TB Saracen UK Alpha Fund

Quarterly Review – March 2020

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

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	TB SUAF	MSCI UK All Cap (TR)	Relative
Q1 2020	-38.3%	-25.3%	-13.0%

Performance Summary

The Fund has had a very disappointing quarter. After a holding up well in January the portfolio has been very badly hit since late February when the impact of the COVID-19 virus began to bite and the global lockdowns came into place. The macroeconomic background was turbulent with the oil price falling to an 18-year low and emergency measures and interest rate cuts being hastily introduced on a worldwide scale. March was particularly brutal for small and mid-cap investors and the Fund was impacted significantly during this period as a result of our being very overweight in this part of the market.

Cumulative Performance after all ongoing charges to 31st March 2020

	3 months	1 year	3 years	5 years
TB Saracen UK Alpha B Acc	-38.3%	-26.6%	-16.1%	-0.9%
MSCI UK All Cap Index (TR)	-25.3%	-19.4%	-13.3%	1.5%
Sector Average	-27.9%	-19.2%	-14.7%	-1.76%
Quartile Ranking	4	4	3	2

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

Market Overview

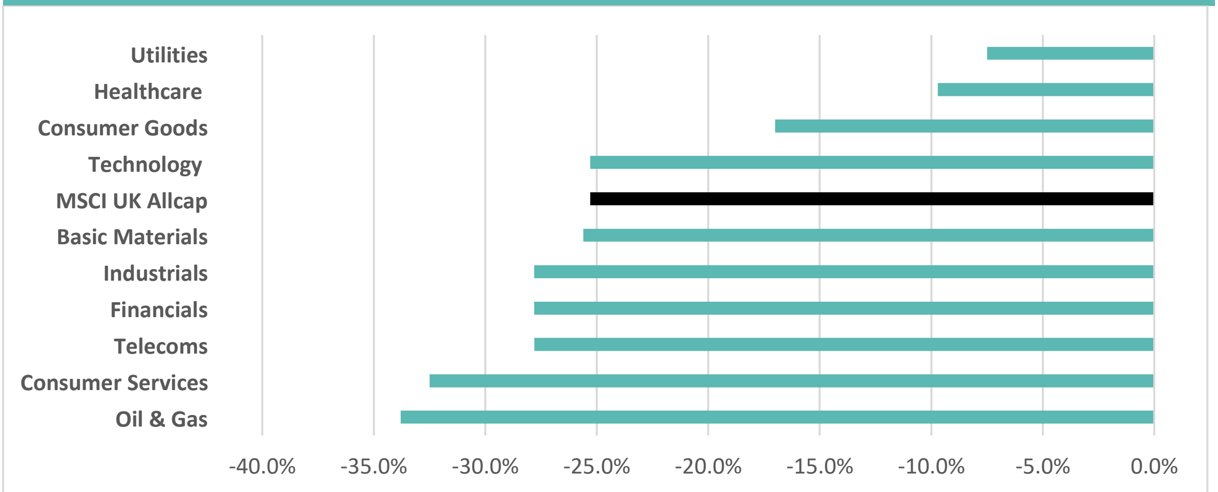
After the relief felt in the UK market post the passing of the Brexit bill the UK market felt relatively stable but, as the Covid-19 crisis unfolded in late February, market sentiment, policy actions and economic developments shifted dramatically. The Bank of England cut interest rates twice and pumped liquidity into the system to avert an economic collapse. Despite this, markets continued to fall sharply in March as the news worsened and governments began to take ever more drastic action, culminating in the current lockdown period that we are now experiencing. The most recent weeks have been characterised by a plethora of companies withdrawing their profit guidance for 2020 and 2021, passing on their dividends, scrapping capex plans, cutting pay for senior executives, furloughing staff and attempting to conserve cash at every turn.

With its higher weighting towards more defensive sectors the FTSE100 held up a little better than the mid and smallcap indices but in reality, it was a period where returns were heavily negative across the board.

Total returns by capitalisation: 3 months to 31st March 2020	
FTSE100	-23.8%
FTSE Mid250	-30.7%
FTSE Smallcap	-27.9%

At a sector level, defensive sectors such as utilities, healthcare, staples and food retail performed relatively well during this market crash, with limited disruption seen in these areas from the global lockdown. At the other end of the spectrum the oil sector continued its miserable form into 2020 with the oil price hitting an 18-year low in March and capex plans being slashed again. In broad terms industrial companies were impacted by the impending collapse in economic growth whilst financials were driven by collapsing asset markets, falling interest rates and the prospect of significant defaults during the current crisis. However, returns were negative across all broad sector groups.

UK Sector Total Returns: 3 months to 31st March 2020



Source: Bloomberg

In our typical quarterly report, we would make comment on a range of factors such as GDP growth rates, bond yields, currencies and relationships between markets and asset classes.

The current crisis means that many of these relationships and correlations have broken down.

We now have:

- Short rates effectively at zero everywhere
- Government bond yields at all-time lows (and in many cases negative)
- Emergency packages amounting to $ trillions across all major economies – "whatever it takes"
- US new unemployment claims at 6.6 million last week versus a more typical 200,000

Most forecasts at the moment are, more so than usual, guesswork. To provide some degree of context the latest Citigroup global GDP forecasts suggest that developed market GDP will fall by almost 7% in the current quarter with further falls in the second half leading to a forecast of -3.6% for 2020 as a whole. The equivalent global forecast is now -1.6% with China and India still expected to show small positives. From a UK perspective recent analysis from the CEBR estimated that UK economic activity is running at 69% of normal levels and Jeffries have just forecast a 25% fall in UK Q2 GDP, with almost 1m new people applying for Universal Credit. Unemployment is likely to double from its previous lows in the UK and could treble in the US, where government support is less forthcoming.

Taking all of these factors into account it is clear now that global recession is inevitable - the big economic question with regard to the current lockdown is therefore 'how long and how deep' and can we avoid a depression? We can only make a broad assumption that things will get far worse before they get better but are working on the hope that things 'normalise' to a degree in the second half of 2020 as restrictions begin to ease.

Portfolio Review

The portfolio has a 'multi cap' structure with high exposure to small and mid-cap companies, which make up over 70% of the portfolio. The focussed nature of the portfolio means that the Fund has a high active share at 93%. This strategic positioning has been beneficial to our results over the years as well as offering considerable long-term flexibility. However, such a positioning has clearly been detrimental in the period under review.

Positive Contributors

There were precious few positive contributions to the fund during the quarter, with only two holdings recording positive absolute returns. These were **Galliford Try**, where the 'rump' business responded well to the sale of housebuilding to Vistry and **Avon Rubber**, where the shares continued to re-rate after last year's acquisition from 3M.

All other holdings fell in value. However, some did demonstrate some relative resilience including **Rio Tinto** and **Imperial Brands**, where the high dividends are deemed to be safer than many, if not completely sacrosanct. High quality smaller companies such as **DiscoverIE** and **Mattioli Woods** also demonstrated some resilience to the broader trends.

Negative Contributors

Unfortunately, we had numerous holdings fall by more than 30% during the period. We can crudely categorise them as follows:

Real Estate –Palace Capital, U&I. As rent deferrals take hold dividends have been passed and liquidity is the key focus. NAV discounts are huge but asset values uncertain.

Cyclical businesses –Wood Group (oil & engineering services), Tyman (construction), TI Fluid Systems (auto components), Melrose (engineering)

UK Consumer/retail – Vistry & MJ Gleeson (housebuilding), Halfords (transport retail & services), Superdry (clothing - now sold)

Financials – Barclays, Intermediate Capital, Premier Miton, Standard Life Aberdeen. Key issues include solvency/liquidity, exposure to falling asset markets and bad debts

In addition, we saw large declines in several good quality smaller companies which we believe will overcome current issues and prosper again. These include Alpha FMC, Restore and Marlowe. The latter two in particular should have decent revenue visibility at present.

Given such a wide array of price declines it would be foolish of us to assume that all of the above businesses will be untarnished during the current crisis and indeed many face severe short term pressures. However, we firmly believe that the vast majority will survive and prosper when and if conditions improve.

Portfolio Activity

The fund has 30 investments which are spread across a variety of market capitalisations. As at 31st March 2020, the breakdown of the portfolio by size was 29% in large cap, 17% in midcap and 51% in small cap/other. The portfolio held 3% in cash at the period end.

Purchases

There were two new investments made during the quarter and, whilst returns in both so far have been negatively affected by the recent falls in markets, we believe that both have considerable longer-term attractions.

A small position was taken in the IPO of an eyewear business called **Inspecs** where we see good opportunities for them to consolidate their market position in a downturn. We also invested in chemicals business **Johnson Matthey**, where uncertainty about long term structural changes in the automotive markets have left the shares very lowly rated and their considerable technological advantages undervalued.

During the quarter we increased exposure to several existing holdings as we grew more comfortable with the business models and the valuation opportunities offered. These included **Imperial Brands, Clinigen, Halfords, Premier Miton** and **Wood Group**. This was a mixed bag with anything bought prior to mid-March proving somewhat painful and additions in recent weeks looking rather more timely.

Sales

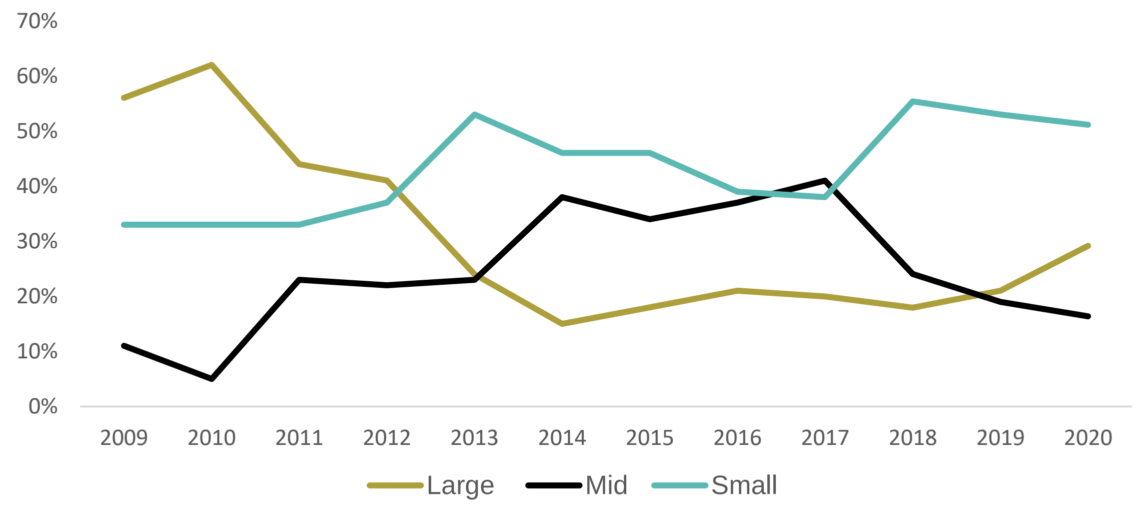
We made four outright sales during the period.

Our remaining holding in **Galliford Try** was sold after Vistry acquired its housing and partnerships businesses. This left us with a small position in an unappealing business that has struggled in recent years. **Superdry** was sold at a painful loss as we realised recovery prospects are now even more distant than they were.

Avon Rubber has been a very successful investment for the fund over a number of years and, following a re-rating of the shares, we concluded that the company no longer offered the same value as it had done and the stock was sold. Finally, we exited our position in **Vitec** prior to the February results as it became clear that the COVID19 pandemic would have a meaningful impact on a number of the group's operations.

Portfolio Strategy & Themes

TB Saracen UK Alpha Fund – Historic Asset Mix by size

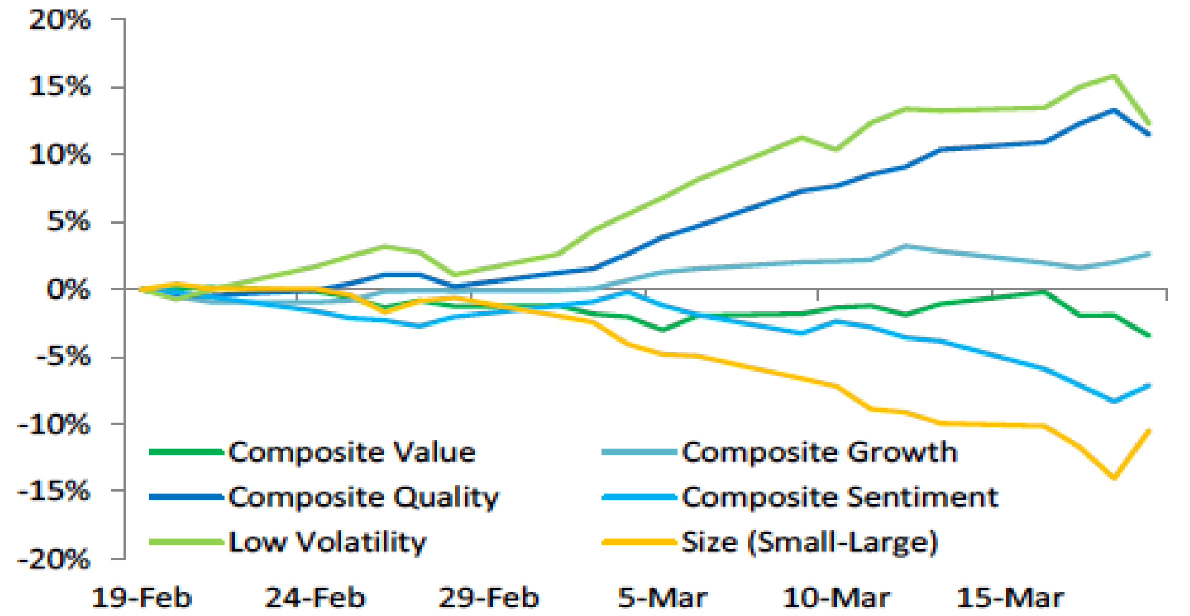


Source: Saracen Fund Managers

That the fund badly underperformed during the first quarter is undeniable. The main reason for this was that the majority of the fund (c70%) was held in small and medium sized companies.

As can be seen from the table below the smallcap segment of the market has fared particularly badly compared to the larger stocks. In addition, our increased exposure in recent years to value factors has been a major headwind when compared to the more growth orientated stocks in the market. The short-term factors are captured in the chart below.

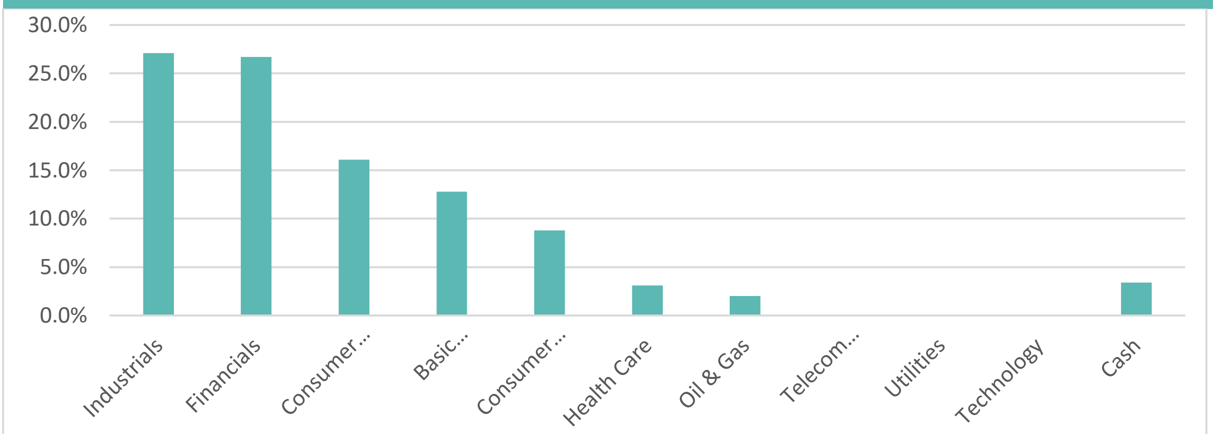
Factor Performance since February 19th 2020



Source: Morgan Stanley Research

As a result, the fund was very underweight in the traditionally defensive sectors of the market such as utilities, food retail and pharmaceuticals whilst having a heavy focus on industrial and financial companies. None of this was helpful.

TB Saracen UK Alpha: Sector Profile



Source: Saracen Fund Managers as at 31.3.20

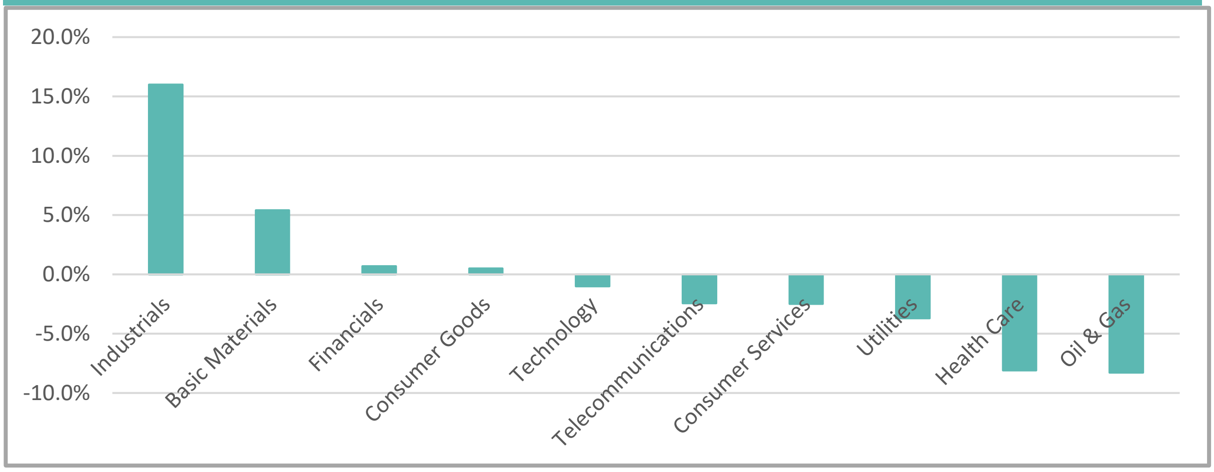
All in all, something of a perfect storm.

As we have alluded to many times before that we do not run the portfolio on the basis of sector allocation but rather, we are very much bottom up investors, investing in companies for their own merits and prospects for long term capital appreciation. The Fund has no need to prioritise dividends and has no formal income target.

You will also see from the chart below that we have very limited exposure to the normally defensive healthcare sector and rather more exposure to industrials and financials which tend to be fairly domestically orientated and, in the case of the industrial companies that we hold, either small or mid-cap stocks.

This inevitably means that we tend to be long sterling assets simply due to the nature and structure of the fund. The Alpha fund has a strategic commitment to medium and small companies and this, combined with our heavy domestic exposure, means that this fund differs very materially from the broader UK benchmark.

TB Saracen UK Alpha: Sector Active Weights



Source: Saracen Fund Managers as at 31.3.20

Over the past eighteen months we have increased our weighting in the Financials sector. Unfortunately, this was one of the weaker performing sectors in the UK market over the course of the quarter and all of our holdings were hit to a greater or lesser extent. It is important to emphasise that we still have great faith in these companies and once things return to normal, that they will resume their underlying progress.

Whilst our exposure to Industrial sectors is significant it is mainly in small and mid-cap companies with strong global market positions and positive long-term growth drivers. They are a wide and varied group of businesses with limited correlation to each other but were no more immune that most others to the spread of the coronavirus and fears of depression.

We do at least have only a modest exposure to the oil sector which has been hit hard. We are still not tempted however given the structural pressures most of the sector continues to face.

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 30 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 68% of the fund with large companies only 29%. 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 (42%* 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 (29%* 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, but we only 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 31st March 2020, 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

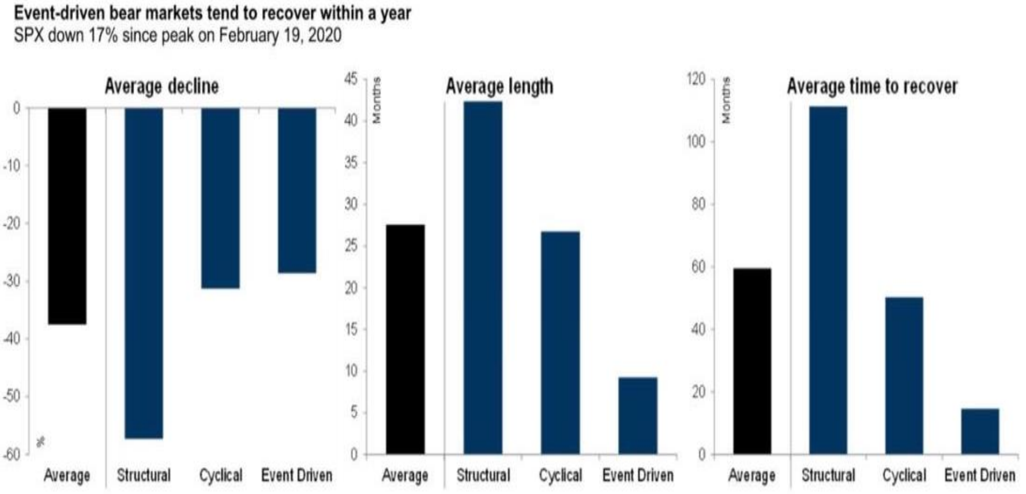
"There are decades where nothing happens; and there are weeks where decades happen." - Vladimir Lenin

What a difference a quarter makes. In January we were looking forward to a period of post Brexit calmness with the extent of the Conservative victory and the easing of tensions between the US and China. That all seems a very long time ago.

The corona virus crisis has evolved at a pace and extent that virtually none of us could have imagined six weeks ago. Our focus has changed from prosperity to survival and it is now almost certain that the pandemic will cause very deep recessions in many countries and ultimately a global recession during 2020.

Whilst coronavirus is very bad, it is unlikely to be the end of civilisation or capitalism as we know them but it will certainly bring profound changes to capital structures and business models in future. But to benefit from the recovery, you have to survive the downturn and as we write it is difficult to know what shape this will take. The following analysis of previous bear markets from Goldman Sachs attempts to provide some historical context. If we believe COVID19 is a manageable event then recovery can be swift, just as the recent crash was rapid.

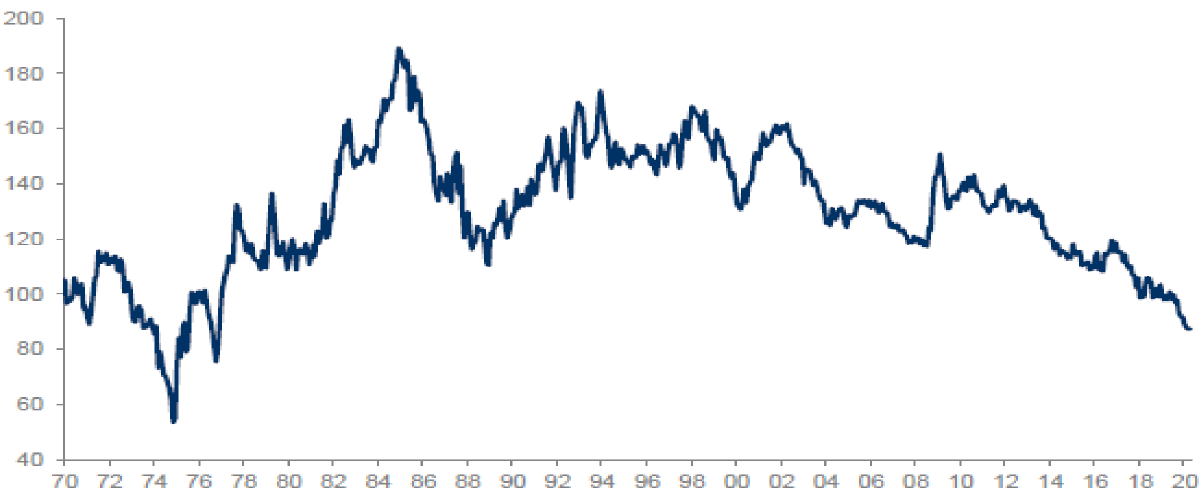
The type of bear market matters



Source: Goldman Sachs Global Investment Research

After a prolonged derating against their global peers over the past decade we had hoped that the improvement in UK equity performance at the end of 2019 had begun to address the significant under valuation of UK equities. However, the weight of the dividend cuts likely from some of our largest companies has postponed that prospect once again.

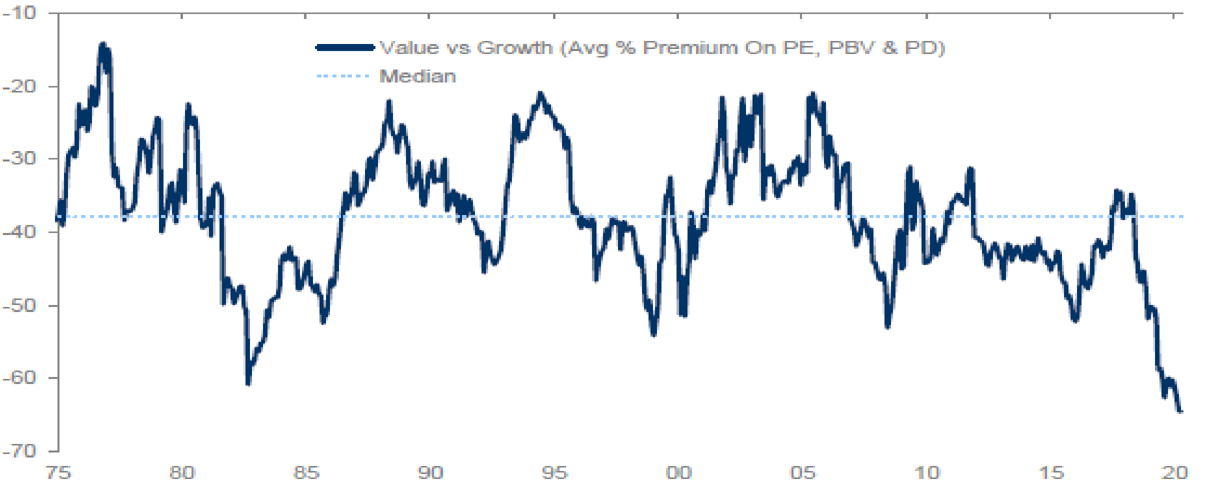
UK v World Equity Returns



Source: MSCI, IBES, Morgan Stanley Research

For similar reasons the value premium remains equally elusive and has plunged to new depths many did not think possible, way exceeding the severe selloffs seen in 2000 and 2008. The current discount sits at 65%, compared to a long run average of just over 35%.

UK Value v Growth Valuation Discount



Source: MSCI, Morgan Stanley Research

As we have pointed out before, there is clear evidence that a value-based approach to investment does work well over the longer term but it is clearly not working in current market conditions and with the current uncertainty such a strategy may well remain under the cosh.

However, the unprecedented scale and speed of fiscal policy should ensure a swift rebound in economic activity when the lockdown ends and we believe that there will be only the briefest opportunity for investors to benefit from any recovery in value factors.

That there will be corporate failures as a result of this crisis seems unavoidable and this story has only just begun. At the time of writing we are starting to see 'emergency' equity issues as companies seek to repair the rapid damage currently being done with businesses such as Hays. Auto Trader and SSP coming to market. There will be many more and the companies could get larger, especially in distressed sectors such as airlines, retail and leisure.

For this reason, we see not only an end to generous dividend payments as previously discussed but also a rapid decline in share buybacks as companies preserve cash. Buybacks also tend to be highly correlated to earnings downturns and earnings are coming down – rapidly.

European Buybacks and Earnings

Source: Barclays Research, Datastream

This is before we consider the moral hazard of excessive buybacks, increased debt levels and executive compensation schemes. Recent work by Citigroup concluded that up to 60% of company payouts to shareholders for the S&P500 were in the form of buybacks compared to around 25% in Europe. Cumulative US buybacks since the financial crisis now equate to more than $5 trillion, including a number of companies now asking for state assistance

It will be interesting to see if M&A activity picks up during the downturn given substantial cash resources available to private equity funds but this feels unlikely in the short term due to the extent and recency of the COVID19 shock. M&A is unlikely to pick up until the broader economic challenges are more certain or have been properly accounted for.

Valuation will eventually matter and our core process and philosophy of focussing on value will not change but given the broad fall in share prices that we have endured there are now more opportunities among stocks that previously we would have deemed too expensive for our portfolios. We have taken the opportunity during this turbulent market period to top up on some of our holdings at very attractive prices. By the same token we must be prepared to take more tough decisions with those holdings which will not make the grade in this new era and we have recently sold out of a couple of problem businesses with the intention of upgrading the portfolio. Work of this nature will continue in the days and weeks ahead.

Over the past five years we have seen four testing periods of performance for TB Saracen UK Alpha – 1) June 2016 post the Brexit vote 2) the fourth quarter of 2018 3) the third quarter of 2019 and 4) the present day. During the previous three events we stuck to our guns and saw the Fund value rebound strongly in each case.

Like most of us we wish we had seen the future more clearly and acted more rapidly but for now lots of milk has already been spilt. Most investors have written 2020 off already and whilst our current performance is not where we would have wished it to be our priority now is to ensure we are fit and ready for any recovery. Our commitment to investing in medium and smaller companies remains intact – these are the FTSE 100 companies of the future, after all. We are also fortunate that our modest fund size may afford us some much needed flexibility to make any necessary changes going forward.

Sadly, the ongoing COVID19 pandemic means that 2020 will go down in history as a year of severe economic and social upheaval. There can be no denying that these are an extraordinary set of circumstances and the ongoing challenges will be vast but our priority is to rebuild shareholder returns by remaining focussed but open minded in our approach and we believe that our flexible, 'multi-cap' approach will serve the fund and our investors well over the longer term.

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

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

David Clark, Scott McKenzie
6th April 2020

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