TB Saracen UK Income Fund

Quarterly Review – March 2020

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PRI Principles for Responsible Investment

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Retail investors should consult their financial advisers

	TB SUIF	MSCI UK All Cap (TR)	Relative
Q3 2020	-38.5%	-25.3%	-13.2%

Performance Summary

It was a horrible quarter for equity markets with the coronavirus crisis taking hold on a worldwide scale, leading to lockdowns across the majority of affected countries. There were dramatic falls in global markets and extreme volatility across asset classes, with a collapse in the oil price, huge cuts to interest rates and enormous stimulus programmes being launched in response to the crisis. As the period drew to a close, we saw significant numbers of companies, both strong and weak, passing their forthcoming dividend payments.

It was a very damaging set of circumstances for the Fund which fell by 38.5%, lagging the UK index return of -25.3%. At a size level large, companies held up better with the FTSE100 falling by -23.8%, compared to -30.7% for the midcap and -27.9% for smaller companies. March was particularly brutal for SMID investors. A summary of performance is shown in the table below.

Cumulative Performance after all ongoing charges to 31st March 2020

	3 months	1 year	3 years	Since launch*
TB Saracen UK Income B Acc	-38.5%	-29.6%	-21.6%	-13.3%
MSCI UK All Cap Index (TR)	-25.3%	-19.4%	-13.3%	1.0%
Sector Average	-28.1%	-20.6%	-17.8%	-6.2%
Quartile Ranking	4	4	3	4

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

Having enjoyed a strong 2019 the Fund was poorly positioned for the unfolding crisis. The key components of the weakness were our large positions in mid and smallcap (more than >60% of the Fund at end February), our strong bias towards a value style and therefore a sector mix which favoured financial and industrial businesses, with correspondingly very low or no exposure to defensive sectors such as food retail and utilities. In addition, to all of these factors our high fund dividend yield was unable to provide downside protection as companies rapidly abandoned dividend payments. At the time of writing 14 fund holdings have suspended their dividends. It was, in summary, a perfect storm for the portfolio.

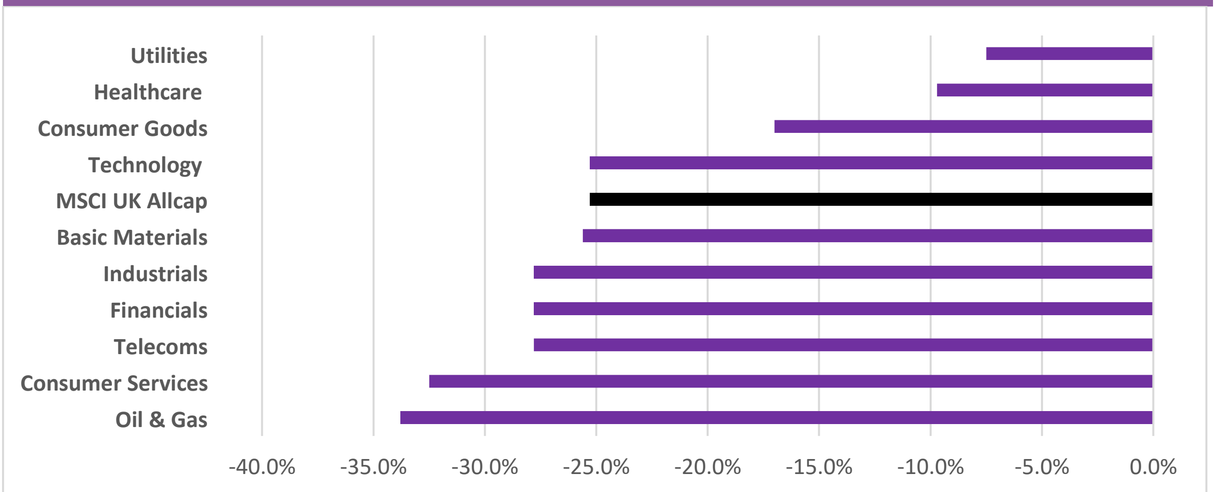
Market Overview

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 December 2019	
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 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

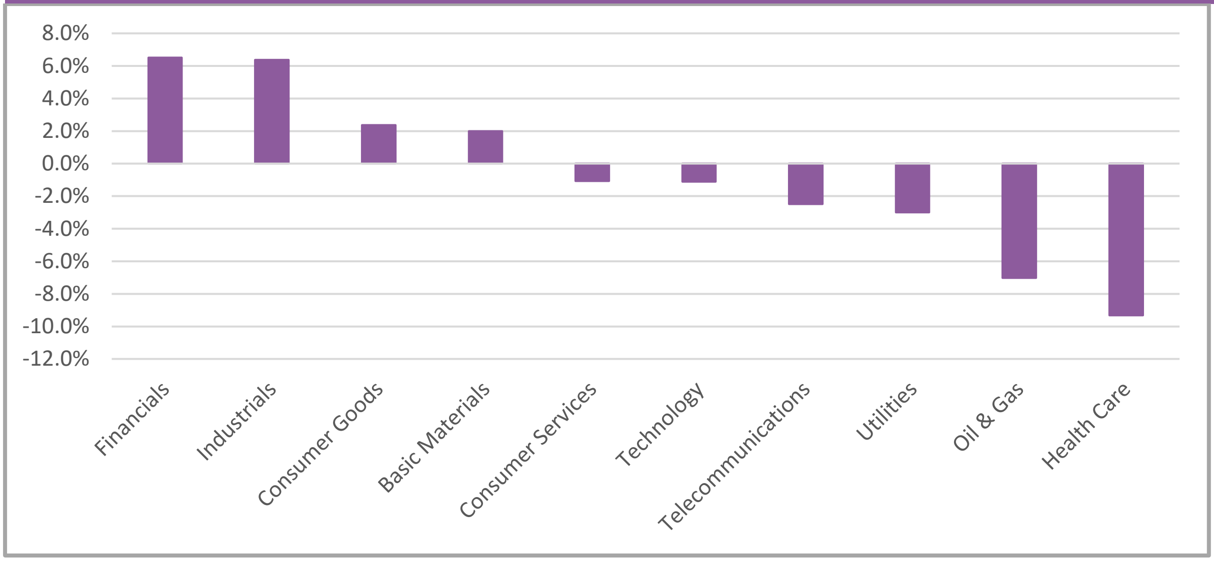
The portfolio has a 'multicap' structure with high exposure to small and mid-cap companies, which is currently 51% of the portfolio, having peaked above 60%. The focussed nature of the portfolio means that the Fund has a high active share, currently at 89%. This strategic positioning had been beneficial to our results in prior years but has clearly been detrimental in the period under review. As the Fund reached it's fifth anniversary on 1st April, we have essentially lost almost five years of solid progress in the space of one month.

There are four broad reasons for the very disappointing performance of the Fund this quarter

1. We are significantly overweight in small/midcap and underweighted to FTSE100
2. We own a number of recovery stocks/cyclical businesses which are GDP-exposed
3. We have virtually no exposure to classically defensive stocks or sectors
4. Our process has a heavy bias towards value factors at the expense of quality and growth

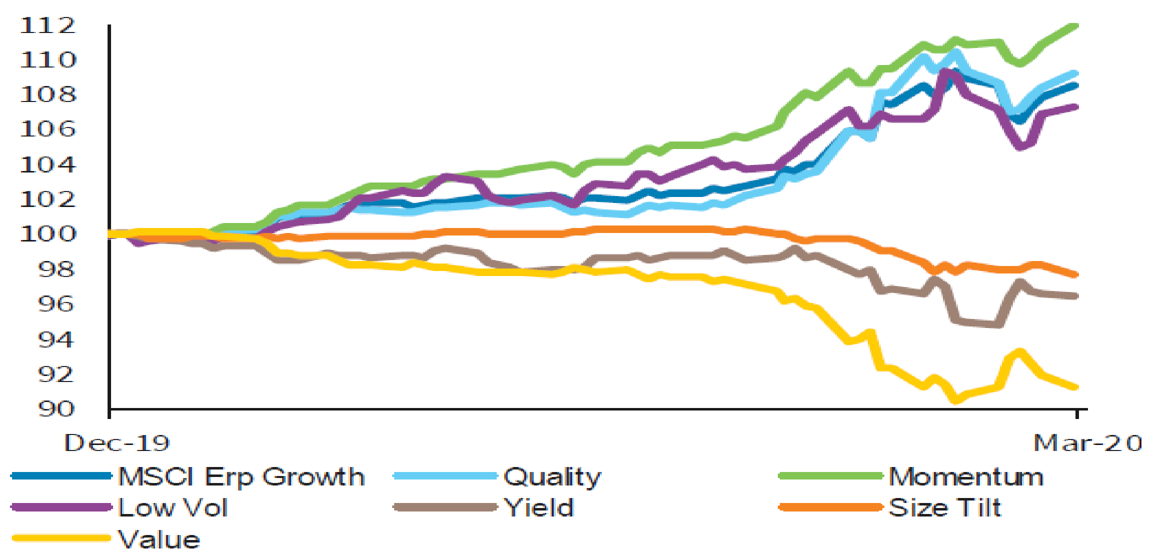
The chart below shows the Fund's current active sector positions compared to the UK index. Our preference for financials and industrials and zero weighting in healthcare is plain to see.

TB Saracen UK Income : Sector Active Weights as at 31st March 2020



The following graph depicts the performance of various style tilts across Europe during the first quarter.

Q1 2020 – European Equity Performance by style factor



Source: Datastream

Our focus on value and yield combined with a smallcap bias has proven to be the worst of all worlds. When we combine the two charts above it is not difficult to see where things have gone wrong for the Fund.

At this stage we would normally update investors on the positives and negatives for the portfolio over the quarter. Somewhat ruefully, in our January 2020 report we wrote – "it is very rare indeed to report a quarter of calm, but this is exactly what transpired, with no stocks falling in value during the period. This is almost unheard of and unlikely to be repeated."

For this quarter almost the opposite is true with only two holdings recording positive absolute returns. These were Galliford Try (sold in January) and Paypoint (a new purchase in late March). All other holdings fell in value.

We had 19 holdings fall in value by more than 30% during the period. We can crudely categorise them as follows:

Real Estate – NewRiver REIT, 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 highly uncertain and transaction evidence scarce.

Cyclical businesses –Wood Group (engineering services), WPP (media), Tyman (construction), TI Fluid Systems (auto components).

UK Consumer/retail – Vistry (housebuilding), Halfords (transport retail & services), Headlam (floorcovering distribution), Superdry (clothing - now sold).

Financials – Lloyds, Aviva, Intermediate Capital, Jupiter, 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 and Gateley. Finally, we should mention National Express (buses & coaches) which until recently had been one of our more consistent performers. The shares fell 56% having been down 80% at their low point. Most of their contracts are backed by public sector guarantees.

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 several face severe short-term pressures. However, we firmly believe that the vast majority will survive and prosper when conditions improve.

Portfolio Activity

The fund has 30 investments which are spread across a variety of market capitalisations. As at 31st March 2020, the split of investment was 45% in large cap, 24% in midcap and 27% in small cap/other, leaving 4% in cash.

Purchases

There were two new stock purchases made during the quarter, both of which we hope will prove resilient during the tough times ahead.

FRP Advisory came to the market as an IPO in early March. Despite this heinous timing the stock is broadly unchanged since purchase. FRP is a leading mid-market insolvency practitioner and is already gaining new mandates during this crisis, including Carluccios and Monsoon. We fear that they will be busy now for many years to come.

Paypoint is a business we have tracked for some time and we made an investment in late March after a 50% decline in the share price. They supply IT and retail solutions to over 28,000 small retailers in the UK, a sector which remains open for business and trading well.

During the quarter the Fund saw some steady inflows and we were able to add to holdings throughout the period. This was a mixed blessing with anything bought prior to mid-March proving somewhat painful and additions in recent weeks looking rather more timely. We are deeply grateful to those who increased their investment in the Fund during this tough time and we expect their fortitude to be amply rewarded in due course.

We have increased our investments in several larger, more liquid stocks (e.g. BHP, Phoenix, Imperial Brands) and have also added to some more cyclical but good quality businesses where we believe valuations have fallen excessively (e.g. Vistry, Intermediate Capital).

Sales

There were two holdings sold outright from the portfolio during the quarter. **Galliford Try** was the 'rump' contracting business left from the sale to Vistry. It rose substantially in January and we took the opportunity to sell what was a non-dividend paying asset. The sale of **Superdry** after the crash in March was a more sobering affair and brought to a close a somewhat dismal investment for the Fund. A lesson in catching falling knives, it's a business where recovery prospects are now even more distant than they were prior to this crisis.

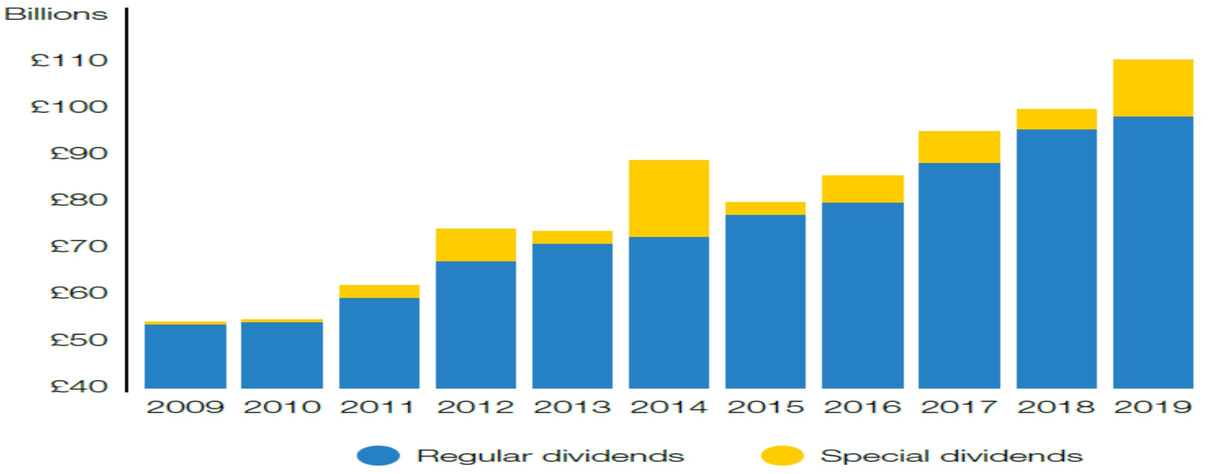
The Dividend Crisis and Fund Income

In recent weeks, stock markets around the world have crashed as a direct result of the coronavirus pandemic. This has led to an unprecedented number of companies cancelling previously announced dividend payments. At the time of writing this figure has reached more than £15bn and is destined to increase. Whilst this trend came first to sectors which are in the frontline of the lockdown (e.g. travel, leisure) or have big working capital or debt swings (e.g. construction, retailing, manufacturing) it has now also permeated to strong businesses across many sectors and has rapidly become the norm for this crisis. In recent days banks and insurers across Europe have been forced to cancel dividends regardless of their capital or liquidity positions as political pressure has been brought to bear.

For income-based strategies such as ours this is particularly painful, coming at a time when dividends are traditionally at their most plentiful. During most 'normal' corrections dividend investors are able to cope with paper losses and remain focussed on receiving dividend payments. For the time being this is no longer possible and both income and capital have been decimated over the past month.

To put this into context the chart below looks at dividends paid by UK companies since the 2008 global financial crisis. Last year's £111bn payout was at record levels and included almost £12bn of special dividends, leaving an underlying total of £99bn.

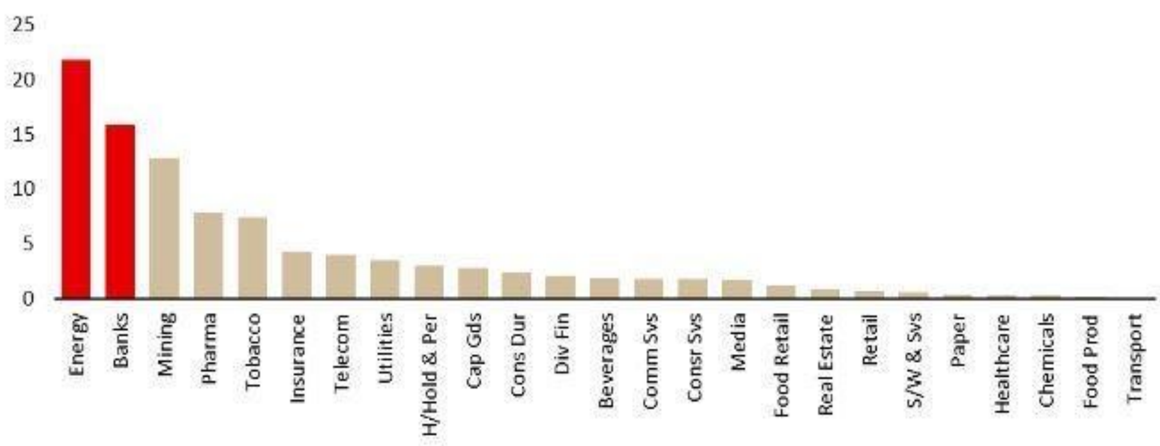
UK dividends (full-year basis)



Source: Link Asset Services

If we drill down further to a sector level, we see significant dependence on oils, banks and mining, which accounted for around 50% of dividends paid in 2019. Indeed, the fifteen largest dividend paying companies accounted for 64% of total UK dividends.

UK sectors: 2019 dividend % market



With regard to the forecast dividend yield for the UK market in total our current central case estimate would be for a fall of 25% in 2020 with our worst case being around 35%. This would give forecast dividend yields for the index of 4.4% and 3.8% respectively.

This assumes broadly a 50% loss of bank dividends in 2020 and a 30% cut to the oil majors. At this stage we leave mining unchanged given their vastly improved debt positions and high returns. As well as the sector biases already referred to UK dividends are fairly sensitive to sterling/dollar rates also. Around 20% of the Fund's income is non-sterling denominated, which is significantly less than the index and most other equity income funds, reflecting our higher mid and smallcap exposure and bias towards domestic earnings. The Fund is therefore long of sterling.

If one looks back in history there have been at least four periods over the past century where dividends have fallen sharply (note – this analysis is based on the S&P500 where the best data is available)

- **Post-World War One recession and the Spanish flu pandemic (1918-1926):** dividends fell by c.35%
- **The Great Depression (1931-1937):** dividends fell by c.55%
- **World War Two and related recessions (1937-1949):** dividends fell by c.50%
- **Global Financial Crisis (2008-2012):** dividends fell by 25%

There was also a long period of stagflation (1966-1990) where dividends grew in nominal terms, but declined in real terms by as much as 25%.

Turning to the Fund's income specifically. Dividends per income share for 2019 were 5.72p, which was an increase of 9% on the 5.24p paid in 2018, which itself grew by 9%. The historic yield of the Fund is currently 8.4%, based on the income share price of 68.1p as at 31st March 2020.

In recent days we have run a number of scenarios with regard to this year's income payments. **Our central case now is that the fund dividend payment for 2020 will fall by 35%. This would imply a current yield on the shares of 5.6%.** This assumes an element of normality returning to life during the second half of the year, allowing most businesses to resume paying dividends of some sort. Our current worst-case modelling assumes no meaningful resumption of dividend payments during 2020. **Our worst-case estimate is for a 50% cut in Fund dividends**. **This would imply a yield of 4.2% at current fund prices.** All of these assumptions are based on the current portfolio remaining exactly as it is now.

As detailed above, there are a number of historical precedents with regards to dividends falling during times of stress and, to conclude, it is inevitable that dividends will fall substantially for the Fund and the UK market during 2020. However, we believe that eventually the global economy, share prices, dividend payouts and life in general will recover and we hope that these dislocations will prove to be temporary.

Should any readers wish more detail on the stock by stock assumptions we have applied please do get in touch. We would be happy to share our thoughts with you.

Outlook

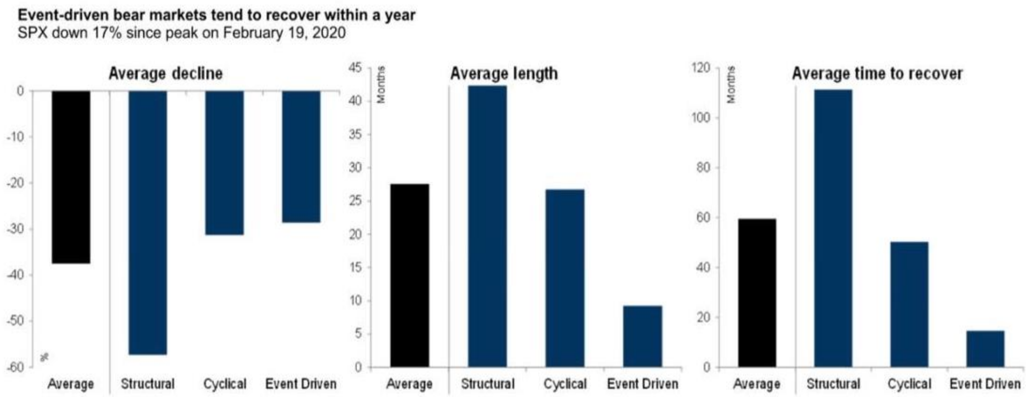
“There are decades where nothing happens; and there are weeks where decades happen.” - Vladimir Lenin

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 analysis below of 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.

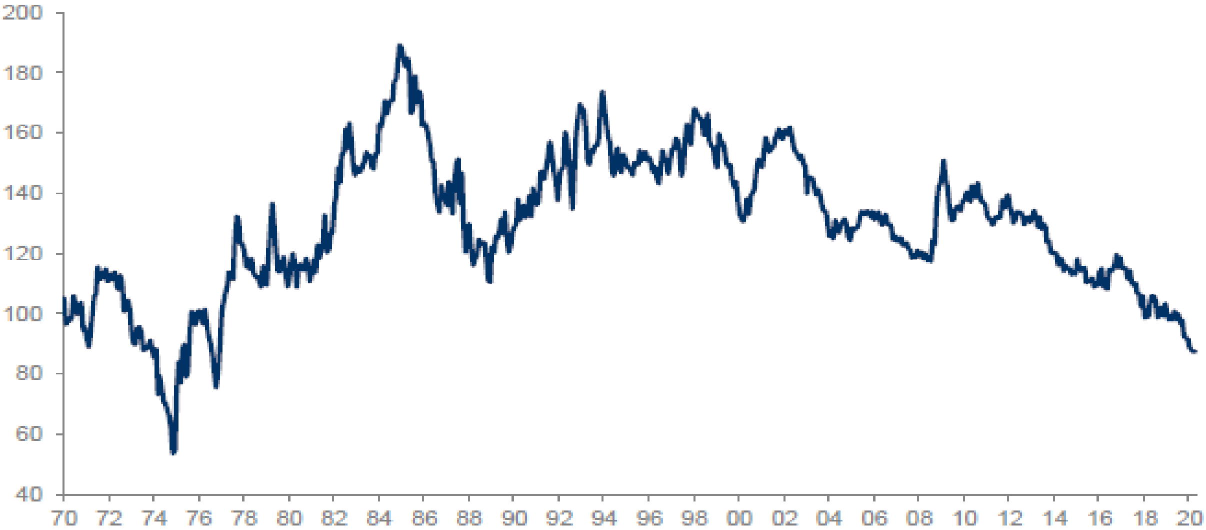
The type of bear market matters



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.

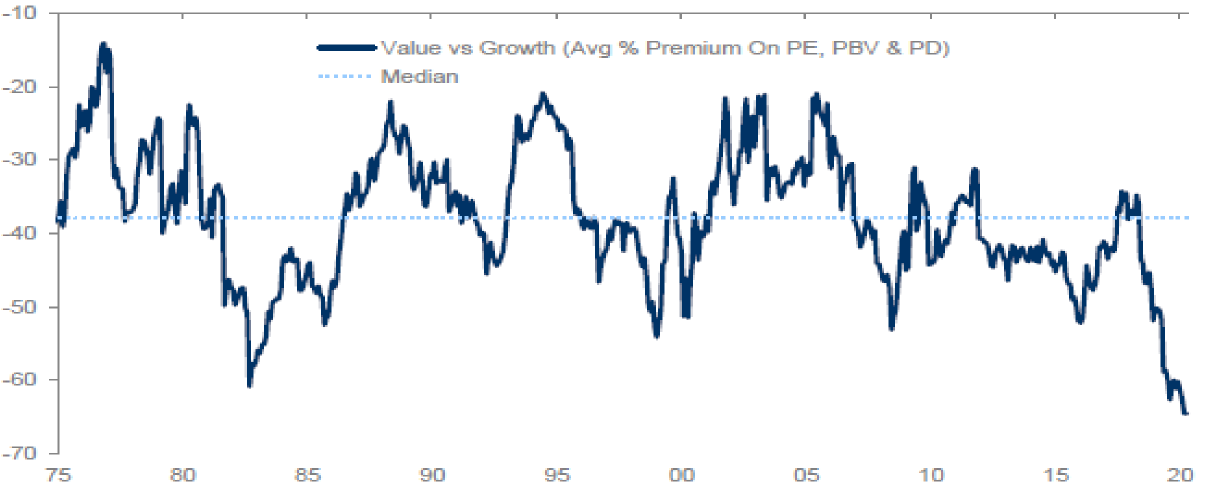
UK v World equity returns



Source: MSCI, IBES, Morgan Stanley Research

For similar reasons the value premium remains equally elusive and has plunged 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 highly correlated to earnings downturns and earnings are coming down – rapidly.

European Buybacks and Earnings

Source: Bloomberg, Barclays Research

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. Our recent purchase of Paypoint we hope will prove to be a good example and we have taken the opportunity during this turbulent market period to top up on some of our holdings at very attractive prices and rotate out of a couple of problem stocks into better quality plays, thus upgrading the portfolio. Work of this nature will continue in the days and weeks ahead.

Since we launched TB Saracen UK Income five years ago we have seen four testing periods of performance for the Fund – 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 dividend guidance is not where we would have wished it to be our priority now is to ensure we are fit and ready for any recovery. We will add to positions in stocks that have suspended dividend payments, if we believe the shares have material upside and will return to paying proper dividends by no later than 2021. 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. Our commitment to investing in medium and smaller companies remains intact and 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.

Scott McKenzie, David Clark
6th April 2020

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Risk factors you should consider before investing:
Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up and you may get back less than the amount invested. A full list of the risks applicable to this Fund can be found in the Prospectus. All fund performance figures calculated on a single price basis.

This Factsheet is for Professional Investors only.

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