TB Saracen UK Income Fund

Quarterly Review – September 2020

SARACEN
share success

Signatory of: PRI Principles for Responsible Investment

Scott McKenzie
Fund Manager

David Clark
Fund Manager

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

	TB SUIF	MSCI UK All Cap (TR)	Relative
Q3 2020	-4.3%	-3.5%	-0.8%

Performance Summary

After the dramatic falls we saw in March and the equally dramatic recovery seen during the second quarter, this quarter was a more sobering affair as investors adjusted to a very different world. This stark new reality was highlighted by the re-imposition of various lockdown restrictions globally as well as a damaging slew of weak GDP and employment data in the light of the first lockdown. The UK market was once again a laggard, with the MSCI UK All Cap falling 3.5%, led by the largest FTSE100 stocks. This was well behind the MSCI World return of 3.2%. The headwinds for UK investors continued, dominated by confused government responses both to COVID19 and the looming spectre of a possible 'no deal' Brexit.

Having enjoyed a strong recovery during the second quarter the Fund ran out of steam somewhat, falling by 4.3% compared to the UK index return of -3.5%. A summary of performance is shown below.

Cumulative Performance after all ongoing charges to 30th September 2020

	3 months	1 year	3 years	Since launch*
TB Saracen UK Income B Acc	-4.3%	-23.0%	-19.9%	-3.7%
MSCI UK All Cap Index (TR)	-3.5%	-18.2%	-11.6%	6.6%
Sector Average	-3.2%	-17.2%	-14.5%	0.7%
Quartile Ranking	3	4	3	3

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

Market Overview

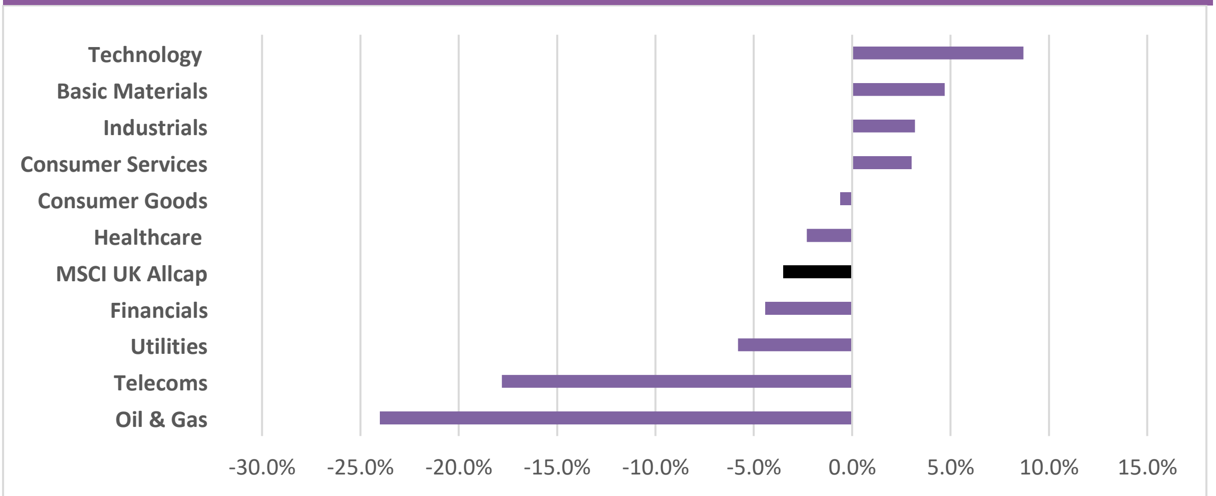
UK returns were dominated by the weakness in the FTSE100, with banks and oils in particular continuing their dramatic fall from grace. In addition, the UK indices continue to suffer from their very low exposure to the high performing technology sectors. By contrast, global equities continued to make progress, driven by the tech sector in the US and better economic trends emerging from Asia.

Looking at the UK market specifically the small and midcap indices continued to make up some lost ground, with the AIM market in particular roaring ahead to pre-COVID levels as investors focussed on the emerging technology and healthcare names which are well represented there.

Total returns by capitalisation: 3 months to 30th September 2020	
FTSE100	-4.0%
FTSE Mid250	+1.8%
FTSE Smallcap	+1.2%

At a sector level, the oil sector continued its miserable form as BP joined Royal Dutch in slashing its dividend as well as their global headcounts. Banks also remain friendless in a zero/negative interest rate environment where their dividend prospects remain uncertain. By contrast basic materials and industrials sectors in general benefitted from early signs of greater economic stability globally and a feeling that the worst may well have been seen in terms of earnings. Having held up fairly well during the early stages of the crisis telecoms and utilities gave up ground again.

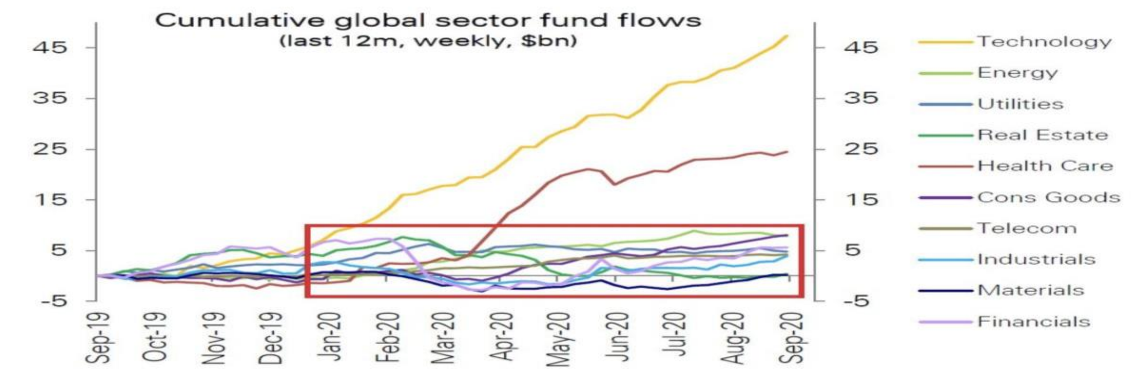
UK sector total returns: 3 months to 30th September 2020



Source: Bloomberg

We continue to live in a world governed by extremities, with acute divergences between perceived winners and losers. Current stock markets exemplify this and more. The boom in the technology sector is widely documented and has become more extreme in a post-COVID world, closely followed by healthcare. Recent fund flow data shown below illustrate how this has become a self-fulfilling prophecy. IPO’s such as Snowflake, a US cloud storage business, also reflect a mania of sorts with a market cap of $69bn and a multiple of 120x projected sales. Time will tell if this valuation is right.

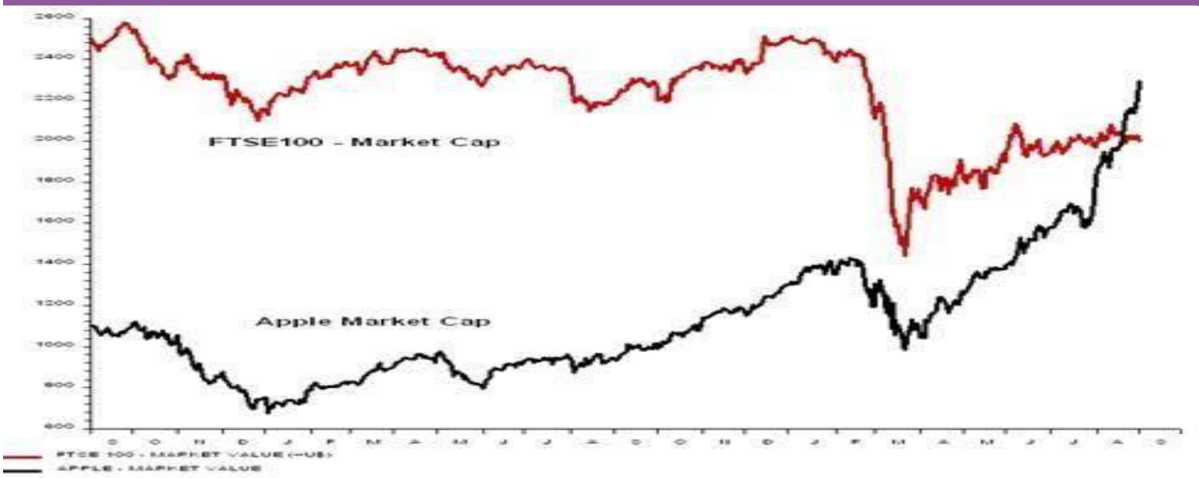
Global Sector Fund Flows



Source: Deutsche Bank Asset Allocation, EPFR, Haver Analytics, Data as of 16.9.20

Having become the first company to reach $1 trillion in value 42 years after it was founded, Apple took just two years to be the first to the $2 trillion mark, on 31 July 2020. This was larger than the individual market capitalisations of 470 of the companies in the S&P500. Even after a recent sell-off, Apple is still worth as much as the entire FTSE 100 index of leading UK businesses. This may reflect Apple’s undoubted strengths and prospects but also highlights the fairly horrific decline in UK large companies of late. The non-UK earnings of the FTSE100 are more than 70% of the total, reflecting their global reach rather than their domicile. Therefore, poor UK economic prospects, Brexit and a bumbling Boris Johnson are not really the issues here. Whilst there are many structurally challenged sectors in this group it’s hard to believe that the majority of this hundred are dead ducks.

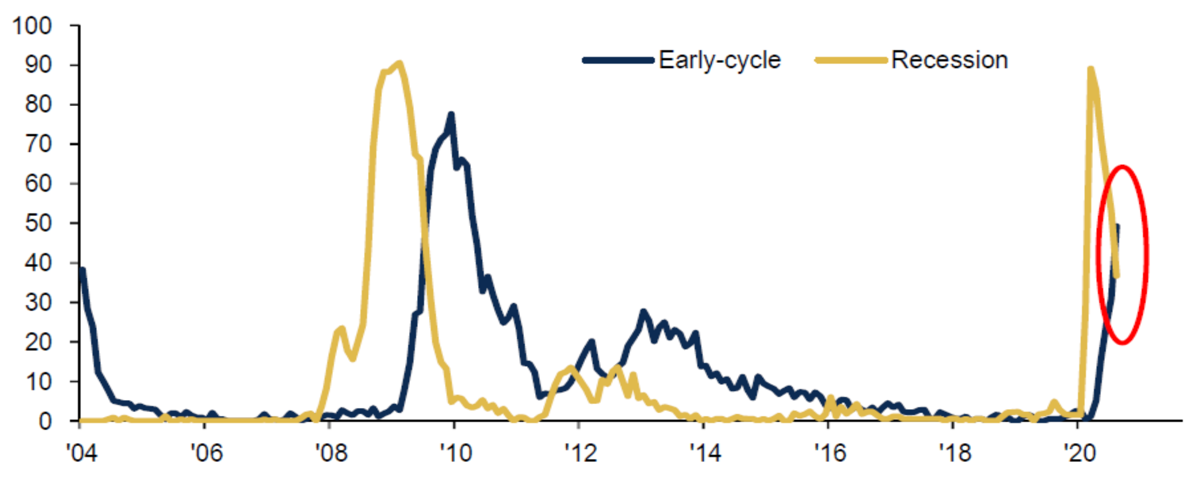
Apple v FTSE100



Source: Bloomberg

Investor sentiment has changed markedly since the onset of the COVID19 crisis in March. At that point the BOAML global survey had 90% of participants suggesting we were in a full-blown global recession. Six months later that figure has fallen to 37%, with almost half now saying we are in an early stage recovery. This was a pretty reliable barometer of market and economic recovery in 2009 also.

Global Recession Indicator (% of respondents)

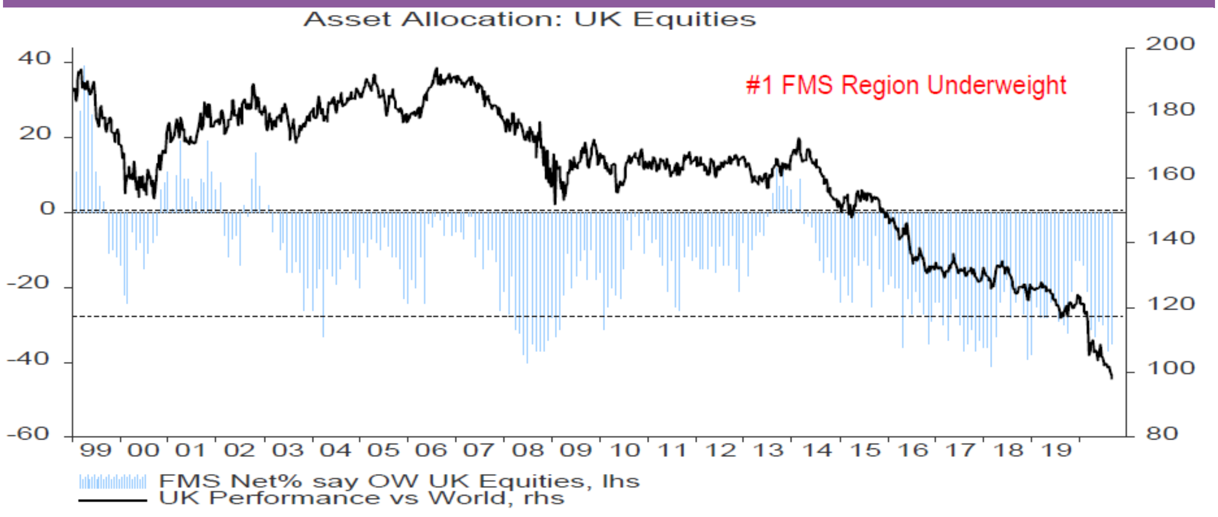


Source: Bank of America Global Fund Manager Survey

Global activity is now rebounding sharply from a low base. A second wave of infections is a clear and present danger but most governments are now better prepared to handle this.

However, closer to home it is a different story and it currently feels like we are close to peak hatred of UK-domiciled assets. We make no apologies for reproducing the chart below, also from the BOAML global survey, which illustrates how irrelevant and unloved the domestic market has become and remains.

Net % Global Asset Allocators Overweight UK Equities



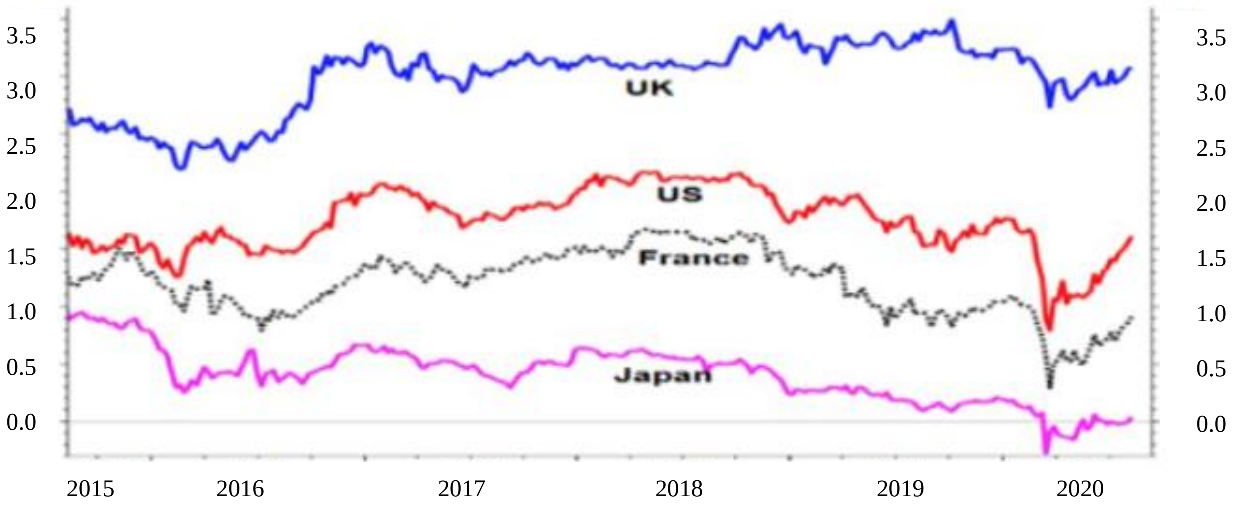
Source: Bank of America Global Fund Manager Survey

It would be foolish to conclude therefore that the garden is rosy. The short-term issues are considerable. A possible no-deal Brexit, the likelihood of a second wave of coronavirus infections causing further damaging lockdowns, low business and consumer confidence and a government which appears to be imploding under PM Johnson are all reasons to be wary.

Our previous concern that unemployment may rise over the 10% level in the UK as furlough unwinds and lockdown measures continue remains a risk. Similarly, a sharp fall in 2020 UK GDP of around 10% also still seems likely, particularly in the light of the 20% fall seen in Q2. However, none of this is new news since our last report and more recently indicators such as PMI surveys, new home sales and retail spending have improved significantly from low bases.

As before interest rates and government bond yields remain effectively at zero, with concerns that the Bank of England will head into negative territory. Whilst neither short nor long rates are likely to change anytime soon, we would again highlight the considerable complacency around inflation. Any sustained uptick here would have considerable implications for market leadership we believe.

Global Inflation Expectations



Source: Datastream

Portfolio Review

The Fund has a 'multicap' structure with high exposure to small and mid-cap companies, which are currently 56% of the portfolio. The focussed nature of the portfolio means that the Fund has a high active share, currently at 89%.

After the traumatic falls in value we endured during March and the strong initial recovery we saw in the second quarter, the third quarter was somewhat more mundane with the Fund and the broader UK markets drifting somewhat over the summer as further lockdown measures were introduced. This made for a pretty volatile period of returns as investors reacted to ever-changing political decisions and a wide range of corporate responses to the pandemic.

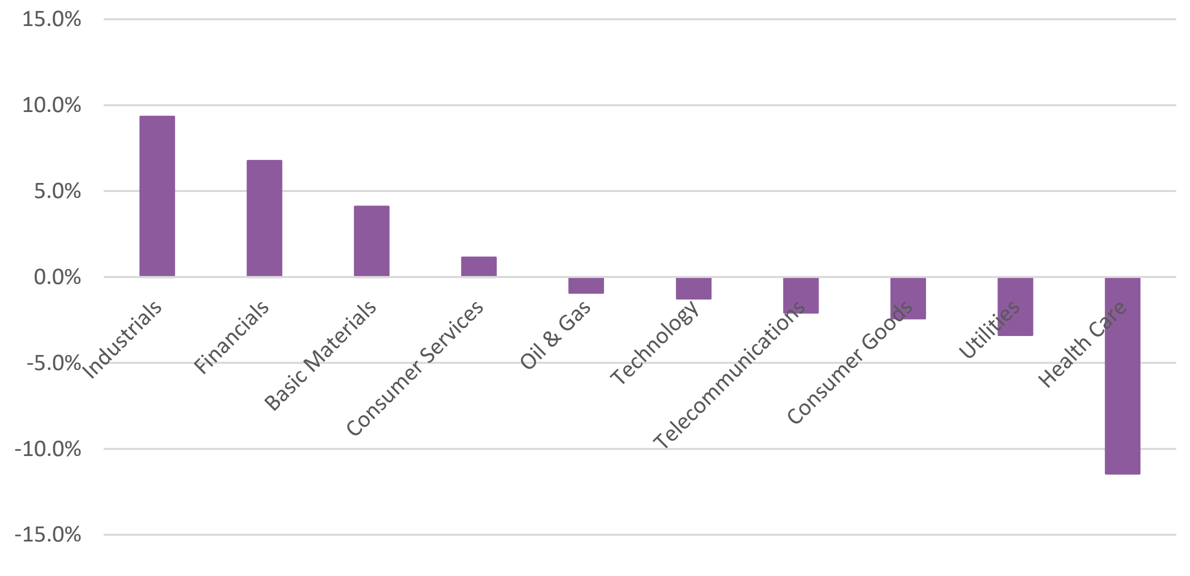
We took the view at the end of March that we should not panic and give the portfolio ample scope to recover. As we enter the final quarter of a very turbulent year there remains plenty of lost ground for us to make up, with many of our holdings yet to deliver their recovery potential. In many cases this potential is significant in our view.

The overall structure and philosophy of the Fund is broadly unchanged and there has been no style drift in response to the COVID crisis. The key portfolio characteristics are as follows

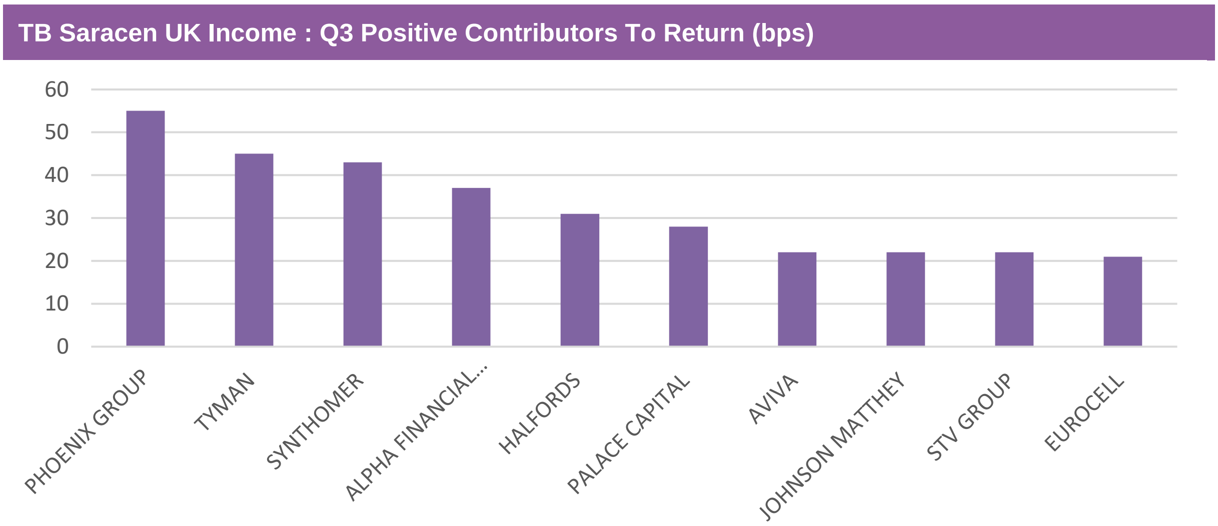
1. We remain overweight in small/midcap and underweighted to FTSE100
2. We own a number of recovery stocks/cyclical businesses which are GDP-exposed
3. We have very low exposure to classically defensive stocks or sectors
4. Our process has a heavy bias towards value factors and a low weighting to growth

The chart below shows the Fund's current active sector positions compared to the UK index. There have been no significant changes made to the sector mix during the quarter with our preference for financials and industrials and zero weightings in healthcare, telecoms and utilities remaining as before. The latter three sectors all fell in value during the period.

TB Saracen UK Income : Sector Active Weights as at 30th September 2020



Having enjoyed meaningful recovery in a number of our holdings during the second quarter, the summer months were a very mixed bag. We had 9 holdings rise in value by more than 10% during the period, offset by 9 holdings which fell by more than 10%. Volatility remains high, even within the same sectors.

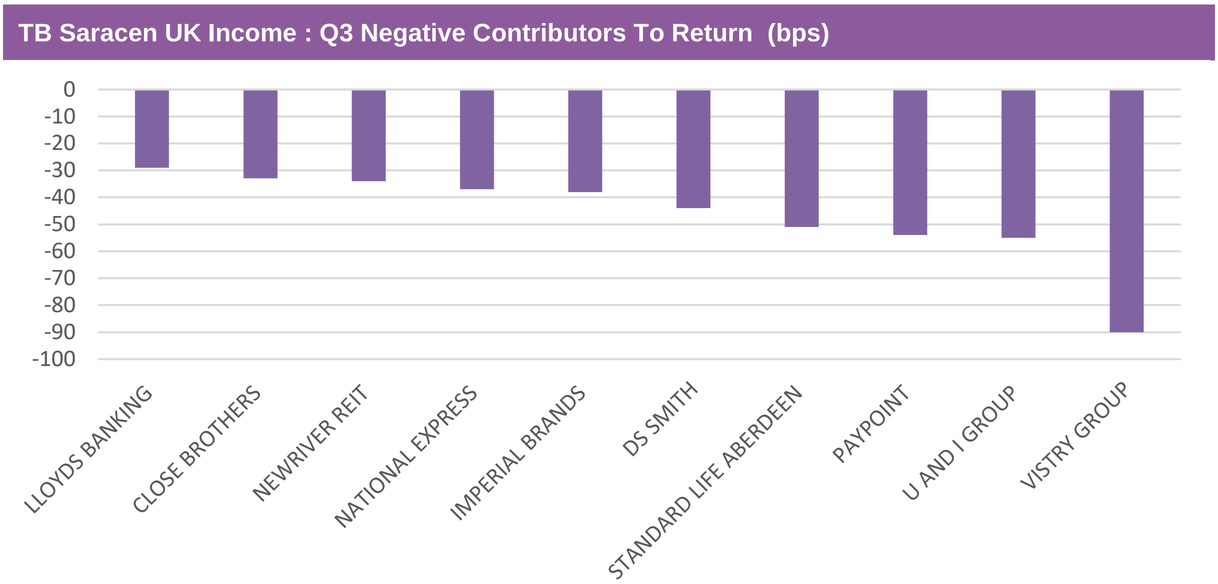


Several of our best contributors have maintained or reinstated dividend payments. In financials, our largest holding, **Phoenix Group**, rose by 10% as they confirmed the long-term stability of the dividend at a time when most financial sectors are under pressure. Similarly, **Aviva** (+7%) reinstated their interim dividend and look to have fresh strategic vigour under the new CEO. Despite a very tough outlook for commercial property **Palace Capital** (+12%) is bucking the trend and has also started paying quarterly dividends again.

We have seen some early signs of recovery in some of our industrial holdings. **Synthomer** (+14%) has been resilient with its nitrile gloves business in particular faring well. Our new holding in **Johnson Matthey** (+12%) got off to a good start as investors begun to appreciate its deep technological expertise whilst **Tyman** rose again (+17%) from a very modest starting valuation.

A number of our smaller companies have continued to deliver with **Alpha Financial Markets Consulting** rising by another 11% and **Halfords** continuing its trading revival, rising by 19%. This was prior to a very positive statement on 1st October which saw the shares surge further.

It was also pleasing to see some of our previous laggards begin to find some form. **STV** rose by 9% as the recent equity issue was completed and solid results were produced in tough circumstances. In a similar vein **Eurocell** (+11%) is also beginning its recovery, having also raised equity during the lockdown period. We believe both businesses have strong management and good long-term strategies. Despite a very weak oil sector **Wood Group** rallied by 10% with its profit margins holding up and its market credentials in non-oil sectors now beginning to be more widely appreciated by investors.



As reported in our previous review the banking and real estate sectors remain completely friendless with bad debts, falling real estate valuations and increasing concerns about the UK economy all conspiring against them. Both of our banks, **Lloyds** (-15%) and **Close Brothers** (-8%) continue to fall despite Close announcing the payment of its final dividend recently.

This decimation of the banking sector has led to most share prices trading below levels last seen during the GFC in 2008, despite clear improvements in solvency ratios and reduced risk appetites. This is not merely a UK trend, but can be observed across Europe and the US too. Our investments in small real estate businesses such as **U&I Group** (-31%) and **NewRiver REIT** (-21%) have been a miserable experience so far in 2020 with their illiquidity and exposure to falling rents and asset values leading to large falls in both capital and dividends.

In the housebuilding sector **Vistry** (-20%) has been persistently weak despite reporting much improved recent trading and, importantly, offering investors a clear roadmap to progress in 2021. We believe that the shares offer significant upside from today's lowly valuation. **DS Smith** (-10%) had a poor quarter as they failed to pay a final dividend and were impacted by weak paper trends.

Our other fallers were a mixed bunch**.** **National Express** (-18%) remains hugely volatile but started to recover in response to a better statement in late September. We await news of management changes there with interest. **Standard Life Aberdeen** (-13%) also lost ground ahead of their new CEO arriving. In a similar vein **Imperial Brands** remains friendless (-10%) but we hope the new CEO there will begin to put past mistakes behind them when results are due soon. **Paypoint** was a big disappointment, falling 17% on the 30th September in response to an OFGEM investigation into its payment systems for utility companies. Without this late blow the Fund would have been in line with the main index over the quarter.

Portfolio Activity

The fund has 33 investments which are spread across a variety of market capitalisations. As at 30th September 2020, the split of investment was 47% in large cap, 25% in midcap and 28% in small cap/other. The Fund is currently fully invested, reflecting the significant valuation upside we now see across the portfolio as a whole

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Purchases

Having bought four new holdings during the second quarter, no further new positions were added during the recent quarter.

We added to three existing holdings as their trading updates began to show signs of improvement but their valuations and share prices remained depressed. These were **Paypoint**, **National Express** and **Tyman**.

Sales

There were no outright sales made from the portfolio during the quarter.

We reduced some of our larger positions in the basic materials sectors, all of which had seen strong recovery from the low points of March. These included chemicals business **Synthomer** and global miners, **BHP** and **Rio Tinto**. The latter two have continued to pay pleasingly healthy levels of dividends at a time when we have seen significant cuts from UK companies. We also reduced the positions in **Alpha FMC** and **DS Smith** but both remain as holdings in the Fund and we hope to see them resume dividend payments sooner rather than later.

Fund Income Update

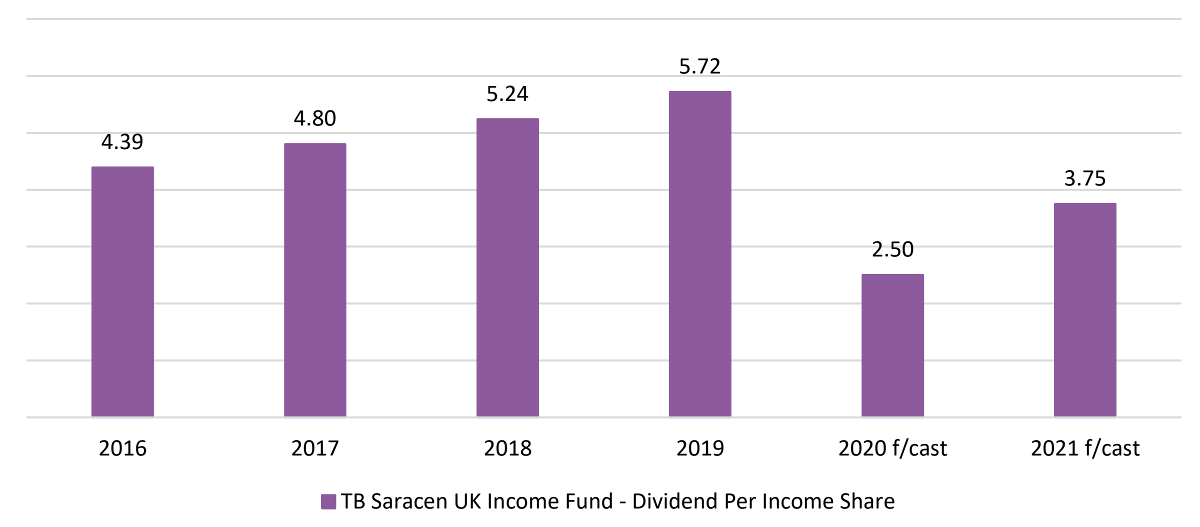
In our previous quarterly review, we gave shareholders a detailed update regarding the outlook for the Fund's income in the light of significant declines in dividends we had seen in response to the COVID-19 crisis. At that point we were projecting a 50% fall in fund dividends for 2020.

During the third quarter we have seen several holdings return to the dividend paying list as we had hoped. These included Aviva, Close Brothers and WPP. There have also been a number of businesses who have now decided to defer any future payments into 2021 and where interim payments have not been made in 2020. Examples in this group are Vistry, Synthomer DS Smith, Gateley and Lloyds Banking.

Taking this in aggregate we are slightly behind where we thought we would be and now expect a 55% decline in income for 2020. The other side of this coin is that we can see a path to a stronger recovery in 2021 as many of our companies resume payments. Our analysis of previous financial crises over the past century which we outlined in April saw declines in dividends ranging from 25% to 55% so this crisis is up there with the worst of them so far.

If we assume that the fund dividend payment for calendar 2020 will fall by 55%, this would imply a current 2020 yield on the income shares of 3.4% (as at 30.9.20). As we look towards 2021 the outlook for dividends is far from clear and the scale and timing of payments may be subject to variance, but we do now see scope for a meaningful recovery, coming from the low base of 2020. Our current bottom-up expectation is that we would expect a 50% recovery on the reduced 2020 pay-out. This would still leave overall income around 35% behind the 2019 payment levels. The chart below depicts our recent income history and the impact of our current forecasts on dividends for 2020 and 2021.

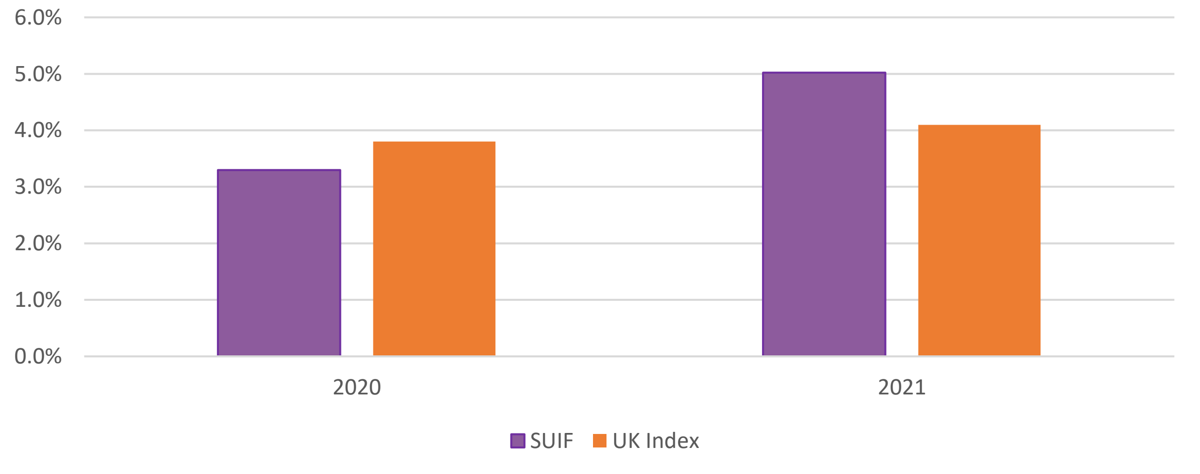
TB Saracen UK Income Fund Dividend



Source: Saracen Fund Managers

If we look at our forward forecast dividend yields for the Fund over the next two years, we have the portfolio offering a potential dividend yield of 5% by late 2021. Using Bloomberg estimate data this compares to a yield on the UK index of 4.1% at that point and an income return of effectively zero today from cash and UK gilts.

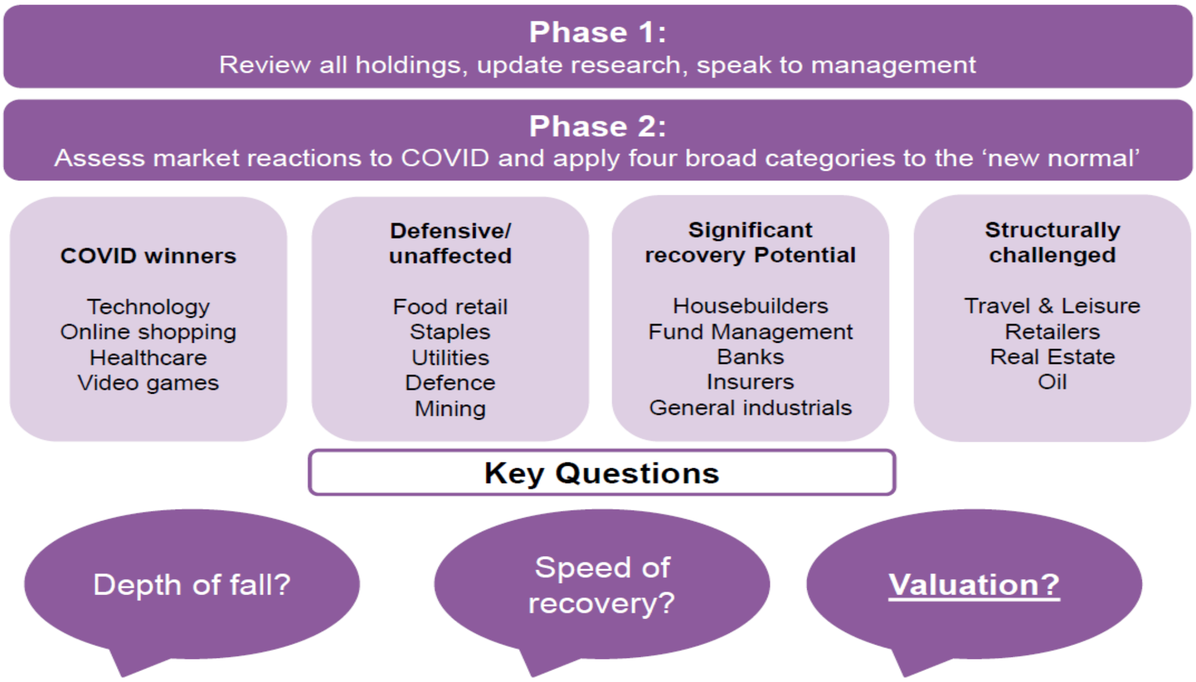
Fund v Index Forecast Dividend Yields



Source: Saracen Fund Managers, Bloomberg

Outlook

Since the COVID pandemic took hold in March we have had to quickly reassess what has become a very different world for us as investors and most of the businesses we invest in. Often this has been done against a background of companies themselves having no clear view of events and timescales. The dangers of using short term extrapolations are currently very high. The schematic below attempts to outline the approach we have taken since.



If there has been a positive to come out of this crisis it is that we have enjoyed more frequent and better access to the management of the businesses in which we invest and we have been able to reassess our positions fairly quickly (phase 1 – ongoing).

In many ways making the broad categorisations of phase 2 was fairly straightforward – there have been a number of clear winners and losers throughout the pandemic. However, that is the easy part of the exercise and identifying a cosy consensus does not necessarily help us improve returns to investors. To us the following questions therefore remain key – how far has the share price fallen (or risen), how quickly will the business recover its earnings/cashflow and what are the implications for long term valuations? This latter point is crucial. Pretty soon 2020 will be over and there may well be brighter skies on the horizon.

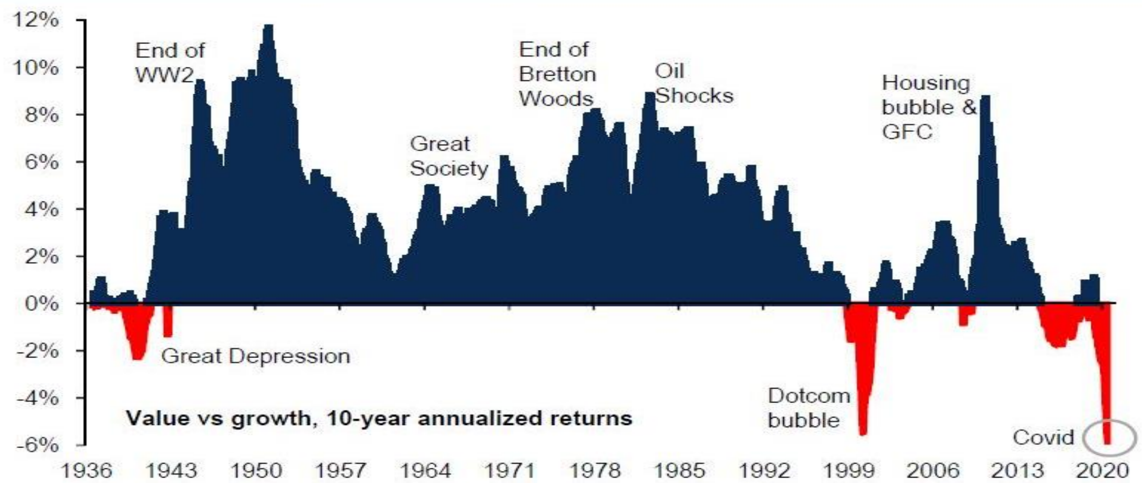
Taking all of the above into account we can broadly characterise the portfolio into three key earnings segments – 1) largely unaffected 2) recovery potential and 3) structurally challenged. The chart below is our assessment of all of our portfolio holdings, warts and all.

Largely unaffected	Recovery Potential		Structural ?
Alpha Financial Markets Consulting	Aviva	Johnson Matthey	National Express
BHP Group	Close Brothers	Jupiter	NewRiver REIT
FRP Advisory	DFS Furniture	Lloyds Banking	Palace Capital
Imperial Brands	Eurocell	Smith (DS)	Royal Dutch Shell
Intermediate Capital	Euromoney	STV	U&I Group
Paypoint	Gateley	Standard Life Aberdeen	
Phoenix Group	Halfords	Tyman	
Rio Tinto	Headlam	Vistry	
Synthomer	(John) Wood	WPP	
35% of Fund	**54% of Fund**		**11% of Fund**

More than half of the Fund by value we deem to have clear earnings (and share price!) recovery potential and this is the main area of the Fund where we have looked to add new ideas or increase our investments. These typically have very low valuations compared to their history, particularly when we look beyond the disruption seen in 2020. Readers could also rightly challenge the small proportion of the Fund held in structurally challenged areas. We shall remain vigilant and open minded with regard to these holdings but, in most cases, they could offer significant upside, albeit with high levels of risk attached.

Regular readers will be aware that the Fund employs a value-based process. The value premium has evaporated over the past decade and underperformance is now at levels not seen in living memory. In the UK the current value factor valuation discount sits at 65%, compared to a long run average of just over 35%. Whilst we are used to being somewhat out of fashion and going against the grain, the current market circumstances for value investors are more hostile than any we have seen previously in our careers, surpassing the tech boom of 1999/2000 and the GFC of 2008/09.

Global Value v Growth – A Longer Term Perspective

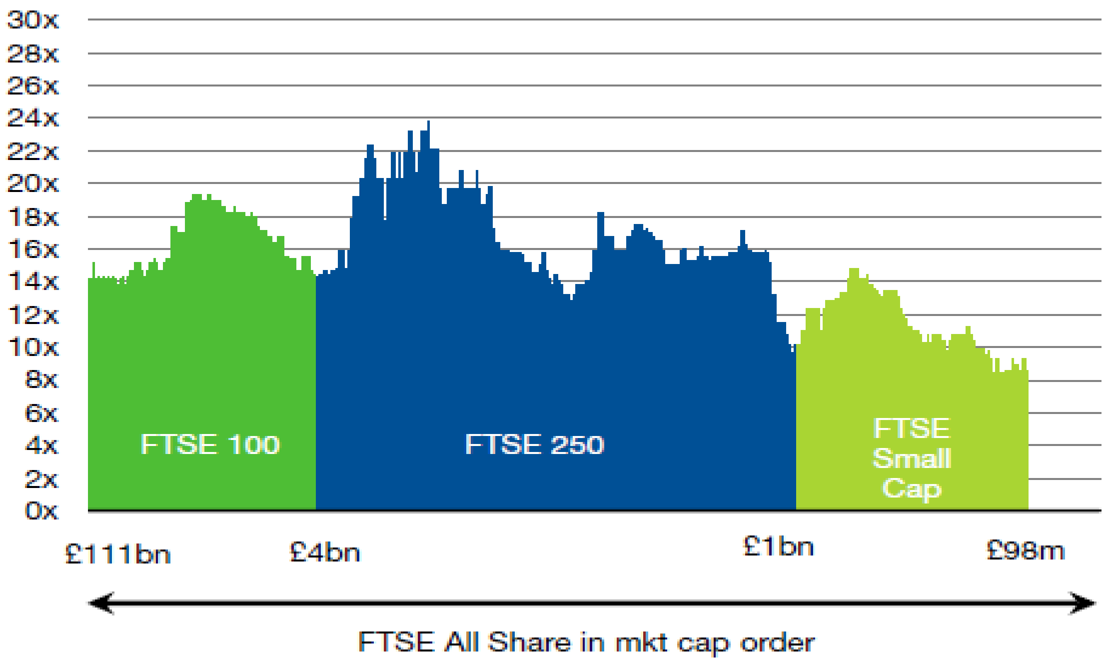


Source: BofA Research Investment Committee, Fama & French

Our commitment to investing in medium and smaller companies remains a key part of the Fund's philosophy and affords us the opportunity to cast our net far away from the maturity of the majority the FTSE100 index.

Whilst we have enjoyed a meaningful recovery in SMID indices during the past six months (and in AIM particularly) we would observe that a clear valuation discount remains the further down the market capitalisations we go. This can be rationalised to varying degrees. In times of crisis investors tend to seek more liquid safe havens and UK smaller companies also suffer from higher levels of domestic exposure and cyclicality in general. However, we do see a multitude of opportunity in small caps at present, providing the underlying quality and margins for error are there. The valuation gap is summarised nicely in the following chart.

12 month forward median PE ratios by size factor

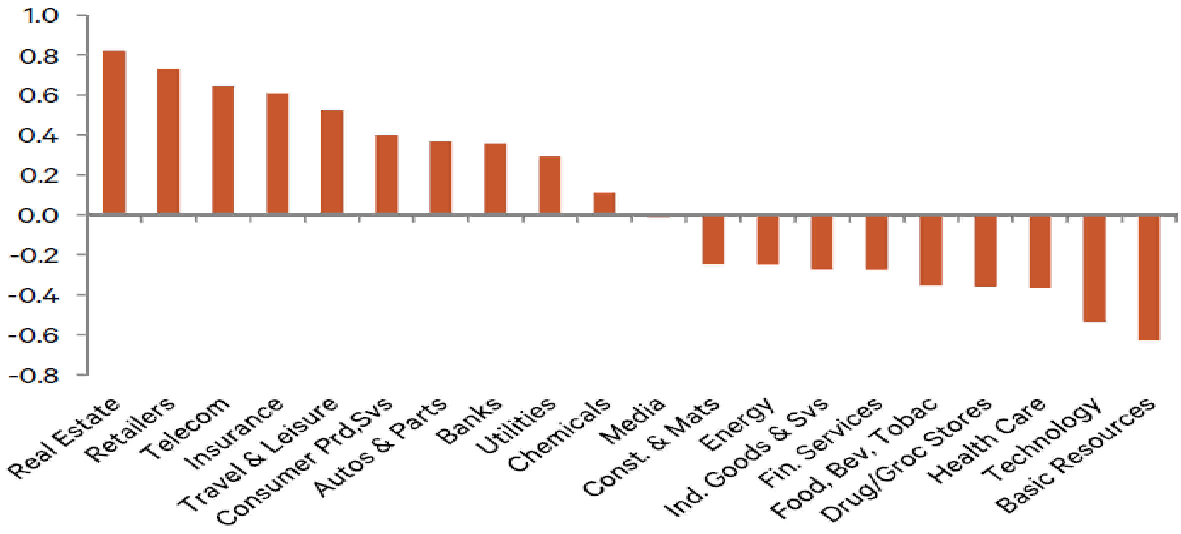


Source: Liberum, Datastream

Another related observation would be the potential for the valuation of domestic earnings to improve should Brexit be resolved in a remotely satisfactory manner before the end of 2020. This is an issue which must be resolved one way or another and was a theme that we utilised to the advantage of the Fund during the latter part of 2019 prior to the finalisation of the initial Brexit agreement but which has since unwound significantly.

Whilst we acknowledge the risks inherent here, we are happy for domestic earnings to remain a feature of the portfolio today given their recent performance and valuation gaps. It is a position which would clearly benefit from a strong pound should that ever come to pass. The chart below looks at correlations between UK sectors and a rising sterling.

FTSE350 Sector Correlations With GBP/USD



Source: Berenberg, Eikon

Conclusions

Whilst the Fund has made some good progress since the painful low points seen in March, we are mindful that there remains much work still to do to get back to our previous standards of performance. The broad UK market is down around 20% in the year to date, making it one of the worst performing global markets. Whilst it is easy to get downhearted about this, our rose-tinted view of this phenomenon is that we now have a considerable opportunity to buy shares in sound companies at bargain prices.

Our value-driven process has been sorely tested during 2020 but we strongly believe that the worst is now over for our style of investing. It feels like we have reached the end of the limits of monetary policy and the massive fiscal stimulus we are now seeing should hopefully benefit our positioning if inflation returns and bond yields rise from currently abnormally low levels.

We have recently seen bids for companies such as William Hill and G4S and it will be interesting to see if M&A activity picks up during this downturn, given the substantial cash resources available to private equity funds and corporates. Valuations will eventually matter and we remain resolute in our pursuit of value, having resisted the considerable temptation to change our course and process during these testing times.

As a result, we see great scope for the Fund to continue its recovery given the low levels of valuation in the portfolio. The ongoing challenges are clear but our focus is to continue to rebuild capital lost so far in 2020 ahead of a meaningful improvement in both capital and income during 2021. We shall remain 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.

In summary, the challenges we face remain broadly similar to those we outlined in our previous review but we continue to approach them with confidence and vigour.

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

Scott McKenzie, David Clark
8th October 2020

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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.

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Investment Manager - Saracen Fund Managers Ltd, 19 Rutland Square, Edinburgh, EH1 2BB Tel: 0131 202 9100/ Fax: 0131 221 1895

ACD & Fund Administrator – T Bailey Fund Services Limited (TBFS), 64 St James's Street, Nottingham, NG1 6FJ Tel: 0115 988 8274

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

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

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