TB Saracen Global Income and Growth Fund

Quarterly Review – June 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
Q2 2020	+18.6%	+14.2%	1

Source: Saracen Fund Managers as of 30 June 2020

Value on the Road to Recovery?

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

Introduction

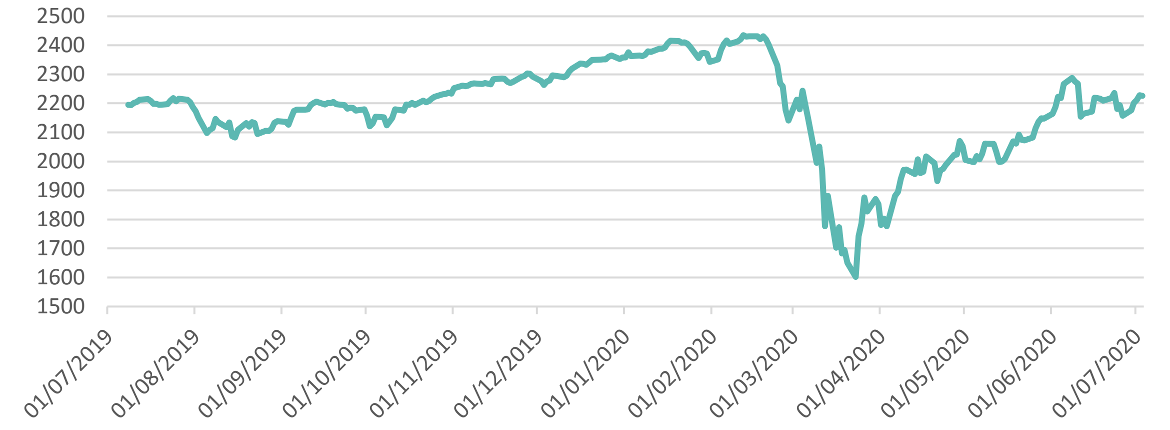
Normally we spend a lot of time in May and June hitting the road and meeting investors, before the holiday season begins. This year has been quite different for all of us and while we have not had the pleasure of meeting clients face-to-face, we have at least managed to avoid the drudge of airports, trains and tube travel. Nevertheless, over our many virtual meetings it seems that we all have appreciated having to travel less and productivity has been high as we have had more time and less interruptions to focus on key issues. The crisis has accelerated the digitisation of the economy. In addition, we can now all demonstrate that our contingency plans work!

Several themes have regularly been raised in our virtual meetings: views on Value as a style have been at the forefront of most discussions. We also noted the downplaying of traditional valuation metrics when discussing many highly valued businesses.

There were also some thoughts on changing leadership or market breadth, which we will discuss in this Quarterly.

It is encouraging that after the most severe fall in economic activity in living memory, equity markets have recovered and taken strength from a better than anticipated pick-up in activity from the lows of April and May. Remarkably, global Equities had their best quarter since 1998 and the S&P had it best 100 day run since 1933 – rallying over 40% from the March lows!!

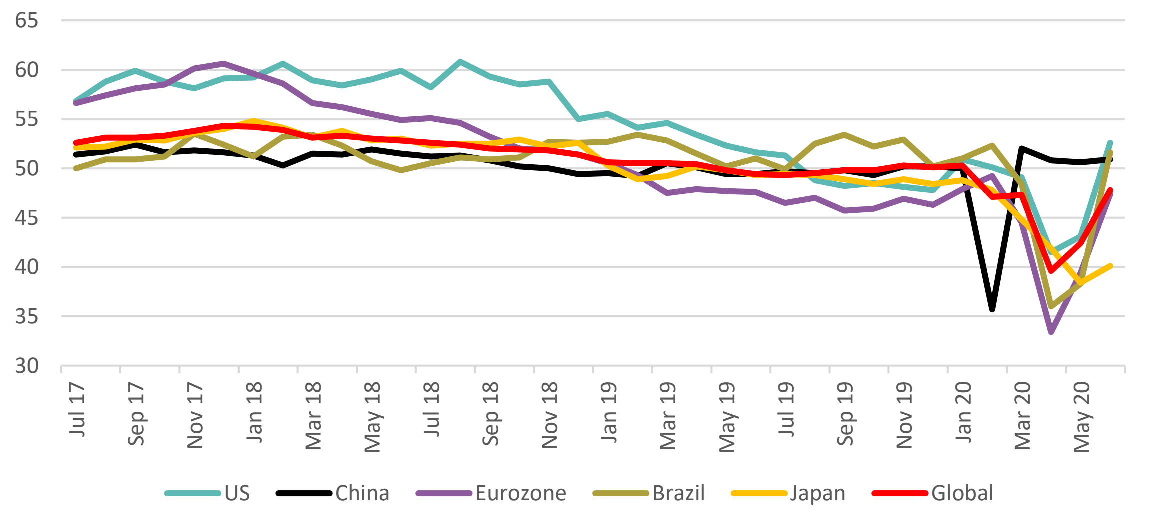
MSCI World – not far from pre-Covid crisis level



Source: Bloomberg

The Bank of England has increased its' Q2 forecast by 7% from -27% to -20%, European PMIs have bounced sharply and the US non-farm payroll, comprising goods, construction and manufacturing companies added 4.8m more jobs in June. Comments from many companies also suggest that economic activity in China is almost back to normal.

Purchasing Managers Index (PMI)

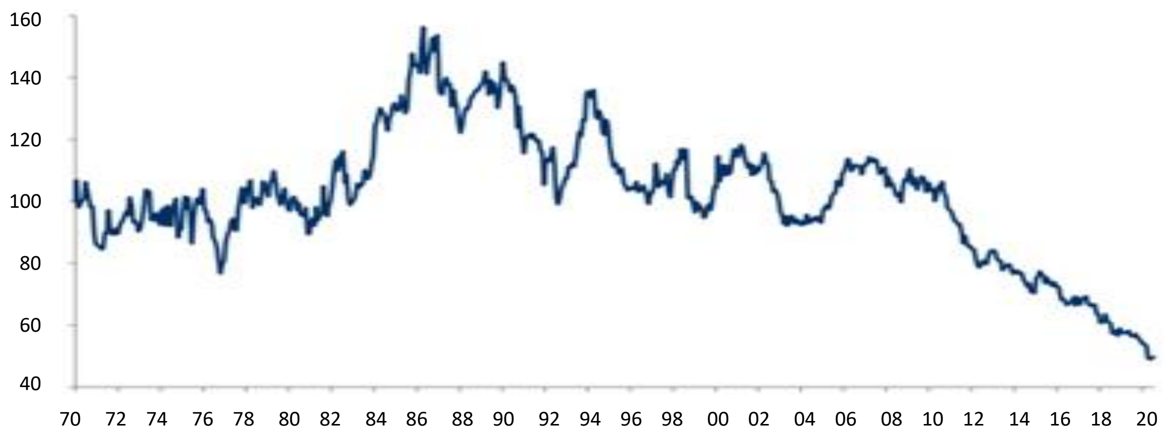


Source: Bloomberg

Most of the optimism has resulted from the cessation of lock-down as Covid cases declined to marginal, or at least manageable levels. The situation in the US is more complicated by a resurgence of cases, indicating that lockdown was perhaps lifted too early in several States. This has probably contributed to the relative outperformance of the Euro compared to the USD and European equity markets.

Setting aside your views on the direction of travel and integration within the Eurozone, developments have been well received by investors. In particular the move by the European Central Bank to extend its asset purchases under the so-called Pandemic Emergency Purchase Programme (PEPP) by €600m to €1.35trl. This was more than expected and increased confidence that an economic decline could be averted. While such aggressive monetary policy is often viewed as adverse for a currency, the co-ordinated response and sharing of liabilities by member states has given more credibility to Europe forming a closer common fiscal policy to align with the common monetary policy. This and was also well received by investors. After many years of underperforming compared to the US, it is possible that this catch up has much further to run.

Europe vs USA Price Performance

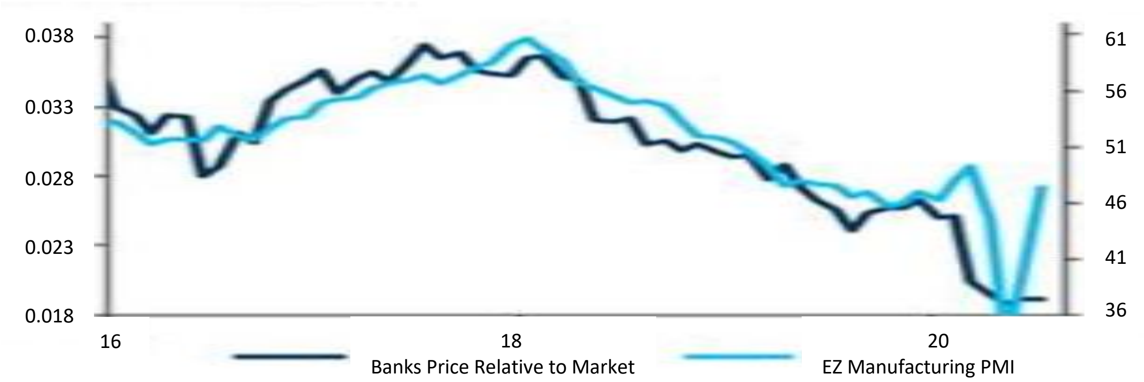


Source: Morgan Stanley

What are clients saying about Value?

In our discussions, it is clear that some investors have all but given up on Value or have at least moved further from some of the deeper value styles that focus primarily on survival or a recovery in asset values. Consequently, property and banks are two of the least favoured sectors.

Banks have not rebounded with PMIs and might be due a catch up



Source: Refinitiv, Barclays Research

We have commented on several occasions of the crowded trades in expensive defensive companies (we think) or so called ‘quality’ shares. We noted a growing realisation that economic events have changed and governments are more active in use of fiscal policy, which tends to favour businesses that are classified as ‘value’ such as mining, construction and engineering/capital goods. Consequently, we received many calls and had discussion surrounding looking at value directly, or as a step towards re-balancing portfolios.

At Saracen we have always been careful in the use of the term ‘Value’, as it means different things to different people. When we consider or screen any investment, we look for high and sustainable margins, a positive ROIC spread, a strong balance sheet, healthy dividend cover etc. No matter how favourable all of the above factors the share must also pass the vital test of “Is it cheap?”

Our starting point is that buying good businesses at attractive prices and not overpaying for illusory growth appears a sensible approach. As the chart below highlights, it has worked well for over 100 years. However, it has not delivered (until recently) over most of the past 10 years.

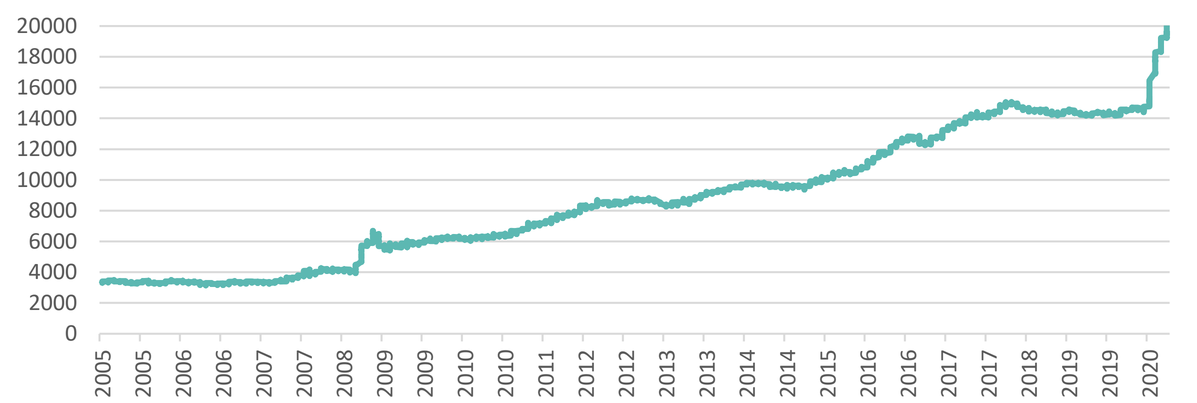
US Value versus Growth

Source: Kennedy Centre for Research

Where Value can fail is when an investor does not understand the drivers behind the business, or where the structure of the industry changes and instead of a cheap ‘growth’ investment, they end up holding a ‘value trap’. At Saracen we have been running all of our investments through a Value Trap Checklist for the past 18 months to try and eliminate this occurrence. (If you would like more detail of this, please contact us.)

We accept that a forcibly flat yield curve makes it harder for banks to make money: if banks aren’t making money, they curtail lending and this constrains economic growth. However, Central Banks are piling on the debt in true Keynesian fashion in an attempt to stimulate growth and reduce unemployment. The law of supply and demand suggests that bond yields may not remain flat for ever.

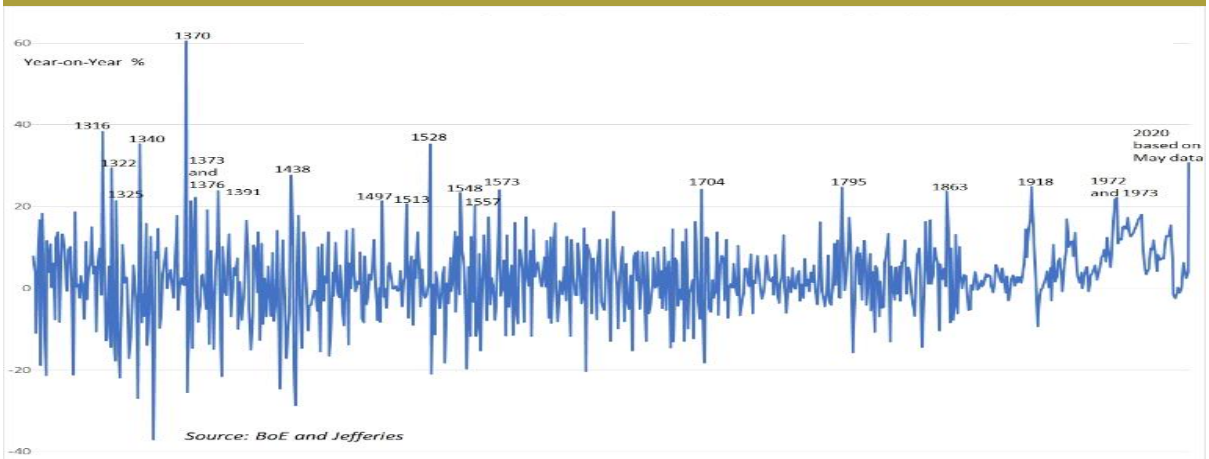
Combined Balance Sheets Fed, BoJ, ECB (in US$bn)



Source: Bloomberg

Another feature of note is the rapid growth in money supply. The chart below, which shows money supply growth in the UK since 1271, highlights the extremity of the current rates of growth. This tends to be a lead indicator for inflation. While few commentators view inflation as a near term risk, as economies are still operating far below full capacity, we know from experience that Central Bankers are slow to confiscate the punch bowl, when the party is in full swing!

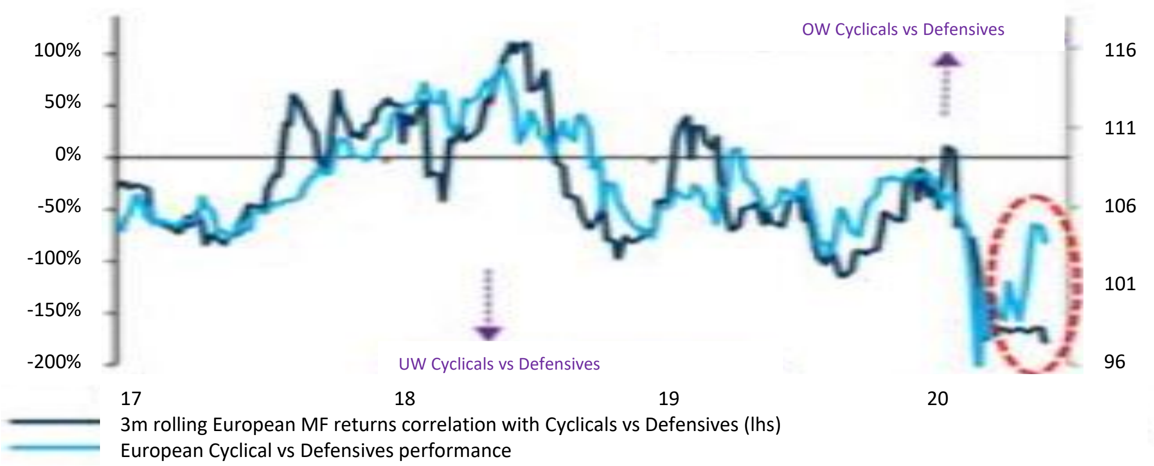
Composite broad money M3/M3 growth in the UK since 1271



Source: BoE, Jefferies

For Value to continue to perform, it is likely that we will see some steepening of the yield curve, indicating optimism for economic recovery. Very few investors are positioned for this eventuality.

Mutual funds are still defensively positioned



Source: EPFR, Datastream, Barclays Research

The Decline in the use of Traditional Valuation Methods

We have noted in recent years the decline in discussion, or even comment on valuation when discussing potential investments. This tends to occur when the tried and tested tool is no longer supportive to the recommendation and a new tool is adopted. We are frequently dismayed by the acceptance of adjustments that companies make to GAAP earnings to 'helpfully' provide an 'underling measure". This is a particular problem in the US where managers frequently exclude large cash items, such as litigation and restructuring which appear almost every year. In fact, the exceptional would be their non-appearance!

The most common strategy to get round valuation issues, is to compare something that is expensive with something that is even more expensive. It's like saying, "Don't burn your hand in the fire, scald it in hot water instead! We have seen this relative approach tried before and it didn't end well.

Surely share valuations must be a reflection of investors' expectations of future prospects. We are firm believers in a valuation methodology that is based on long-term cash earnings. It seems a strange approach to ignore the price you pay, when considering an investment. Similarly, if there is an attractive price to buy a share, there must also surely be a price when it is overvalued and should be sold. It seems like the industry has forgotten, or more likely, conveniently ignored any Sell Process to allow managers to retain shares, when they intuitively know they are expensive: but there is safety in numbers!

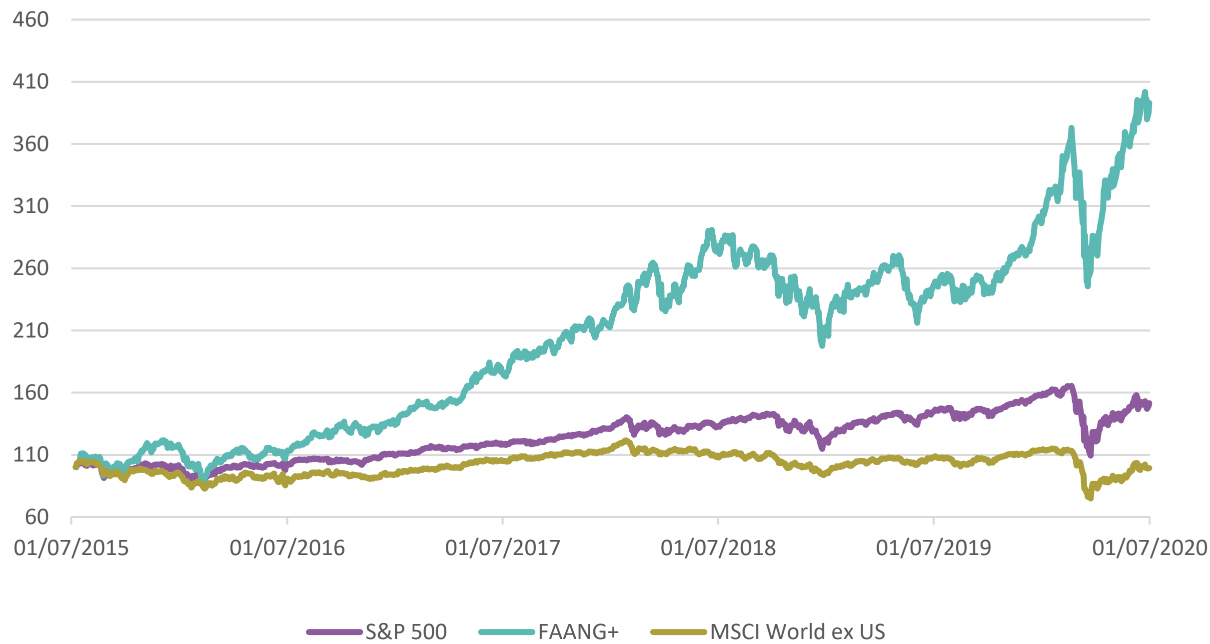
Changing Leadership Required

Given the extremities in valuations across markets, a sharp recession may be the catalyst for a long-awaited change in market leadership. If investors were going to sell expensive shares on valuation grounds, they would have probably sold them long-before now.

While there is always the potential for expensive shares to become more expensive, that does nothing to discredit the argument that investors should be looking to identify more attractive alternatives.

Market leadership has been unusually tight. Year-to-date around 85% of the move in the S&P 500 index is explained by just five stocks – FAMAG (Facebook, Amazon, Amazon, Microsoft, Apple and Alphabet/Google). It is hard to see how this level of concentration can continue, especially given the already 'rich' valuations these businesses have achieved: it is more likely that for markets to progress, leadership will change and widen. This should be very positive for fund performance.

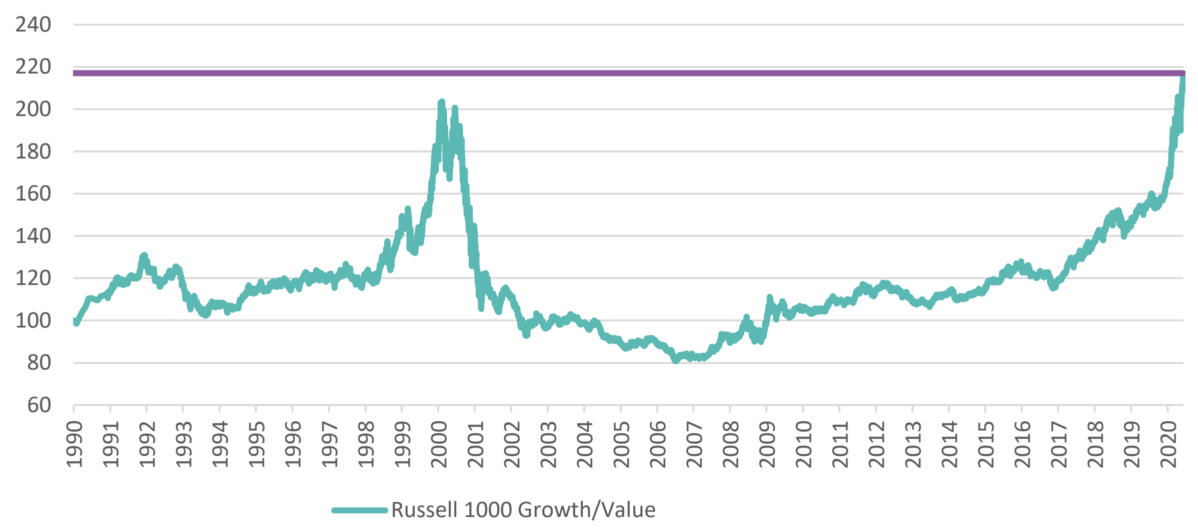
FAANG+ stocks are driving the market higher



Source: Bloomberg

We observe that growth versus value keeps reaching new highs and is now even more extended than during the tech bubble in 1999/2000. We believe that this disparity is now simply too big for investors to ignore.

The turning point Value? Growth hitting new all time high relative to Value



Source: Bloomberg

Performance Review

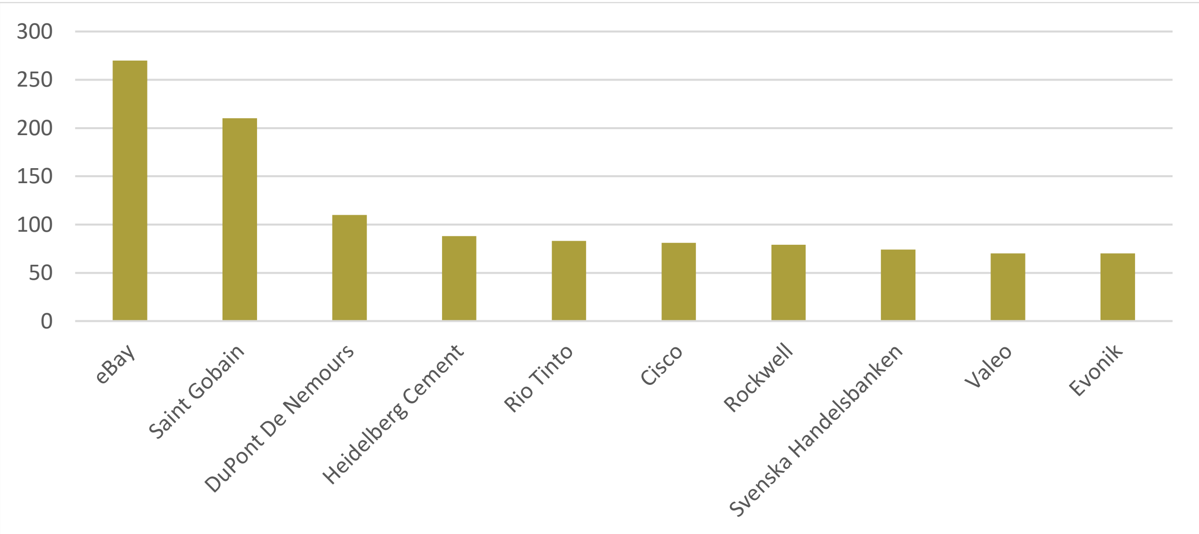
The fund has recovered well from the March lows and is top decile in the peer group rankings over the last 3 months. However, there remains much work to be done.

The valuation differential in markets remains at extreme levels and we expect the fund to continue to make up lost ground as market leadership broadens.

	1 month	3 months	1 year	3 years	5 years	Since launch*
TB SGIG B Acc	+2.2%	+18.6%	-10.3%	-5.0%	+29.4%	+91%
Sector Average	+2.1%	+14.2%	-2.6%	+9.4%	+42.9%	+97%
Quartile Ranking	2	1	4	4	3	3

*Source: Financial Express; *launch date 07 June 2011* *Sector: IA Sector (Global Equity Income)*

Positive Contributors



Source: Saracen Fund Managers

Many of our holdings had a very strong quarter as markets recovered from the March lows.

eBay (+72%) was the biggest contributor to performance. The global lockdown and shift of consumption online resulted in the Ebay's core marketplace returning to growth. eBay had two positive profit warnings during the quarter. Despite the strong share price performance, the shares only trade on 16X 2020 PER. We expect the sale of the classified's division (which includes Gumtree) and a significant return of capital to shareholders to be announced during Q3.

Both **Saint Gobain** (+57%) and **Heidelberg** (+35%) benefitted from a quicker than expected recovery in trading conditions and the numerous fiscal stimulus packages announced by global central banks (particularly the proposed €750bn EU Recovery Fund). At their AGM at the beginning of June, Saint Gobain said that trading had recovered to 80% of the previous year's level in many countries. They have subsequently stated that trading continues to improve and that they expect a strong Q3. Despite the rally, the shares still look good value – Saint Gobain trades on 12X 2021 earnings and Heidelberg Cement on 9X 2021 PER – and remain core positions for the fund.

Both **Dupont De Nemours** (+57%) and **Rockwell** (+39%) recovered strongly after falling significantly in March. Dupont De Nemours benefitted as investors looked for recovery in its early cycle industries such as autos and construction, increased cost cutting and improved execution from the new CEO. Rockwell, which was a new addition to the fund at the end of March, performed well as demand held up better than feared. Rockwell appears well placed to benefit from changes that are beginning to take hold in global manufacturing including an increased focus on resiliency/flexibility and some re-shoring of manufacturing processes.

Many of our lowly valued global-leading cyclical businesses that happen to be listed in Europe performed very strongly. Companies such as **Valeo** (+63%), **Evonik** (+27%) and **Rio Tinto** (+27%) all had good quarters as investors looked through the short-term COVID-19 impact.

Cisco (+20%) performed well after reporting solid results and a better than expected outlook. Many businesses are now looking at how to operate efficiently in a post COVID-19 world and more employees will undoubtedly spend more time working from home. Cisco looks well placed to benefit from this trend with increased corporate cap-exp on IT networks and network security.

Banks, in general, have been slow to recover from their March lows. However, **Svenska Handelsbanken** (+21%) with its high quality loan book and low expected default rates performed strongly.

Negative Contributors

Given the strong market backdrop, none of our investments posted a negative return over the quarter. It was, however, noticeable that our defensive companies, which are in the Healthcare and Tobacco sector, significantly lagged the market recovery. Our holdings in Bristol Myers (+11%), Merck (+7%), Novo Nordisk (+13%), Pfizer (+7%), Philip Morris International (+3%) had a relatively weaker quarter after a lengthy period of outperformance.

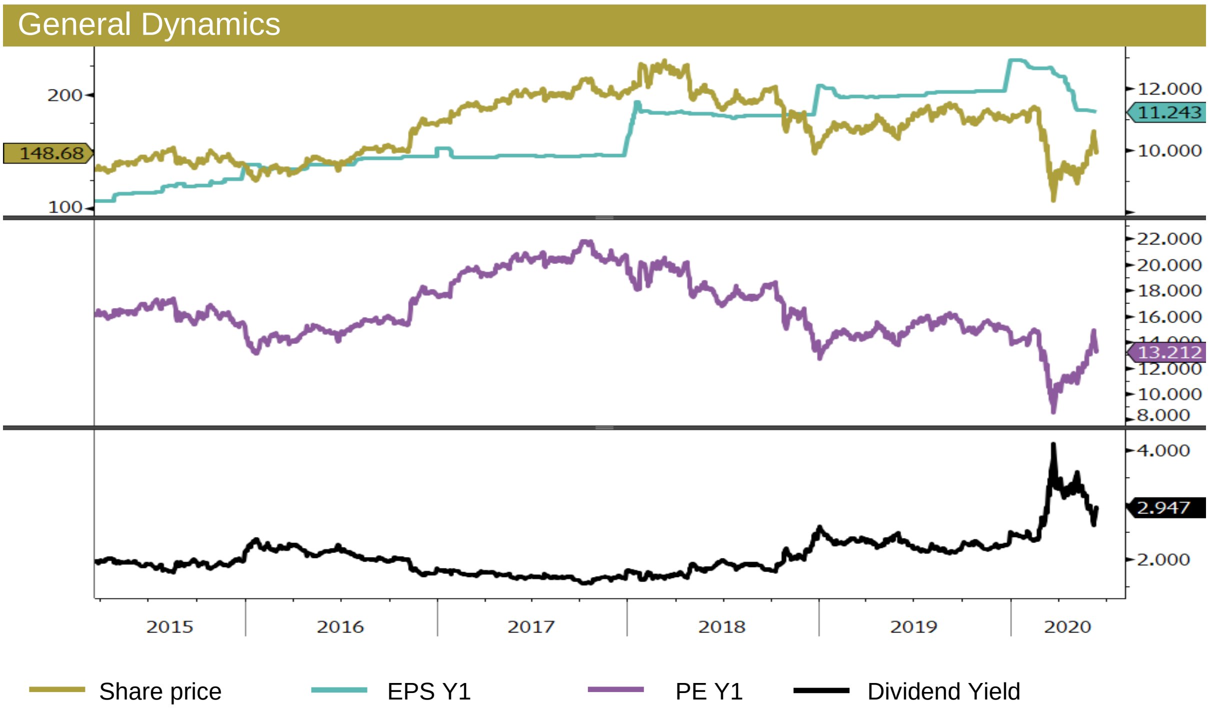
Portfolio Changes

After the unusually high level of activity in March, we only made minimal changes to the portfolio during the quarter.

We sold **BP** and reinvested the proceeds into **General Dynamics**.

General Dynamics is a global aerospace and defense company that is a global leader in its chosen segments namely: Gulfstream Busines jets, Combat Systems, Information Technology, Mission Systems and Marine Systems. It is a dividend aristocrat having increased its dividend for the last 23 years and enjoys a high ROIC.

The shares have been weak given the businesses exposure to the business jet market, which provided the opportunity for the fund. The shares trade on 14X 2020 earnings and yield 3%.



Source: Bloomberg

We also bought more Danone and Philip Morris Intl, as both shares have significantly lagged the market recovery. We also continued to build our position in Fuchs Petrolub. We funded these purchases by reducing weightings in Rio Tinto, Rockwell, Saint Gobain and Schneider Electric – all of which had performed very strongly since the market low at the end of March.

SGIG Portfolio strategy and valuations

Whilst our value stance has been painful, we hope that the worst is over!!

It is clear we have reached the end of the limits of monetary policy. Expensive defensives are aptly named and will not benefit from an economic recovery. The massive fiscal stimulus should benefit more cyclical / value orientated businesses.

We expect our portfolio to continue the recovery witnessed in Q2.

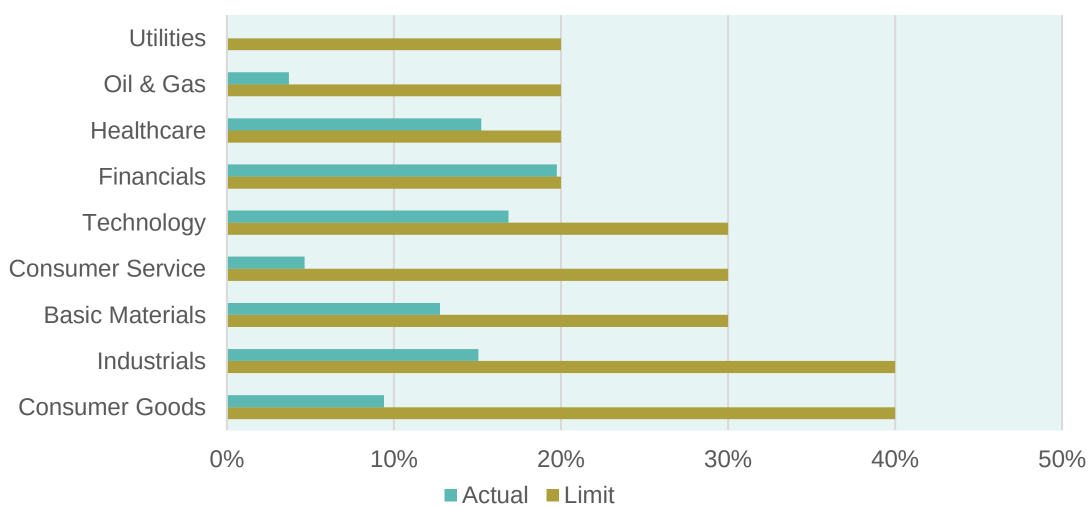
We, therefore, retain large weightings in companies that are classified in the following sectors:

- **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)

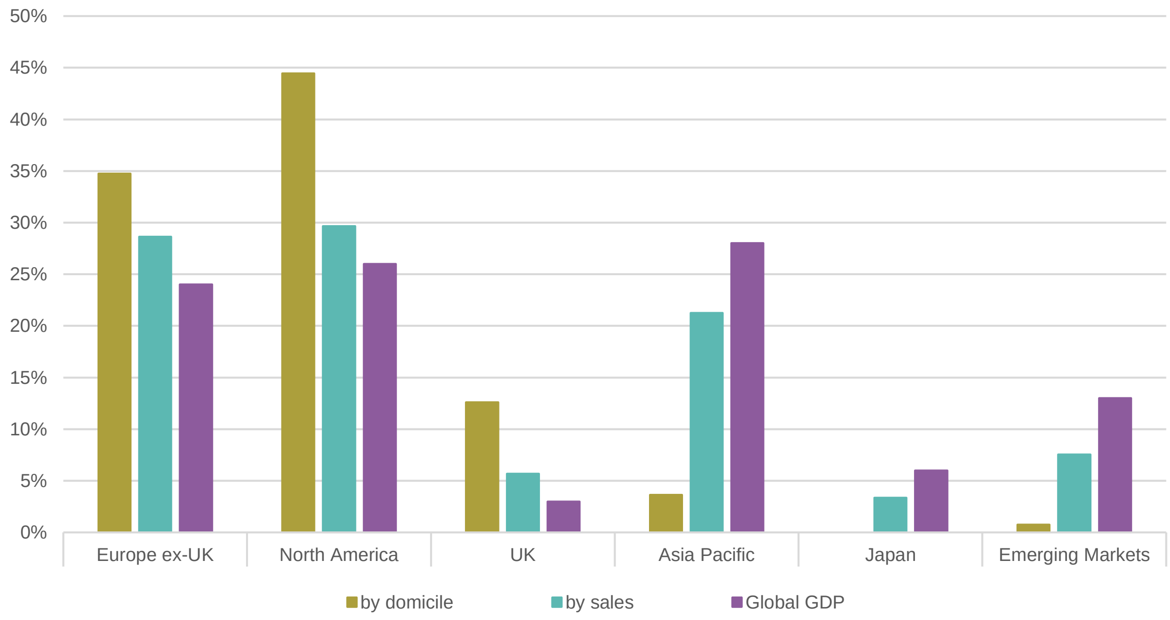
TB SGIG sector split



Source: Saracen Fund Managers as at 30/06/20

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

TB SGIG geographical split



Source: Saracen Fund Managers as at 30/06/20

Most importantly, the fund remains very differentiated in the global equity income peer group and attractively valued both against the peer group and the market – currently trading on 14.4X 2021 eps and yielding 3.9%.

We believe we have significantly improved the quality and long-term growth prospects of the Fund through our portfolio upgrade in March – when we were able to invest in high quality businesses such as American Express, Danone, Fuchs Petrolub, Prudential and Rockwell at very attractive valuations. We did a portfolio upgrade of similar magnitude in Q1 2016 which aided performance significantly. We strongly believe that several of our holdings are materially undervalued

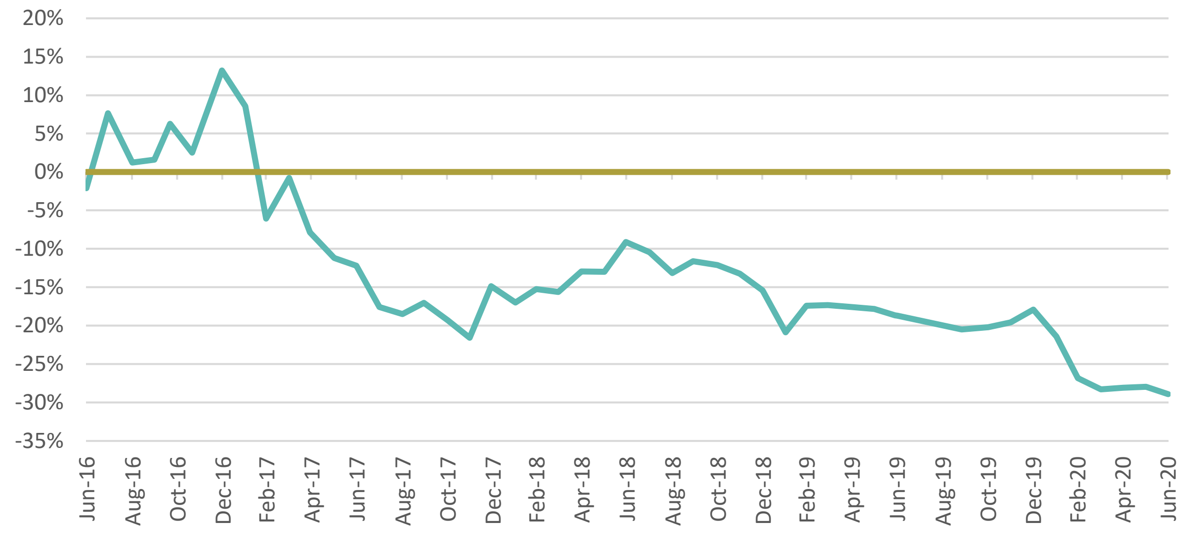
SGIG value characteristics versus FTSE All World index

Characteristic	TB SGIG	FTSE All World	+/-
Best P/E 1Y FWD	14.4	18.9	-4.5
Best Dividend Yield 1Y FWD	3.9%	2.5%	+1.4
Best P/CF 1Y FWD	9.1	11.6	-2.5
Best P/B 1Y FWD	1.5	2.1	-0.6
Best P/S 1Y FWD	1.4	1.6	-0.2
5 Year ROIC	13.0%	12.8%	+0.2

Source: Bloomberg 30/06/20

In addition, as the chart below highlights, the fund continues to trade close at an all-time high discount to the market.

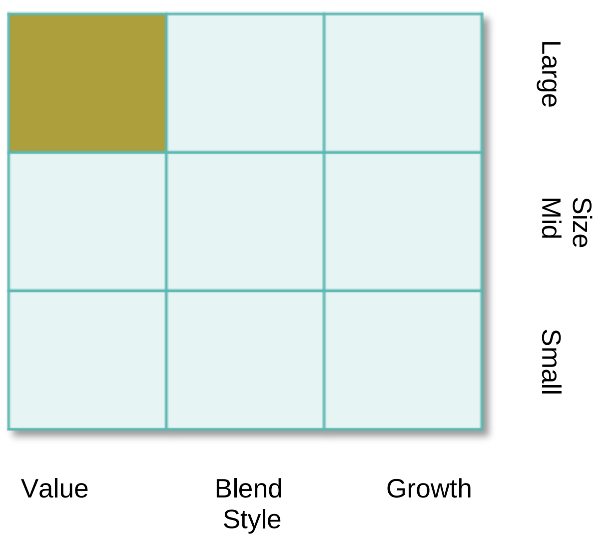
TB SGIG PE discount to FTSE All World PE



Source: Bloomberg 30/06/20

Our process has not changed and given the lack of middle ground, the fund has never had a greater value bias. As the Morningstar style chart in the table below highlights, there has been no style drift here! We want to invest in growth, but we are disciplined in the price we will pay. SGIG only invest in companies that we consider as undervalued.

TB SGIG Equity Style



Source: Morningstar

Dividend outlook

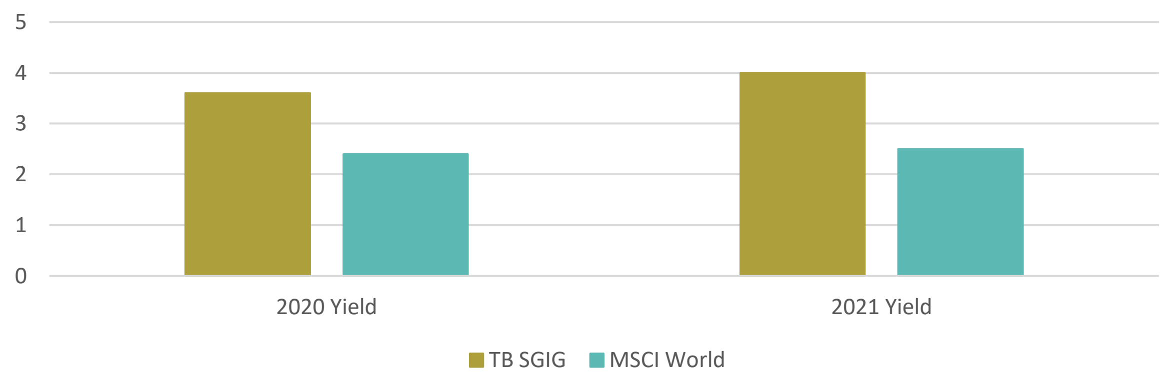
We pride ourselves on having grown the dividend every year since the fund was launched in June 2011. However, as we made clear in our last quarterly review, given the impact of COVID-19 and the reaction from some Governments and Regulatory authorities across the globe, the fund dividend will fall in 2020.

We provided an interactive dividend model for clients so that they could make their own assumptions. However, we gave a base case dividend cut of 15% year on year and a worst-case dividend cut of 33%.

We now have more visibility on the 2020 dividend and our new central case is for a 20% fall year on year. The worst-case remains unchanged.

Therefore, the central case 2020 dividend yield on the fund (based on the 30 June unit price) is still an attractive 3.6%.

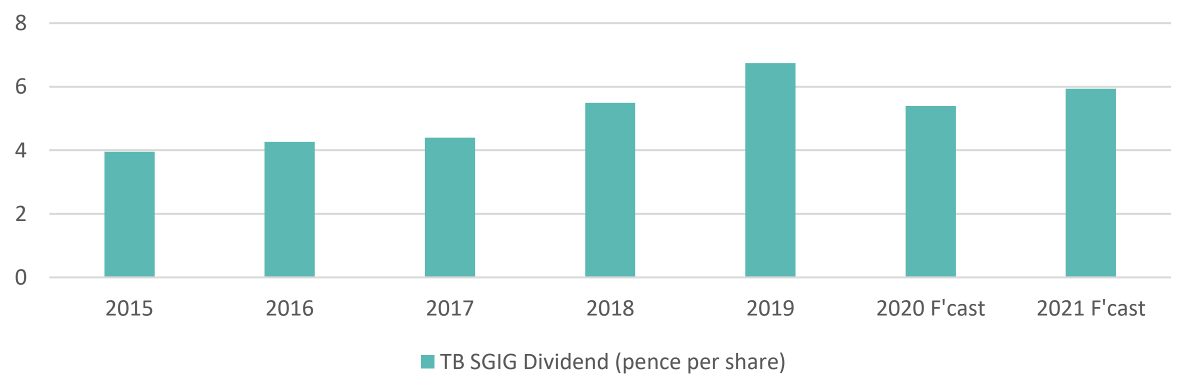
TB SGIG vs MSCI Forecast Dividend Yield



Source: Bloomberg, Saracen Fund Managers

The fund declared a dividend for H1 2020 of 2.45p which compares unfavourably with the 3.95p declared in H1 2019 and represents a year on year decline of 38%.

TB SGIG Dividend



Source: Bloomberg, Saracen Fund Managers

We would make a couple of observations which explain why we have confidence in the 20% central case number for the full year.

Firstly, some of our European companies delayed their AGM's and will make payments in H2 as opposed to the usual timetable in H1. For example, AXA delayed its AGM until it had reached a satisfactory agreement with the regulator. It will now pay its €1.43 dividend (8% dividend yield) in two tranches in H2 as opposed to the normal pay date of May. Also, both Danone and Michelin paid their dividends in July as opposed to the usual May date.

Secondly, some European companies split the usual annual payment paid in H1 into two payments split equally between H1 and H2 to manage cashflow. For example, Evonik paid 50% of its dividend in May with the remaining 50% to be paid in September.

There remains some uncertainty re what Banks will be allowed to do. DBS Group continues to pay its quarterly dividend. UBS will pay a dividend but is splitting it over H1 and H2 as opposed to making one payment in May. AIB, Barclays, Handelsbanken were all blocked from making payments by the regulator. All three companies were able and willing to pay a dividend. Barclays shares had actually gone ex-dividend the full final dividend before the payment was blocked!!

We expect that these companies will be able to make small dividend payments in H2.

A key point is that 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. **We expect the fund to yield approximately 4% based on our 2021 dividend forecasts.**

Investment Approach

TB Saracen Global Income & Growth Fund aims to provide a long-term return from investing in a portfolio of low risk, highly liquid global equity securities. There is an explicit recognition that income is an important factor for many investors and a significant contributor to long-term investment returns.

We have a focussed and highly differentiated portfolio of 40-60 quoted global companies, a high conviction fund with a significant active share, which is currently 93%. There is no formal benchmark for the fund, although we do report performance against the IA Global Equity Income Sector.

We aim to invest in global-leading businesses which can sustainably grow their revenues, their profits and ultimately, their dividends. We are attracted to businesses which have high and sustainable margin profiles, create value by generating a return on investment above the weighted average cost of capital and have a strong Balance Sheet. We also like to see directors owning shares in the business and being remunerated on total shareholder returns as opposed to an earnings-per-share measure, which can be easily manipulated. However, the most important things that we look for in an investment are an attractive valuation and a starting yield of more than 2%. We don't simply buy great businesses at any price - they must be demonstrably cheap!!

Our Wish List for Companies

- Global Leading Businesses
- Long-term revenue growth potential
- Positive return on equity spread
- Sustainable margins
- Strong Balance Sheet
- Acceptable Worst Case (extent and likelihood)
- **Attractive valuation and starting dividend yield more than 2%**
- Alignment of interest with directors

We have a long-term approach and the turnover in the fund has, on average, been less than 20% per annum since the fund was launched.

SGIG portfolio holdings: Investing in Global Growth

Outlook

Lenin said, “There are decades where nothing happens; and there are weeks where decades happen”.

His quote encapsulates the market backdrop since the outbreak of COVID-19. Investors have endured 4 out of the worst 25 trading days of the Dow Jones in history, the fastest 30% drawdown in history, the largest ever scramble into money market funds, a record close in the VIX in March all followed by the best 100 trading days on the S&P since 1933 with equities rebounding by over 40%!!

After the best quarter for Equities since 1998, markets could remain volatile. Whilst investors have begun to look through the virus impact on short-term numbers, the upcoming Q2 results season may bring a reality check. Concerns over rising COVID-19 cases as economies begin to reopen and rising unemployment once the furlough schemes are withdrawn may also impact sentiment. Investor attention will also turn to the upcoming US Presidential election which may bring a new Democratic President and Democratic control of both houses.

However, we expect the following themes to continue to develop.

Value as a style has been at the forefront of investor discussions. There appears a greater willingness to add to the style or at least blend positions.

There is greater confidence in the Euro after Eurozone countries agreed a closer fiscal policy to tackle the Covid-19 pandemic. After many years of underperformance, this may have much further to run.

Central Banks have massively increased their Balance Sheets to support economic recovery. The rapid increase in the money supply is often a lead indicator to inflation.

Equity market leadership is extremely concentrated. This is likely to broaden if equities are to make progress.

While there is always the potential for expensive shares to become more expensive, that does nothing to discredit the argument that investors should be looking to identify more attractive alternatives.

The global economy will recover. Confidence in the recovery is likely to be indicated by a steepening of the yield curve. There is no reason to believe this time will be different. Most countries should now be much better prepared to deal with the COVID-19 threat without having to reinstate lockdowns. In addition, the combination of the steepest recession on record with unprecedented monetary and fiscal support should boost economic activity. This is usually a positive scenario for ‘Value’ investors!

We believe that the TB Saracen Global Income and Growth Fund with its attractively valued portfolio of global leading businesses is well positioned to continue to recover lost ground as investors refocus on valuation and market leadership broadens.

We leave the final word to John Authers, who writes a brilliant daily blog on Bloomberg which in our view is essential reading. In his blog on 26 May which was titled "Buffett and Charlie Brown Are Due Some Relief", he argues that after many false dawns, a turning point for value investing may finally have arrived.

The blog can be found here - https://www.bloomberg.com/opinion/articles/2020-05-28/value-stocks-at-turning-point-will-relieve-buffett-followers?cmpid=BBD062420_AUT&utm_medium=email&utm_source=newsletter&utm_term=200624&utm_campaign=authers

He concludes with the following "***One behavioral investor once told me that he adopted a "sharp intake of breath" test for potential investments. If a name provoked that reaction, the chances were that sentiment had moved too far and it was now too cheap. It is at this point that value investors can make a killing. Put differently, to quote Oaktree Capital Group's Howard Marks from an interview with me earlier this month, "every great investment begins in discomfort."***

Precisely because it feels so uncomfortable, it is time to start moving back into value".

We agree and hope he is right!!

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

Graham Campbell
David Keir

30 June 2020

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

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Custodian – The Northern Trust Company, 50 Bank Street, Canary Wharf, London, E14 5NT

Depositary – NatWest Bank PLC, 135 Bishopsgate, London, EC2M 3UR

Regulatory Status:
FCA Recognised: Yes
Scheme Type: OEIC

Issue date – 8 July 2020