TB Saracen Global Income and Growth Fund

Quarterly Review – March 2020

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

David Keir
Chief Executive Officer

Graham Campbell
Executive Director

	TB SGIG	Sector Avarge	Quartile
Q1 2020	-24.7%	-17.9%	4

Source: Saracen Fund Managers as of 31 March 2020

Volatility Brings Opportunity

Firstly, may we take the opportunity to wish our readers and their families good Health!

Introduction

Those of us who have been through the Global Financial Crises of 2007-8 thought that we would not see a more severe economic downturn in our lifetimes: how wrong we were!

When volatility increases, we tend to be more active and the quarter under review is no exception. There are many high-quality companies that currently have a sizeable difference between today's share price and their longer-term prospects. We have no confidence that market timing is a plausible strategy. However, we find current levels very attractive and have used the opportunity to top-up some existing holdings and added some new positions. We remain fully invested.

Given the market backdrop, we have dispensed with the usual format of the quarterly review to focus on a few key topics. Namely: -

- The role of Valuation in an uncertain environment
- Performance and the poor showing from Value in every scenario so far encountered!
- Portfolio changes
- Portfolio weightings
- Balance Sheet profile
- Dividend outlook
- What's changed and how the recovery phase might evolve
- Outlook

We do not anticipate a sustained rally until there is more confidence in the 2nd derivative, i.e. the rate of change, as then there will be more visibility in the final shape and extent of the virus. Nevertheless, we view many share-price setbacks as an opportunity to invest in some high-quality businesses, trading at bargain prices!

Ever since Mario Draghi in his closing ECB speech questioned the limits of monetary policy last September, we have speculated on when governments will start to adopt a more aggressive fiscal stance. The recovery will not be driven by a another 0.25% cut in base rates, but by co-ordinated spending to restart the economy and stimulate global economic growth. This is usually a positive scenario for 'Value' investors!

The Role of Valuation in an Uncertain Environment

We have frequently stated that our philosophy is that share prices should reflect the long-term cash generation of a company. Through our research we aim to calculate the value of a business, then hope to purchase shares that stand at a significant discount to this 'fair value'. We are looking at businesses that have a robust long-term franchise, can earn a high return on capital, maintain a solid balance sheet and are cash generative.

The impact of the coronavirus and the enforced shutdown of many businesses will decimate 2020 estimates. Furthermore, there is no obvious comparison to realistically compare against a similar scenario, to estimate the depth or duration of the impact.

Our approach has been to initially gauge the robustness of the company. Can it still trade and how strong is the Balance Sheet? We then aim to assess how the business fundamentals have changed and how it is likely to perform thereafter. In brief, we are asking it if will survive without impairing the long-term cash earnings potential. Our "central case" assumptions for all holdings now look similar to how the business performed in 2008/2009 (the Great Financial Crisis).

Performance and the poor showing of Value

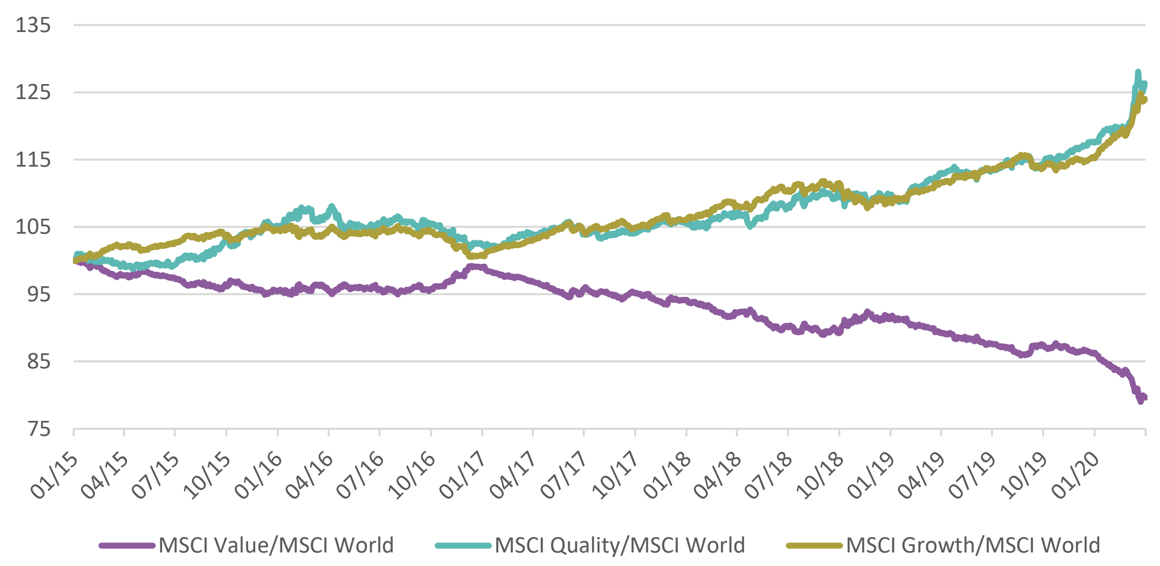
We firstly must acknowledge that fund performance has been poor since the beginning of 2018 and Q1 2020 continued the recent trend. We are sure that this is testing our investors' patience as much as our own!!

Global equities suffered one of the sharpest drawdowns in history during the quarter as most developed nations went into lockdown to prevent the continued spread of the coronavirus. The situation was exacerbated by a spat between Saudi Arabia and Russia which saw the oil price fall to an 18-year low.

The extreme 'risk off' environment was a headwind to Fund performance. Expensive defensives performed strongly and cheap cyclicals, banks and commodity sectors, fell materially.

Whilst we will be the first to admit that we have made mistakes, the market backdrop has been incredibly unhelpful for our "pragmatic value" style of investing. Our strict valuation framework has struggled against the sustained outperformance of, in our view, fully valued quality and growth stocks. The chart below highlights these trends.

Global Value / Quality / Growth relative to the market



Source: Bloomberg

We have written extensively on this subject before and don't plan on revisiting our thesis here – as our views have not changed.

While we have some sympathy that investors will value defensive and growth attributes when economic growth is declining, the divergence is nevertheless extraordinary. What we have found surprising is that "Value" stocks have continued to underperform during the market collapse, despite having materially underperformed in recent years. There would appear to be no market conditions where investors appreciate 'Value' characteristics!! We observe that the underperformance of value is significantly above TMT levels.

MSCI Europe Growth relative to MSCI Europe Value – price performance

Source: Credit Suisse

The old saying tells us that "it's always darkest before the dawn." The coronavirus has created massive uncertainty for both businesses, consumers and investors and the impact on the global economy will be significant. However, the impact of the virus should be finite and the massive and incredibly swift globally co-ordinated policy response should see growth rebound during the second half of 2020 (e.g. US $2.2 trillion fiscal stimulus package which was announced and signed into law within a matter of days).

Given the extremities in valuations across markets, a sharp recession may be the catalyst for a long-awaited change in market leadership. Bear markets end with recessions, they don't begin with them! We haven't changed our style or process and expect the fund to materially recover lost ground when this change occurs.

Portfolio Changes

Rarely do markets become so dislocated as they have in the past month, but such are the conditions from which great investment opportunities are born.

We view these times as an occasion to upgrade the quality and risk profile of the portfolio by investing in companies that were previously too expensive or where the yield was too low. We have watched many of these businesses for years, waiting for the share prices to provide an attractive investment.

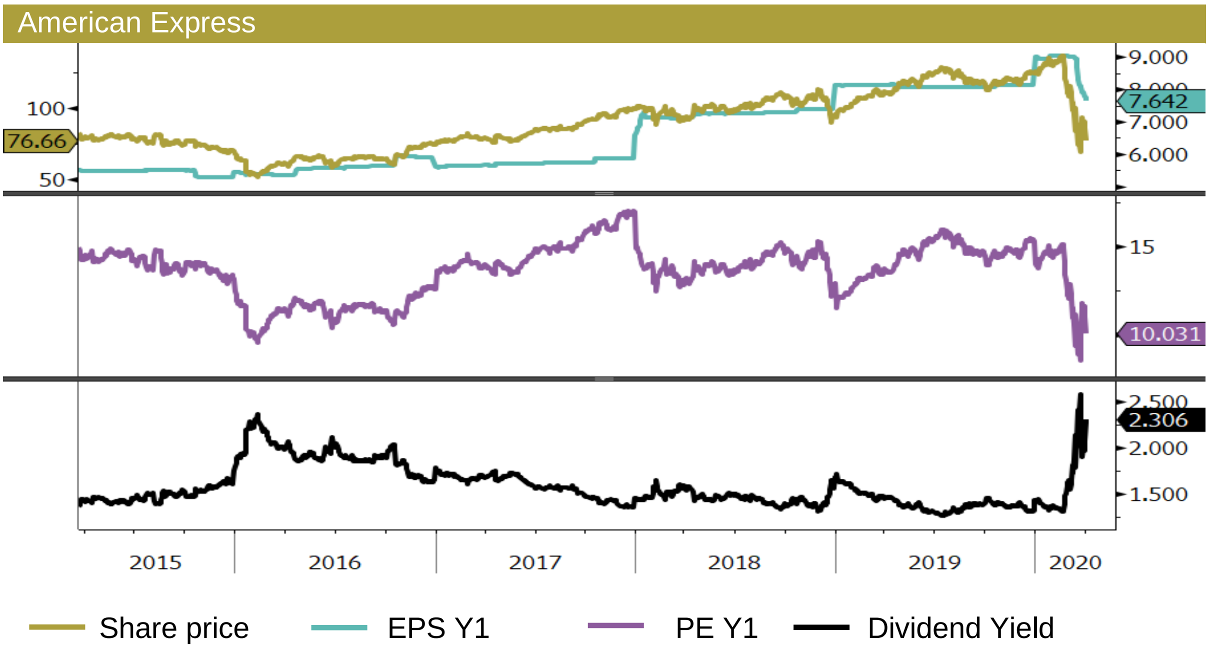
There are many months where we do not add any new positions. March was not one of these months. We added **American Express**, **Danone**, **Fuchs Petrolub**, **Prudential** and **Rockwell**. Their share prices had fallen by between 30% and 55% in just 4 weeks! We also topped up core positions that had been badly impacted by the market weakness such as **AIB, Barclays, Axa, BP, Cisco, Du Pont De Nemours, eBay, Intel** and **Rio Tinto**. We have high conviction on their longer-term prospects.

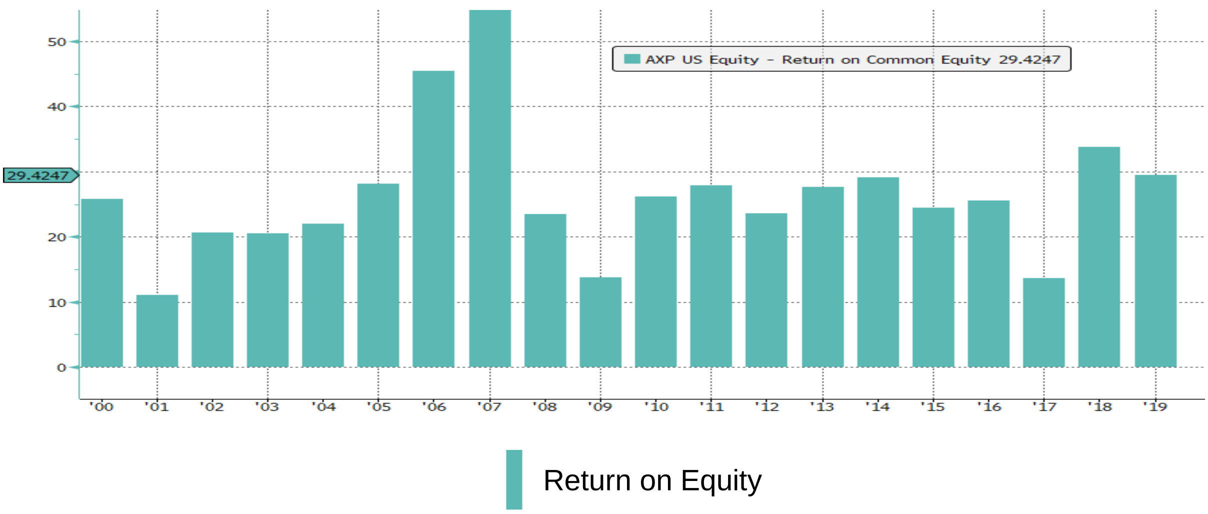
We funded the purchases by selling ABB, Asahi Group, AstraZeneca, Dow Inc, HSBC, Pandora and ProSieben. We also switched our Carnival Corp into **Sabre**, which as a software company selling into the travel industry is less operationally and financially geared and will benefit instantaneously when demand returns.

We have summarized the reasoning for these actions below. For those wishing for additional detail, we would be delighted to receive your enquiry.

American Express is a high-quality business that benefits from both business and consumer spending, domestically and on travel. Returns are high and the dividend has grown by 10% p.a. for at least the past 7 years. The share rating and price has collapsed due to concerns over travel and business spending as a result of the coronavirus. There is considerable surplus capital and the pay-out ratio remains at only 20%. 2020 is expected to be tough, but it is likely that the shares will rebound to business as usual. Accordingly, we viewed the recent 50% share price hit as a Buying opportunity.

We funded the purchase by selling our holding in **HSBC** where we have concerns over the scale of the internal reorganisation that is occurring at this time, the potential for sharply rising bad debts in HK and a capital position that does not give us adequate comfort.



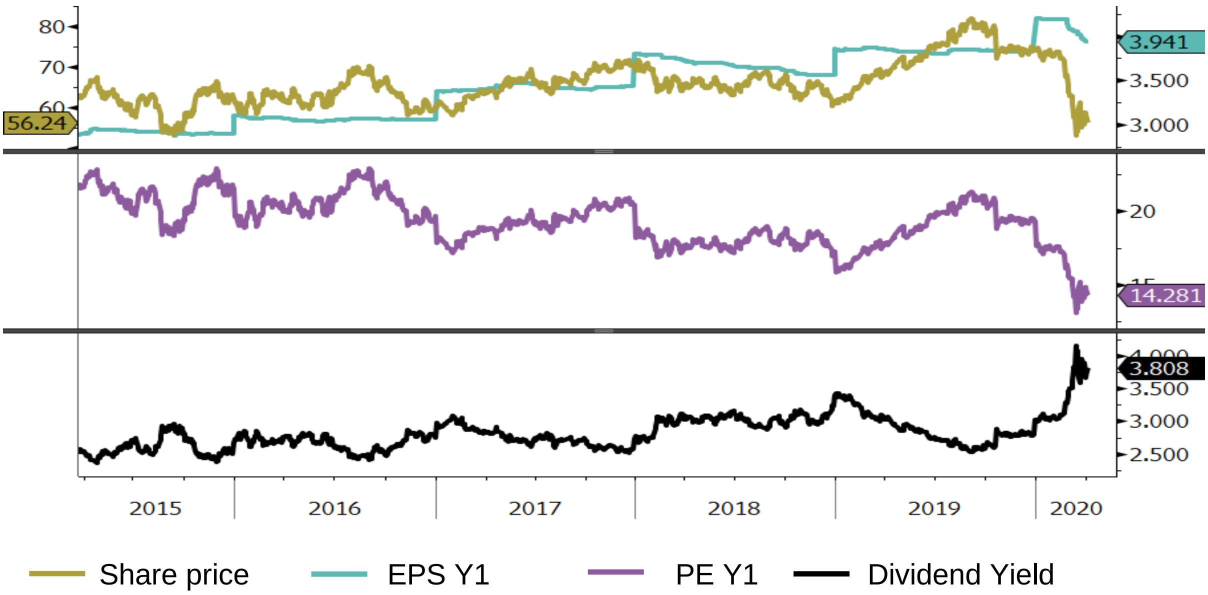


Source: Bloomberg

We have watched **Danone** transition itself over the last few years into interesting growth areas such as plant-based products, a long-term trend in its infancy. In addition, the traditional dairy business appears to have stabilised. The company is highly ranked on ESG matters and is a frontrunner in the fight to reduce plastic waste. Danone was one of the few consumer staples companies whose share price didn't hold up relatively well during the quarter as the shares fell from over €80 towards €50. With the shares trading on 14X year 1 PER and yielding 3.8%, we bought a position for the fund.

The purchase was funded by selling our positions in both **Asahi Group** and **AstraZeneca.** Asahi Group recently announced the acquisition of the Australian beer assets of ABI. Given the market backdrop, the deal looks incredibly poorly timed given market valuations and investor focus on leverage. AstraZeneca shares have performed incredibly well since we bought them 5 years ago and now look more expensive on an absolute and relative basis.

Danone

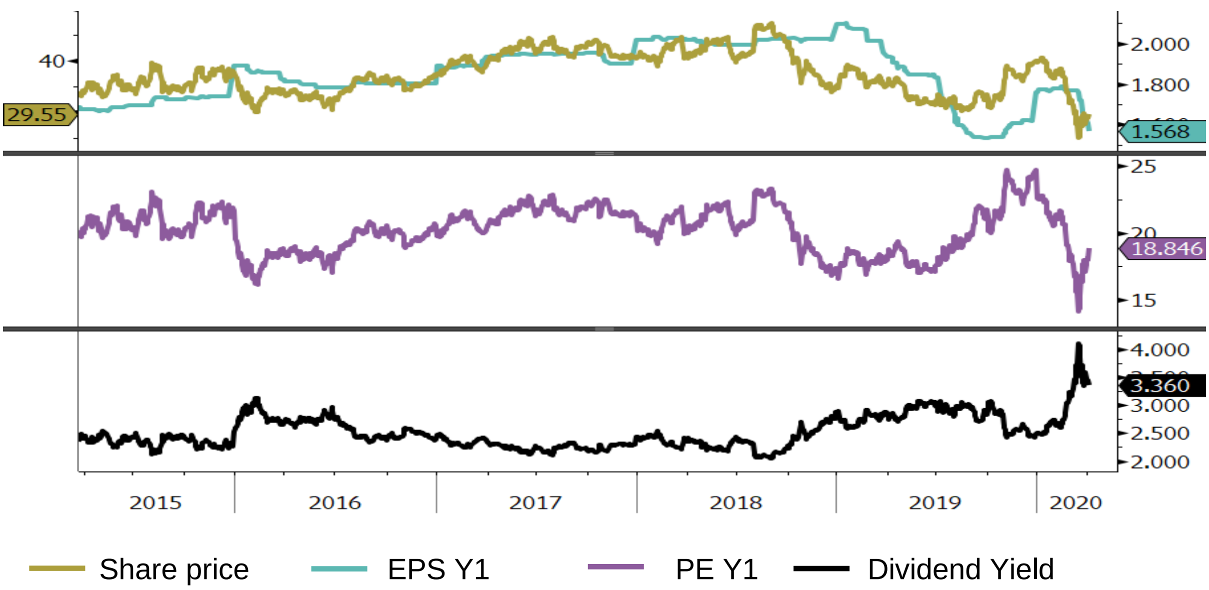


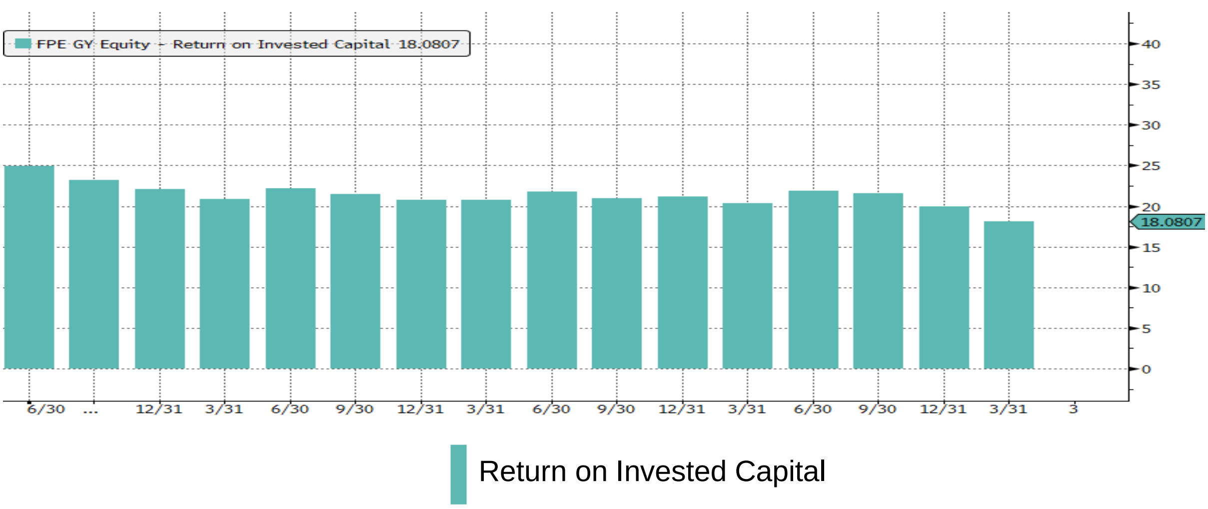
Source: Bloomberg

Fuchs Petrolub has many of the attributes that we look for in a business: management focus on LT shareholder value, high and sustainable margins, strong Balance Sheet, CFROI > WACC. Management reinvests in the business or makes small bolt-on acquisitions to add to their product range or accelerate global distribution. It is a Family owned business (55% - Voting Shares) specializing in lubricants. While it is the No.1 independent supplier of lubricants, Fuchs comes in 9th overall. However, the lubricant businesses are small and almost insignificant within the oil majors, allowing the focus and service of Fuchs to grow market share by quality and service and into speciality areas. As machining tolerances increase, so does the requirement for specialised lubricants. The Balance Sheet is conservative, and the dividend is solid. Accounts are refreshingly transparent. The share price has sold off due to concerns of global recession and the exposure to automotive and this provided an attractive entry point for a high-quality business.

We funded the purchase by selling our holding in **Dow Inc** which de-merged out of DowDuPont in 2019 and is much more cyclical and lower quality than Fuchs.

Fuchs Petrolub

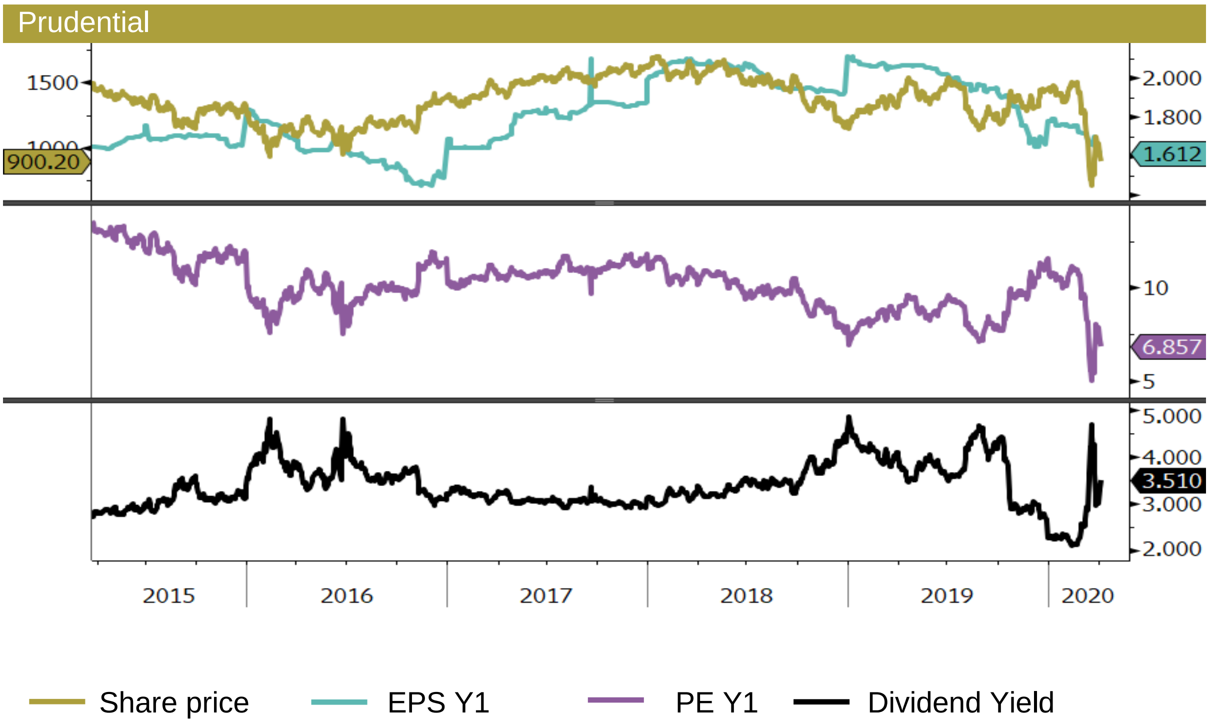


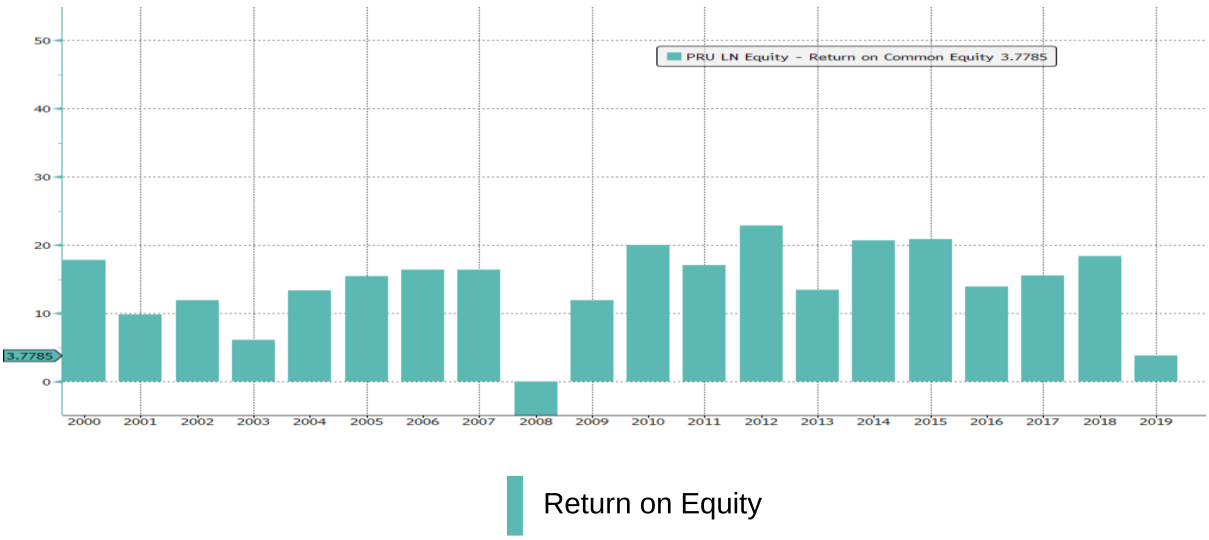


Source: Bloomberg

Prudential - We have always been attracted by the Asian growth story but had been put off by the ex-growth UK pensions business and opaque variable annuity business in the US. However, the UK business was de-merged in Q4 2019 and the share price fell from £15 to £7 in March which implied the market was ascribing a negative value to the US business. With the shares trading on 5X Year 1 PER and yielding 4%, we took advantage of the share price weakness to buy a position for the fund. We note that an activist investor has built a 5% stake and is pushing the management team to reduce central costs and sell/de-merge the US business which will leave a very attractive Asian franchise which we want to own for the long-term.

We funded our purchase by selling our holdings in **Pandora** and **ProSieben**, which appear destined to remain lowly valued.



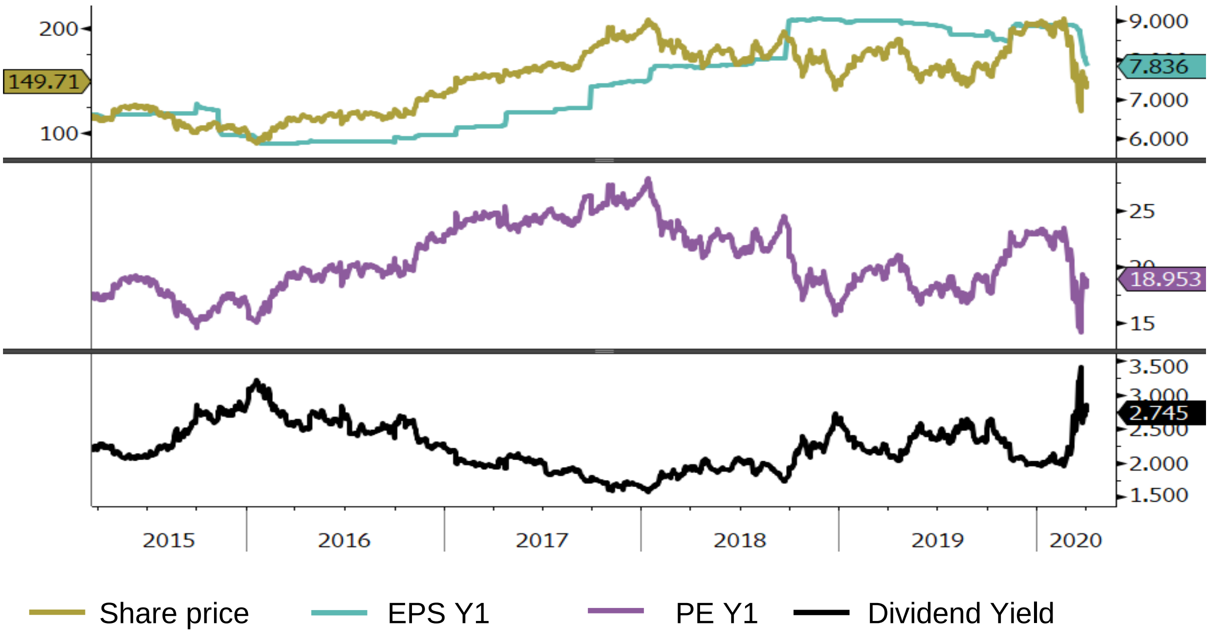


Source: Bloomberg

Rockwell is a leader in industrial automation and is at the forefront of automation, digital manufacturing and monitoring: technology driven productivity. It is a high-quality company with many of the characteristics we look for: global leader, strong margins, high ROCE, and strong Balance Sheet. It has increased the dividend for the past 31 years. The company is at the forefront of the big data manufacturing and maintenance revolution. Rockwell will continue to benefit from the trend towards efficiency and automation and the desire to reduce waste and emissions. While this has a hardware component, Rockwell is at the forefront of the integration of software to generate and manage the data. We used the significant share price weakness to initiate a position.

We sold **ABB** to fund the purchase. ABB's shares had rallied hard over the last 6 months on expectations that the new CEO can improve the group's margin profile and no longer looked good value, with a more sever worst case emerging.

Rockwell



Source: Bloomberg

SGIG Portfolio weightings

Whilst our value stance has been painful, we believe that it continues to have long-term merit and has rarely appeared so attractive.

It is clear we have reached the end of the limits of monetary policy. Expensive defensives are aptly named and while they might hold up relatively well in the short term, they will not benefit from a recovery. There will be a massive fiscal stimulus and more cyclical / value orientated business should be at the forefront of this.

We expect this portfolio will do very well under this scenario.

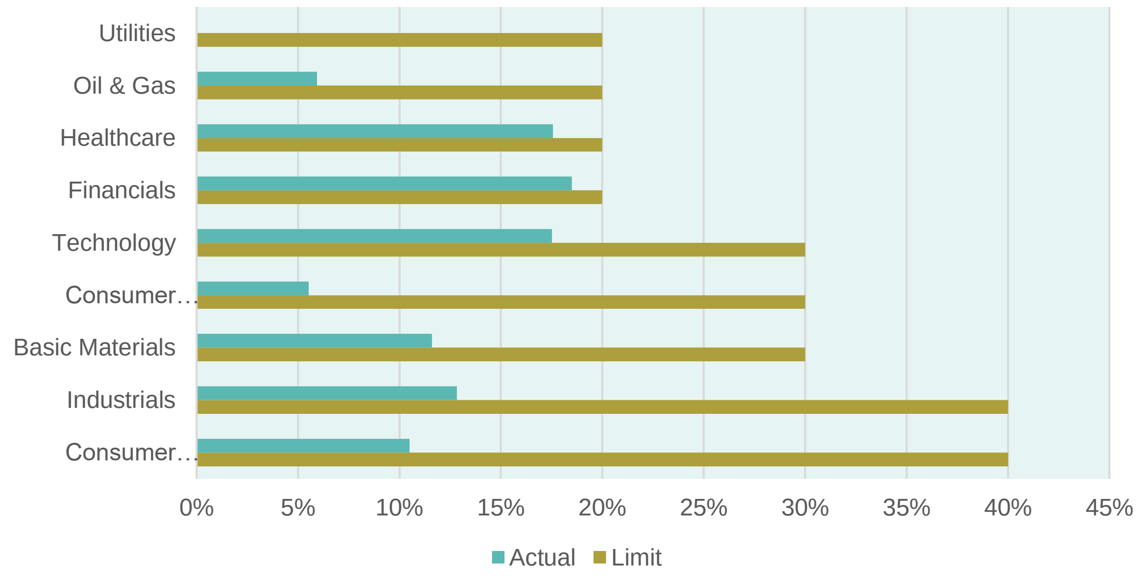
We, therefore, retain large weightings in companies that are classified in the following sectors:

- **Industrials**
- **Basic Materials**
- **Financials**
- **Healthcare**

And we continue to find limited value in bond proxies like:

- **Consumer Staples** (expensive for expected growth)
- **Utilities** (limited growth and too much debt)
- **Telecoms** (limited growth and too much debt)

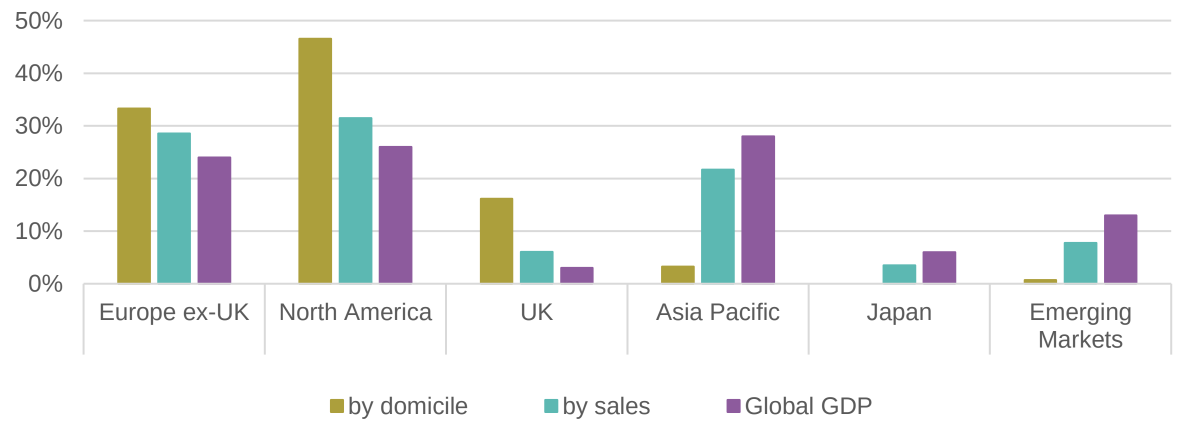
TB SGIG sector split



Source: Saracen Fund Managers as at 31/03/20

The fund's sales exposure is closely aligned with global GDP distribution:

TB SGIG geographical split



Source: Saracen Fund Managers as at 31/03/20

SGIG Balance Sheet Profile

A key lesson from the Great Financial crisis was to avoid leverage. We suspect that it will be equally important during the coronavirus crisis too.

We are massively focussed on avoiding leverage where possible and have stress tested the Balance Sheets of all the companies that we are invested in. We provide a breakdown of the debt levels within SGIG in the table below. It highlights that 70% of the portfolio (ex-Financials) has net debt to EBITDA of less than 2X.

Approximately 10% of the portfolio has net debt to EBITDA greater than 2X which we are keeping a close watch on. However, it is actually more defensive holdings such as Bristol Myers Squibb, Danone and Imperial Brands that make up most of this category.

We currently have approximately 20% in Financials – where net Debt to EBITDA is not relevant. We can, however, assure readers that we only own financials that have surplus capital on their Balance Sheets.

TB SGIG financial leverage exposure

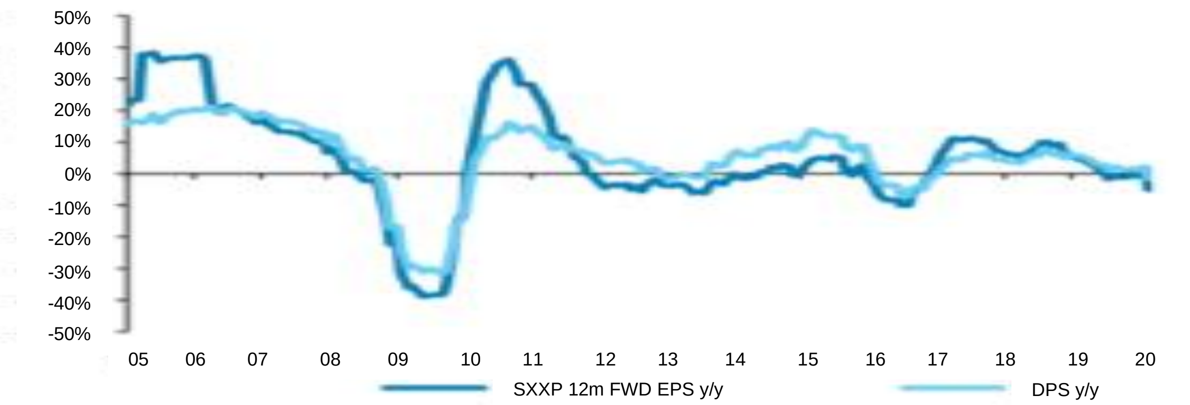
Financial Leverage	Exposure within TB SGIG
Net cash on Balance Sheet	7%
Net Debt to EBITDA 0-1X	29%
Net Debt to EBITDA 1-2X	34%
Net Debt to EBITDA >2x	10%
Total exposure in Financials	20%

Dividend outlook

We pride ourselves on having grown the dividend every year since the fund was launched in June 2011. As a reminder, we target mid-single digit dividend growth over the long-term. Given the impact of the coronavirus on trading and from the reaction of some regulatory authorities, our dividend will fall in 2020. The big question is by how much?

We expect the economic fallout from the coronavirus to be as severe as the '08-09 recession, but shorter, and look for significant earnings declines this year, before rebounding next. The hit to dividends could equally be significant as companies preserve capital/cash flow, come under pressure from regulators to stop payments (sector specific like Banks and certain countries like Germany and France) and prioritise social responsibility over pay-out.

Dividends follow earnings – big fall ahead



Source: Refinitiv

However, we would expect any decline in income to be temporary given the unprecedented degree of fiscal and monetary stimulus, which should create a strong rebound when the lockdowns are removed. Indeed, we view the overwhelming majority of the dividend cuts as temporary and expect payments to normalise in 2021.

The issue is made slightly more complex given that European companies tend to make one dividend distribution per annum which unfortunately tends to be paid in April/May. We are seeing many European companies delaying their AGM's until the summer in the hope that they can still pay a dividend in H2 2020. American businesses pay dividends quarterly which gives the companies a lot more flexibility.

We provide a detailed breakdown of our dividend expectations in the table below (there is also an attachment if you prefer to see the impact of your own assumptions). The table highlights the current Bloomberg consensus dividend yield on the portfolio is 5.7% - which we believe is unrepresentative as not all estimates have not been adjusted yet. We therefore highlight our central case and worst-case scenarios for the 2020 dividend yield.

Our central case scenario is based on our defensive core of stocks which represent 30% of the portfolio – namely our holdings in Pharmaceuticals, Tobacco and

Consumer Staples - and all our technology stocks (ex-Sabre) to pay their dividends in full. We forecast a 15% decline in dividend in 2020 for TB SGIG, which means that the fund yields a still very attractive 4.9%.

We also provide a worst-case scenario – which we hope is too conservative – which results in a 33% cut in dividend year on year. Even under this scenario, the fund still yields nearly 4%.

TB SGIG dividend cuts

Name	Conensus Div Yld	Base Case Div Cut	Base Case Div Yld	Worst Case Div Cut	Worst Case Div Yld
BP	9.35%	-30%	7.98%	-50%	5.70%
Chevron	7.13%	0%	6.94%	-20%	5.55%
Schlumberger	14.69%	-50%	7.94%	-100%	0.00%
	0.00%				
DuPont	3.79%	-45%	3.65%	-45%	3.65%
Evonik	6.02%	0%	5.99%	-20%	4.79%
Fuchs Petrolub	3.41%	0%	3.30%	0%	3.30%
Johnson Matthey	4.47%	-30%	3.50%	-50%	2.50%
RioTinto	7.16%	0%	10.39%	-20%	8.31%
	0.00%				
Heidelberg	5.97%	0%	5.55%	-20%	4.44%
Michelin	4.82%	-48%	2.50%	-48%	2.50%
Rockwell	2.86%	0%	2.70%	-10%	2.43%
Saint Gobain	6.41%	-30%	4.23%	-50%	3.02%
Schneider	3.53%	-30%	2.22%	-50%	1.58%
Valeo	7.76%	-50%	4.32%	-100%	0.00%
	0.00%				
Danone	3.76%	0%	3.68%	-10%	3.31%
PMI	6.70%	0%	6.50%	0%	6.50%
Imperial Brands	13.28%	0%	13.20%	-15%	11.22%
	0.00%				
Bristol Myers Squibb	3.28%	0%	3.06%	0%	3.06%
JNJ	3.11%	0%	2.91%	0%	2.91%
Merck Co	3.25%	0%	3.06%	0%	3.06%
Novo Nordisk	2.26%	0%	2.07%	0%	2.07%
Pfizer	4.68%	0%	4.60%	0%	4.60%
Roche	2.93%	0%	2.83%	0%	2.83%
	0.00%				
Hugo Boss	10.49%	-50%	6.11%	-100%	0.00%
Interpublic	6.85%	-25%	4.85%	-50%	3.23%
Samsonite	5.94%	0%	0.00%	0%	0.00%
	0.00%				
AIB	12.45%	-50%	4.12%	-75%	2.06%
American Express	2.27%	0%	2.11%	-10%	1.90%
AXA	10.14%	-50%	4.83%	-75%	2.41%
Barclays	8.52%	-50%	5.32%	-75%	2.66%
DBS	6.82%	0%	6.68%	-25%	5.01%
Handelsbanken	6.57%	-25%	5.13%	-50%	3.42%
Prudential	3.22%	0%	6.13%	-20%	4.90%
UBS	7.98%	-25%	6.13%	-50%	4.09%
	0.00%				
Cisco	3.69%	0%	3.55%	0%	3.55%
eBAY Inc	2.20%	0%	1.95%	0%	1.95%
Intel	2.53%	0%	2.43%	0%	2.43%
I.B.M.	6.40%	0%	6.12%	0%	6.12%
Sabre	2.92%	-75%	2.82%	-75%	2.82%
SGIG Portfolio Yield	**5.76**		**4.92**		**3.86**
Difference to consensus			**-14.6%**		**-32.9%**

What’s changed and how the recovery phase might evolve

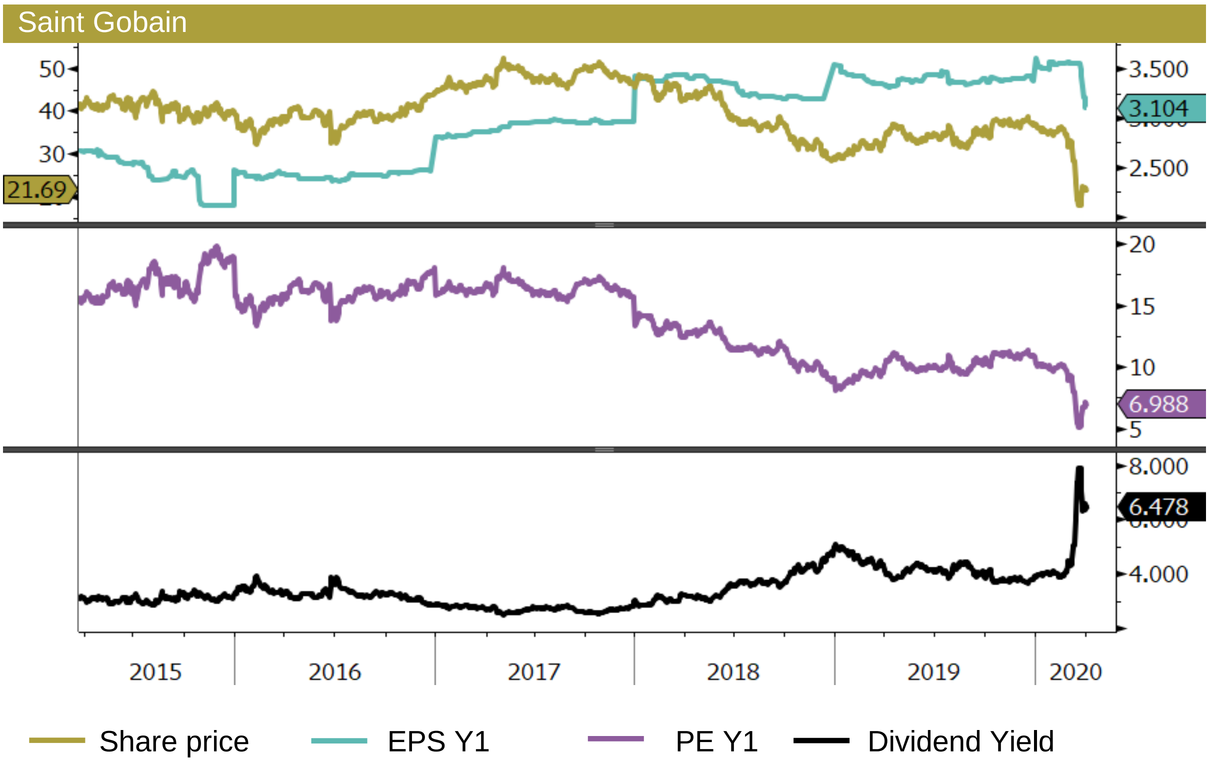
We expect the fall in earnings to be of similar magnitude to ‘08-09. Current consensus estimates of +2% EPS growth in 2020 implies the bulk of earnings cuts still lie ahead. Caution remains warranted, but early signs of a slowing outbreak along with an aggressive policy response suggest we may have passed peak panic. A key difference with the Great Financial Crisis is the most banks are sufficiently capitalised, so funds can flow, and businesses and workers can be supported.

As our base case looks for a quick macro recovery in the second half of 2020, the earnings recession should be brief.

Given the limits of monetary policy, governments are likely to adopt more traditional fiscal means to restart economic growth and reduce unemployment. This environment is typically favourable for more cyclical and value-based investors.

We highlight two stocks which are big positions in SGIG and appear like anomalies, namely Johnson Matthey and Saint Gobain. Neither has ever traded on lower multiples nor yielded more in recent history.

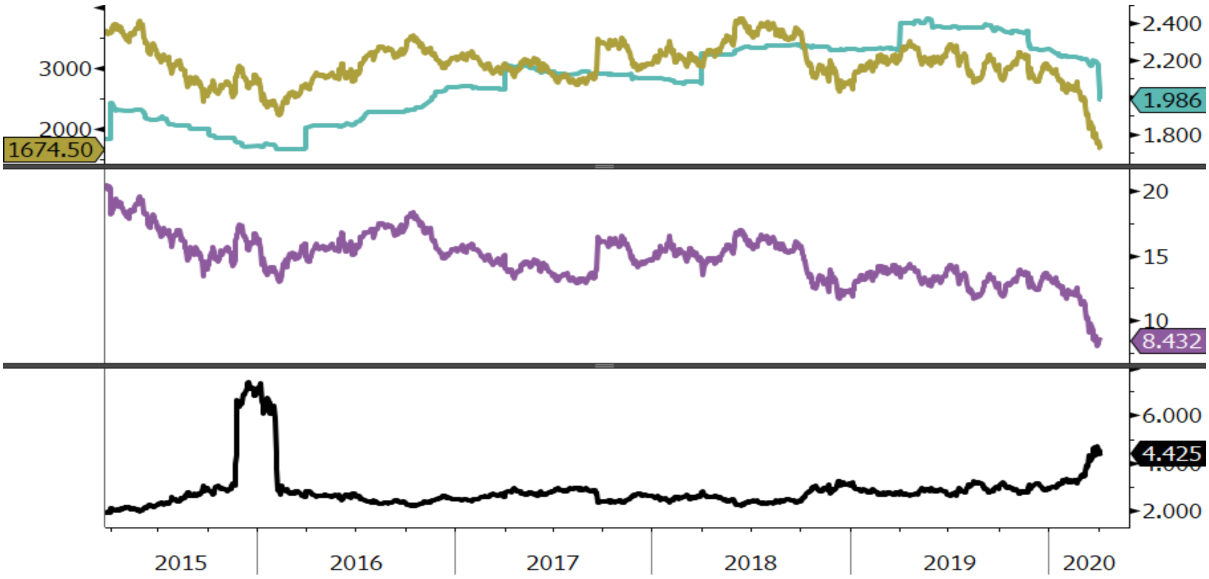
When looking at Saint Gobain, even if earnings fall 40% equivalent to the fall in 2009, the share would still be on 10X earnings and the dividend is still covered by cash. Historically, cyclical shares normally trade on a very high multiple of trough earnings.



Source: Bloomberg

Similarly, Johnson Matthey is a global leading business that generates high returns on capital. Short-term it has been impacted by slower auto sales in the Clean Air division and from working capital pressure from higher platinum and rare metal prices. These costs will work through. This is a specialist chemical business that builds close likes with customers and we believe the prospects are not reflected in the share price.

Johnson Matthey



Outlook

It is clear that a Value bias has not been favourable in recent years. Value has so far significantly underperformed in all market conditions since 2009.

We expect coronavirus to cause a sharp recession.

However, the unprecedent scale and speed of fiscal policy should ensure a swift rebound in economic activity when the lockdown ends.

We expect this to result in a change in market leadership towards Value stocks! Bear markets end with recessions, they don't begin with them!

We have taken advantage of the market downturn to significantly upgrade the portfolio and buy high quality businesses that we have always wanted to own where previously the valuation wasn't attractive enough nor the yield high enough. We consider the portfolio to be well-positioned for the long-term and do not expect to make more significant changes.

The fund looks cheap on all metrics and currently yields 4.9% based on our central case assumptions. As a reminder, the fund remains very liquid with the average market capitalisation of companies currently £55bn.

We are committed to our process: valuations do matter over the longer-term. We expect the fund to materially outperform and recover lost ground when we enter the economic recovery phase.

Thank you for your continued support during these challenging times. We hope you and your families stay safe!

We will keep readers up to date with our thoughts and actions over the coming weeks and months.

Graham Campbell
David Keir

31 March 2020

For further information on TB Saracen Global Income and Growth Fund please contact:

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