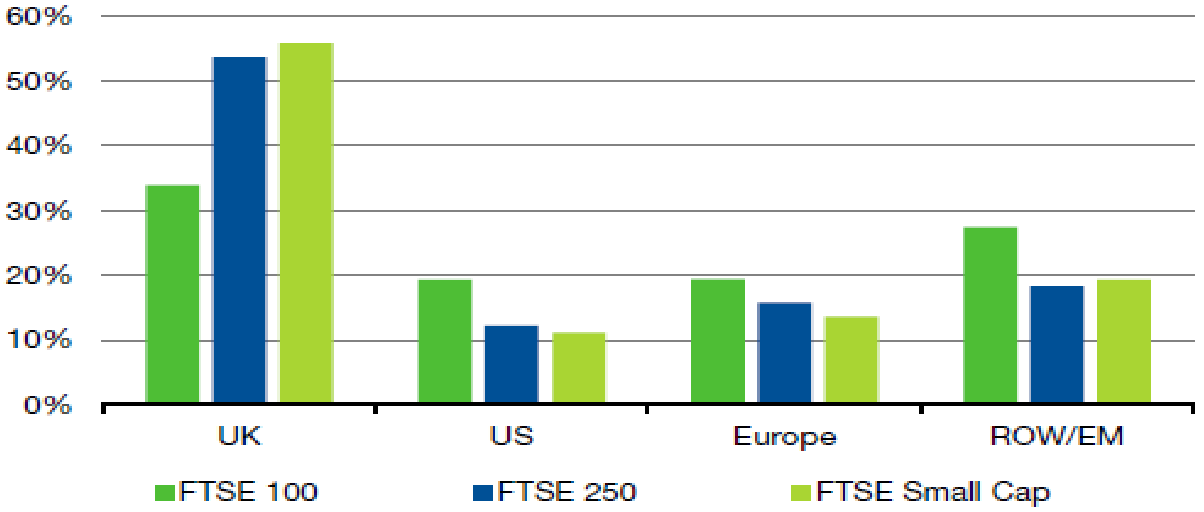


Source : MSCI, Factset, IBES, Morgan Stanley Research

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 but we must be vigilant regarding risks to the global economy in this segment.

Given our strategic commitment 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 outlines the revenue mix by size index, demonstrating the high exposure to the UK economy that small and midcap investors generally have, compared to investing in the FTSE100. Our current portfolio 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 we hope that we already have a large margin for error in the valuations of many of our holdings.

Geographic Revenue Splits by Market Capitalisation

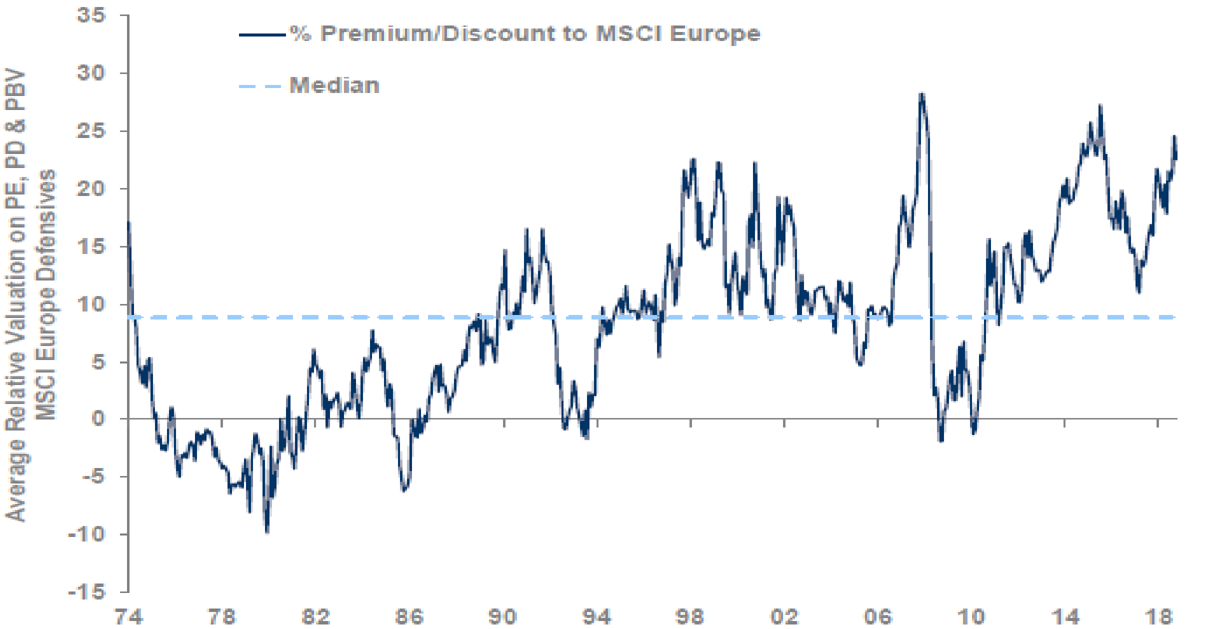


Source: Liberum, Datastream

We have no investments in utilities where a combination of high debt and the risk of increased political interference leave us feeling underwhelmed. The same would apply to the telecoms sector where ongoing investment requirements are onerous. In both sectors dividend cuts have already been seen and we think more are likely over time.

In terms of sectors where we have low exposure, we continue to avoid the most defensive sectors of the market which we believe are both overpriced in absolute terms and heavily correlated to the current absurdly low (or negative) government bond yields. This would include consumer staples where we see significant valuation risks and low underlying growth. The chart below summarises our concerns fairly succinctly. We are happy to sit on the sidelines when valuations are so far away from the long term median.

European ‘Defensives’ Valuations



Source : MSCI, Factset, IBES, Morgan Stanley Research

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 (51% of portfolio)*

Businesses which are facing challenges at present but who we believe offer secure, high dividend yields. A typically uninspiring bunch of companies but there to do the heavy lifting for shareholders’ income. At times companies in this group will cause us some heartache, often being reviled by others and being vulnerable to the risk of dividend cuts.

Dividend Growers (49% of portfolio)*

These are companies with essentially bright or improving prospects which can compound into high levels of dividend growth. They may offer modest yields at purchase but have the potential to become high yielding over the medium term. We hope that in due course they become the dividend stocks of tomorrow, whilst driving increased income to shareholders.

** as at 30.9.19, 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 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 5.2%, based on the income share price of 101.3p as at 30th September 2019.

The forecast portfolio dividend yield based on our current expectations is just under 6%. 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 just below 5% but future dividend growth is quite sensitive to sterling/dollar rates. Only 15% of the Fund's income is non-sterling denominated, significantly less than the index and most other equity income funds.

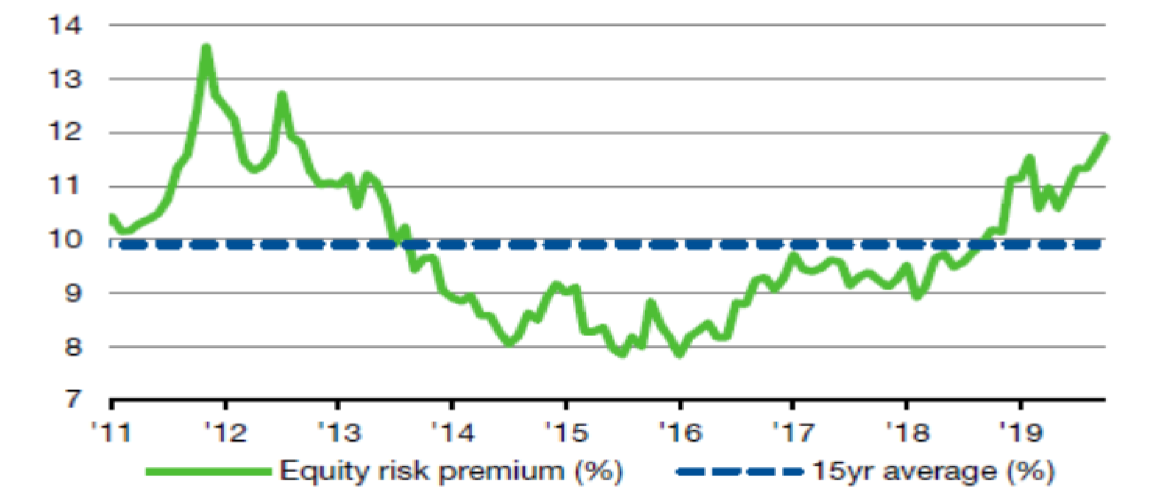
Given the already high payout ratio and significant dividend yield on offer from UK shares in general, we would expect overall dividend growth to be modest in the years ahead. However, we expect to grow underlying dividends per share ahead of inflation for the Fund again in 2019 and shall be budgeting for a similar outcome as we move into 2020.

Outlook

In our previous quarterly review we identified a number of dislocations which we found hard to fathom. Most of these have remained in place, albeit there are some early signs of shifting sands. We take some encouragement from the shorter term improvement in our results during September as investors began to focus on valuation at last.

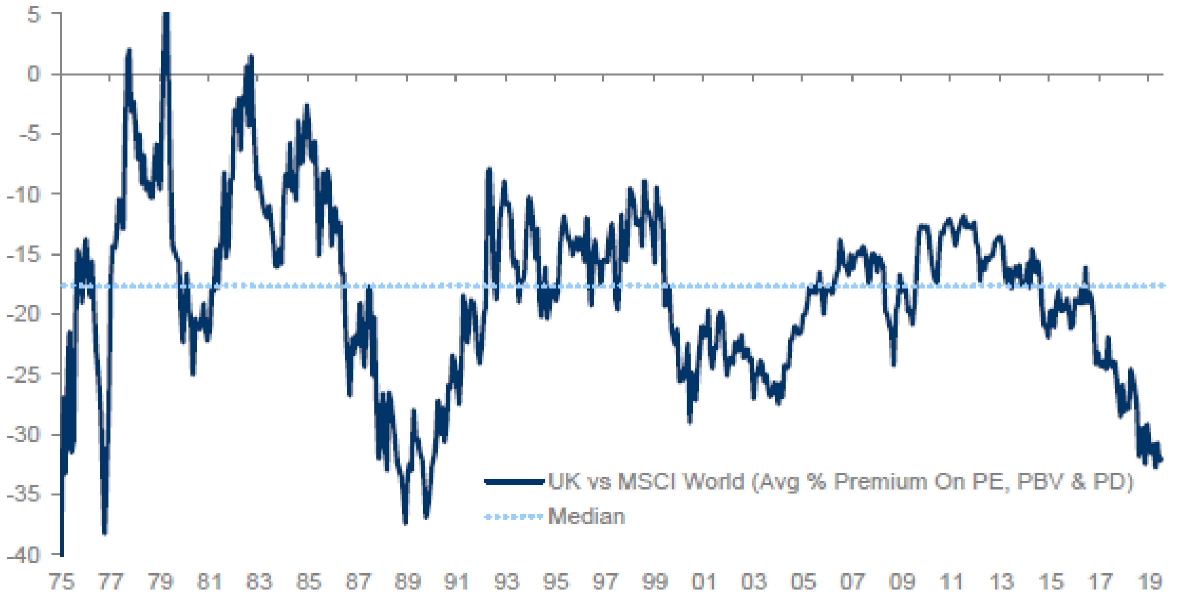
The outlook for investing in the UK remains somewhat cloudy, both politically and economically, but we are very much of the opinion that a lot of risk is already factored into equity prices today. The following charts look at the UK equity risk premium, which has risen by 50% since the Brexit vote in 2016, and the valuation of UK shares in a global context, where we have seen dramatic de-rating in recent years.

FTSE350 Equity Risk Premium



Source: Liberum, Datastream

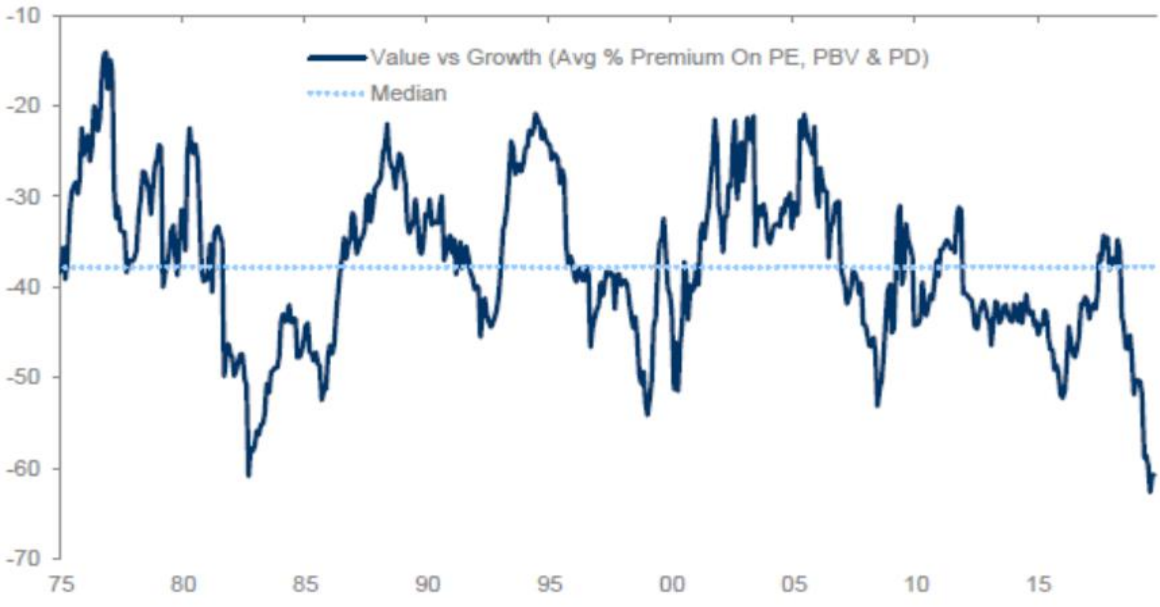
UK v MSCI World – Valuation Discount



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 have never witnessed it in the flesh. Whilst one should always expect to pay a lower price for lower growth and make an appropriate adjustment for the earnings risks inherent in value investing, the current valuation divergence is almost unprecedented in recent history as the following chart articulates.

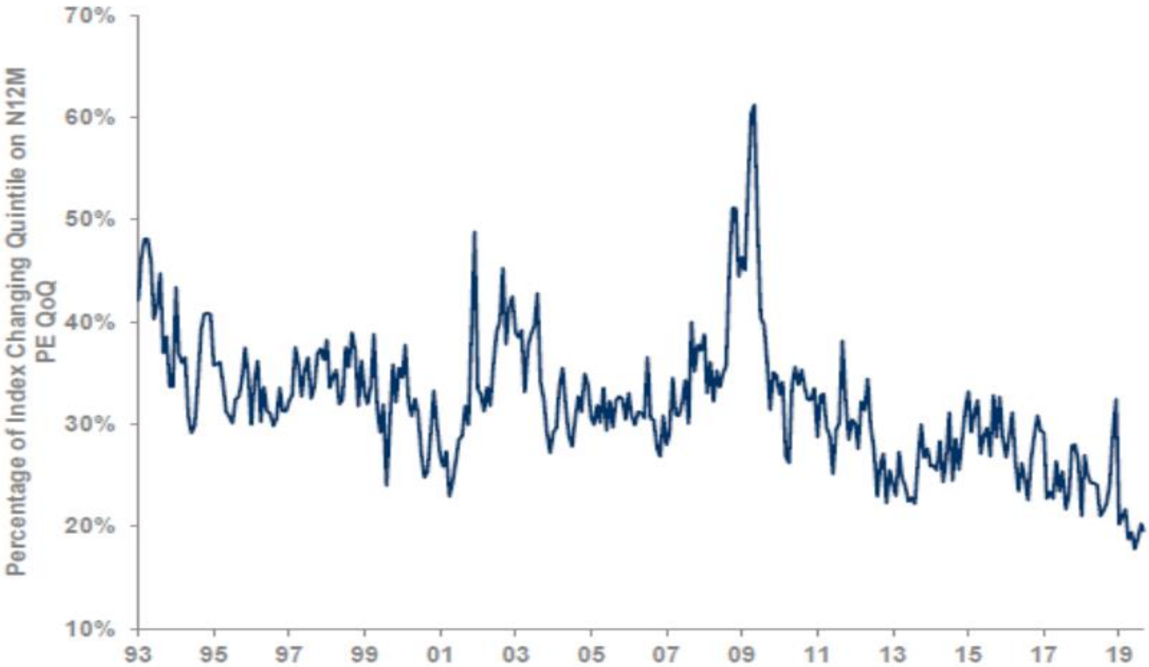
MSCI UK Value v Growth – Valuation Premium



Source: MSCI, Morgan Stanley

Related to this pattern is the absence of any sort of mean reversion trend emerging, with this measure now hitting a 25 year low point as shown below. This demonstrates the power of momentum in today's markets and the increasing gap between the 'haves' and the 'have nots'. There truly has been no hiding place or any sign of respite for the value investor.

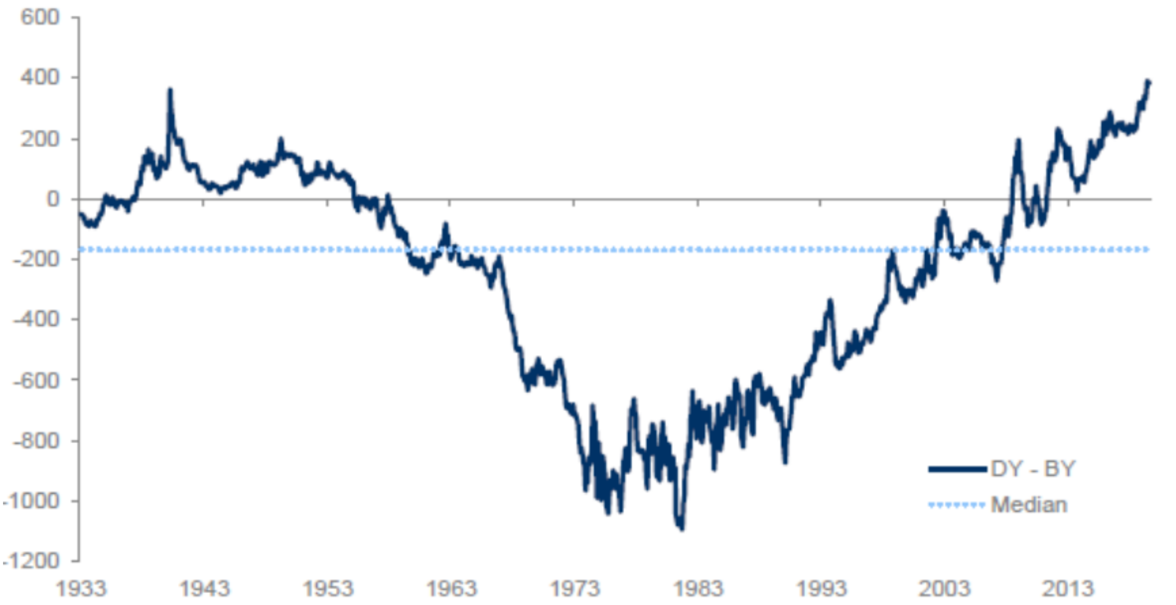
European Equity Mean Reversion Indicator



Source : MSCI, Factset, IBES, Morgan Stanley Research

The yield gap between shares and UK gilts (now above 4%, 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. Regular readers will detect that we have banging on this particular drum for some time, with gilt yields falling yet again during the quarter to current yields of only 0.5%. This remains extreme when put into a historical context, all the more so when one considers the chaotic state of UK government likely under a multitude of 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?

The Fund has laboured somewhat during the past year and this continued through the third quarter as the huge disparity between value and growth/quality factors continued to take its toll on our returns. The weakness of sterling has led to our smaller company investments remaining largely out of favour whilst bond yields plunging new depths has been detrimental to many of our holdings in financials. The extreme dislocations across asset classes that we identified in our previous review are largely still in place, albeit there are early signs of some bubbles now bursting.

Our core process and philosophy of focussing on value will not change and, although it can be testing having a portfolio and style that diverges significantly from a benchmark index, we are comfortable being part of a minority group in this respect, despite it feeling both lonely and painful at times. We continue to believe that valuation does matter but we must be careful to avoid the 'value traps' which are all around us.

We hope that there is significant potential value to be unlocked from many of our portfolio holdings and the current very high portfolio yield gives us cause for optimism in that respect, as do the recent signs of increased takeover activity in the UK market. With weak sterling and low valuations for domestic assets we are likely to see many more Greene Kings.

We have over 60% of the Fund in mid and smallcap companies and 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. We cannot predict when this will change, therefore our key objective in the short term is to keep our heads above water and deliver reasonable returns whilst awaiting better conditions for our style of investing.

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. Whilst the risks of a difficult Brexit outcome or a global recession are clear and present we see significant margins for error in many of our current investments and those who await clarity tomorrow may well miss out on some meaningful investment opportunities today.

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, David Clark
8th October 2019