TB Saracen UK Alpha Fund

Quarterly Review – December 2019

SARACEN
share success

Signatory of:
PRI Principles for Responsible Investment

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FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

	TB SUAF	MSCI UK All Cap (TR)	Relative
Q4 2019	15.4%	3.7%	+11.7%

Performance Summary

The Fund enjoyed a very strong end to the year with the shares rising by 15.4% over the quarter, well ahead of the 3.7% rise in the MSCI UK All Cap index. 2019 ended up being a vintage year, with the Fund rising 31.5% in value, significantly ahead of both the index and peer group funds. Our focus on small and midcap companies along with an ongoing valuation discipline allowed us to profit from anomalies throughout the year, despite a tricky summer period for the portfolio. A summary of performance is shown in the table below.

Cumulative Performance after all ongoing charges to 31st December 2019

	3 months	1 year	3 years	5 years
TB Saracen UK Alpha B Acc	15.4%	31.5%	43.3%	67.1%
MSCI UK All Cap Index (TR)	3.7%	18.3%	20.7%	41.8%
Sector Average	7.1%	22.3%	23.8%	43.9%
Quartile Ranking	1	1	1	1

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

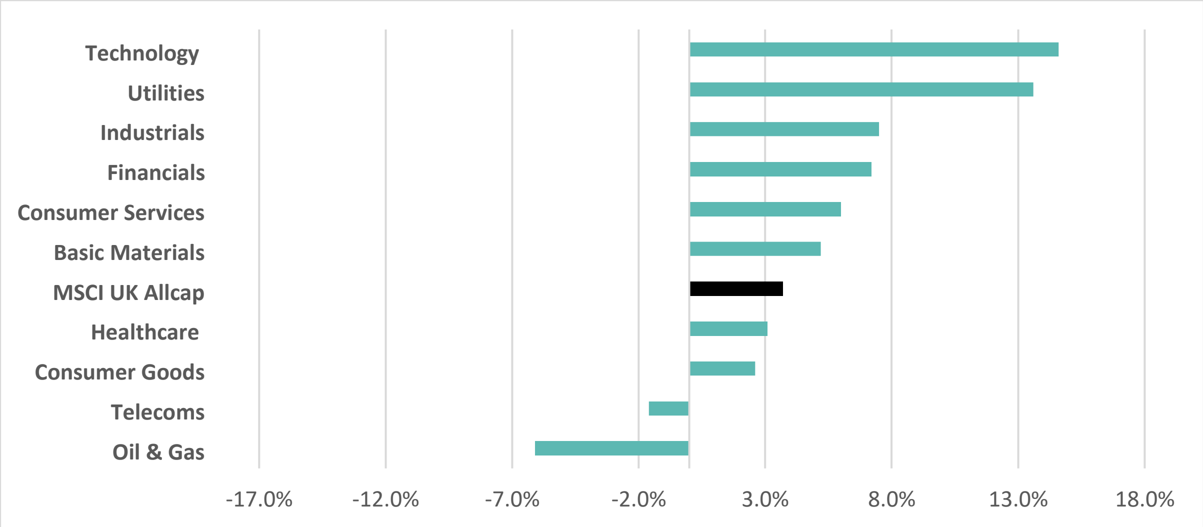
Market Overview

With a clear Conservative majority in the December election and a smoother path to Brexit emerging, we finally saw some much-needed clarity for UK investors, and the UK market responded positively during the quarter. It was particularly pleasing to see significant recovery in medium and smaller companies, especially in December. By contrast, many of the large international earners in the FTSE100 dragged their feet somewhat. There remains an ongoing tussle between growth and value styles but, in general, there was a welcome focus on valuations at last. All of these trends were positives for the Fund.

Total returns by capitalisation: 3 months to 31st December 2019	
FTSE100	2.7%
FTSE Mid250	10.4%
FTSE Smallcap	9.7%

At a sector level, the leaders were more cyclical in nature, with industrials and financials leading the way. Many of the leaders had a UK - centric bias, with sectors such as retail, construction, real estate and banks all bouncing strongly. Utilities recovered nicely as Corbyn and Labour collapsed during the election but most defensive sectors such as healthcare and staples failed to participate in the rally. The oil sector rounded off a fairly miserable 2019, falling a further 6% as investors continued to turn up the heat on ESG concerns.

UK sector total returns: 3 months to 31st December 2019



Source: Bloomberg

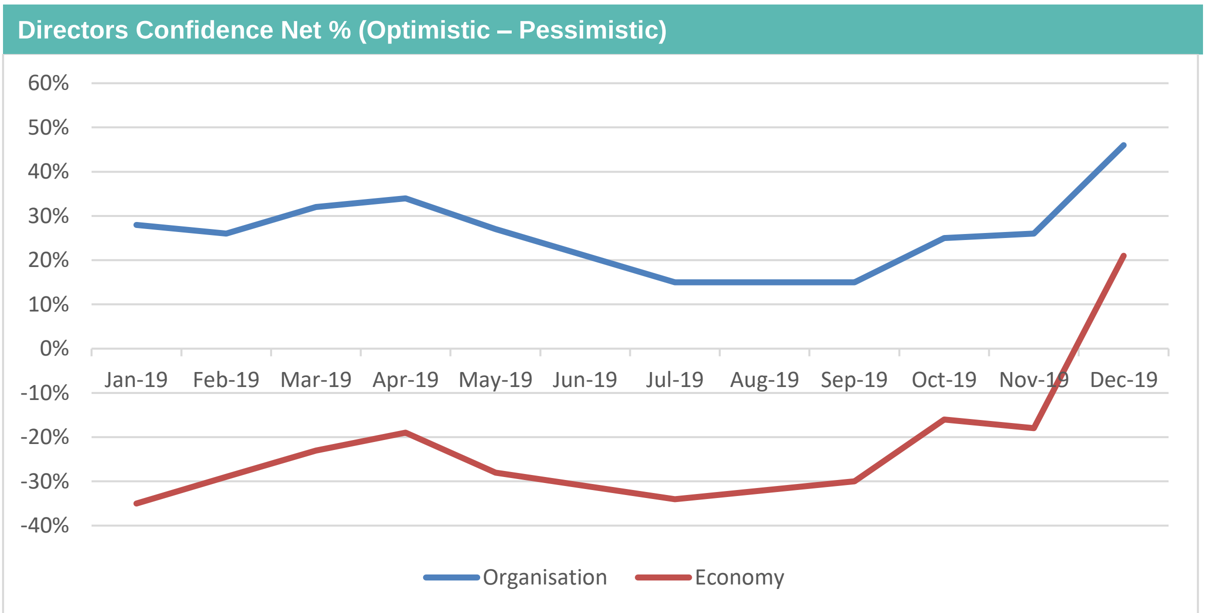
Throughout the quarter market participants remained focussed on the US/China trade war, the Brexit uncertainty, a global slowdown and margin pressure. However, this 'wall of worry' was climbed easily and global equity market returns for 2019 were strongly positive, in contrast to the weakness seen in 2018.

Across the pond the US market ended 2019 at an all-time high despite a slew of ongoing negative commentary. However, it is notable that this performance was driven strongly by a small number of the very biggest technology stocks in the market. It was therefore another poor year for active management in the US. By contrast active managers in the UK had a positive year as our previous data shows, with the average UK All-Companies unit trust outperforming the index over one, three and five years now, in contrast to the prevailing narrative that active management is dead.

After a year of steady falls government bond yields finally relented during the quarter, with yields rising in the key markets of the US, UK and Germany to 1.9%, 0.8% and -0.2% respectively. In general, there was slightly less doom and gloom re global recession around and perhaps a bit of ‘Santa’ optimism going into 2020.

Given the clear election outcome and the risk of the Corbynistas finally disappearing it was no surprise to see sterling bounce nicely, rising almost 8% against the dollar and 5% against the Euro. It still remains below the levels seen prior to the 2016 referendum but now appears to be in more stable territory.

Closer to home UK economic data and surveys remain uninspiring, with both the manufacturing and services PMI figures continuing to fall steadily. On a more positive note the chart below shows the effect of the victory of the Conservative party in the UK general election. The confidence of company directors both in relation to the economy and their own organisations has enjoyed a short-term boost. There are many unanswered questions on the horizon, notably the Brexit process, but some resolution has at least been seen in terms of political certainty. We can only hope that any improved sentiment translates to better UK economic performance from 2020 onwards



Source: Institute of Directors

In our own industry much attention has been given to the demise of the Woodford funds and the attendant causes of this. At the heart of this matter has been liquidity, or lack of it, and this has led to greater scrutiny of these issues across all manner of funds, including property unit trusts, where we saw the leading M&G fund ‘gated’ in response to redemption requests.

Whilst painful for those directly affected, as a small asset manager focussed on investment performance first and foremost, we welcome and encourage such scrutiny. The scramble in recent years towards widespread ownership of a small number of increasingly large open-ended funds is not a healthy one in our opinion. Liquidity and capacity are not problems we face at Saracen !

Investors have shunned the UK equity market for several years now, but it does look as though the pace of investment outflows has finally eased. The fact that we are all but certain to leave the EU now provides some much-needed clarity for the market, which may go some way towards restoring the UK's fortunes as an attractive market in which to invest. In addition, the UK offers one of the highest dividend yields globally, at around 4.5%.

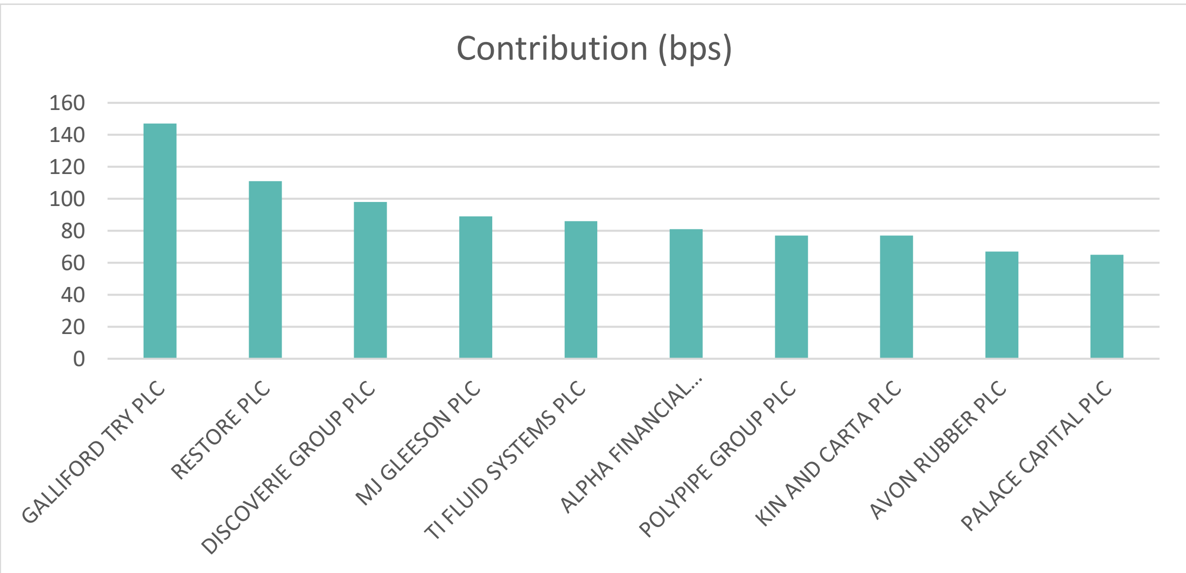
Portfolio Review

The portfolio has a 'multi cap' structure with high exposure to small and mid-cap companies, which make up over 70% of the portfolio. This strategic positioning has been beneficial to our results over the years as well as offering considerable long-term flexibility. Despite a relatively tricky year for UK smaller companies in general we have continued to find great value in this area of the market.

The focussed nature of the portfolio means that our results can often be quite different to the index and our active share is a measure of this, remaining at the high level of 93%.

Positive Contributors

Many of our holdings contributed handsomely to the performance of the Fund over the quarter.



Source: Saracen Fund Managers

The dominant themes over the quarter were our high exposure to UK domestic earnings along with significant weightings towards small and midcap companies

Our holding in **Galliford Try** (+35%) benefitted from an approach from Bovis Homes to purchase its housebuilding and partnerships businesses. In January 2020 we received shares in Bovis and a residual investment in the remaining Galliford. Positive sentiment leaked into other construction stocks with our holding in **MJ Gleeson** contributing meaningfully over the quarter (+22%) as well as **Polypipe Group,** where the shares rose by 32% in response to the clear election result and hopes of increased infrastructure spending.

Amongst our growth stocks **Avon Rubber** continued to respond positively to the proposed transformative acquisition of the 3M business and the stock rallied by 26%. **Restore** (+36%) continued its good run of form over the quarter as new management continue to improve results and focus whilst **DiscoverIE** (+33%) reacted well to further acquisitions and an equity placing during the quarter. **Alpha Financial Markets Consulting** (+22%) recovered nicely in response to solid results and a low starting valuation

At the value end of the portfolio **TI Fluid Systems** (+38%) enjoyed a strong run from what we perceived to be an absurdly low starting valuation. **Kin & Carta** had a good recovery (+24%) following results and an acquisition and equity placing, all of which were well received.

We had patiently built up exposure to small property stocks ahead of the election and both **Palace Capital** (+19%) and **U&I Group** (+15%) have bounced, again from low asset valuation levels. Other highlights in the financials sector included **Barclays** (+19%) and **Standard Life Aberdeen** (+15%). We had been of the view for some time that both stocks were materially undervalued, and they are now beginning to repay our faith.

Negative Contributors

The fund was mercifully free of negative contributions during the quarter with only two of our holdings falling and even then, not by much. The culprits were **Vitec Group** which posted a contribution of -0.2% and **Equiniti Group** which was a drag on performance of only -0.15%.

Vitec posted a somewhat underwhelming trading update in November citing issues with retail destocking and reset market profit expectations a little lower than previously. We are monitoring this situation very closely. With regards to **Equiniti**, the company updated the market in November saying that revenues were expected to be at the upper end of market expectations, but profits would be at the lower end of forecasts due to weaker higher margin corporate activity.

Portfolio Activity

The fund has 31 investments which are spread across a variety of market capitalisations. As at 31st December 2019, the breakdown of the portfolio by size was 21% in large cap, 19% in midcap and 53% in small cap/other. The portfolio held 7% in cash at the period end.

Purchases

There were two new purchases made during the quarter.

We bought transport retailer **Halfords** as we believe that management have a clearer strategy for the group in terms of restoring the brand and improving the services offer. Halfords has been a very poor investment in recent years, but we now believe the company has a sporting chance of success after a run of profit warnings and a dividend cut. At current levels we believe that the stock is heavily oversold and should give us considerable margin for error.

Clinigen is an interesting company operating in the healthcare sector, providing pharmaceuticals and services to pharmaceutical companies and other healthcare enterprises. We believe that this company has considerable potential and is trades at an attractive valuation.

During October we increased exposure to several existing holdings post some of the sharp declines we saw in valuations over the summer. These included **Kin & Carta, Polypipe, Galliford Try** and **Superdry**. In December we added to **Premier Miton** post the conclusion of the merger. All of these positions delivered subsequent rises in value, particularly post the election in December.

Sales

We made two outright sales during the period.

Although we have not held **Polypipe** for a long time it had performed very strongly since it was purchased, and the shares enjoyed a re-rating to a level that we felt that fully reflected the medium term potential of the company as we saw it. It was one of many stocks in the Fund to enjoy a significant post-election rally.

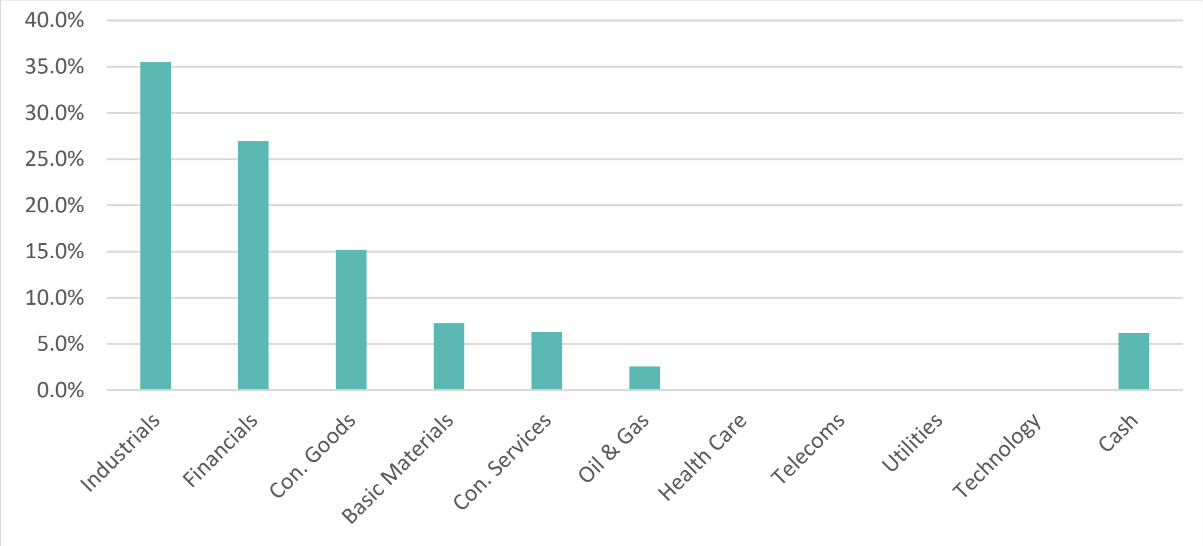
Post its demerger from Prudential, **M&G** became a separate listed entity in October 2019. We believe that this stock is better suited to income investors. The Alpha Fund has no income objectives and therefore we exited the small position

As the year ended, we reduced position sizes in a number of businesses which had delivered excellent returns to the Fund. These included Avon Rubber (+75% in 2019), Melrose (+47%), Restore (+69%) and DiscoverIE (+57%). This is consistent with our strategy of focussing on the best valuation opportunities at all times whilst running winners as long as they continue to deliver.

Portfolio Strategy & Themes

The chart below highlights the mix of the portfolio by sector. It is important to note that we do not run the fund using a sector strategy – the portfolio construction remains resolutely bottom up. However, there are some stock selection themes which emerge.

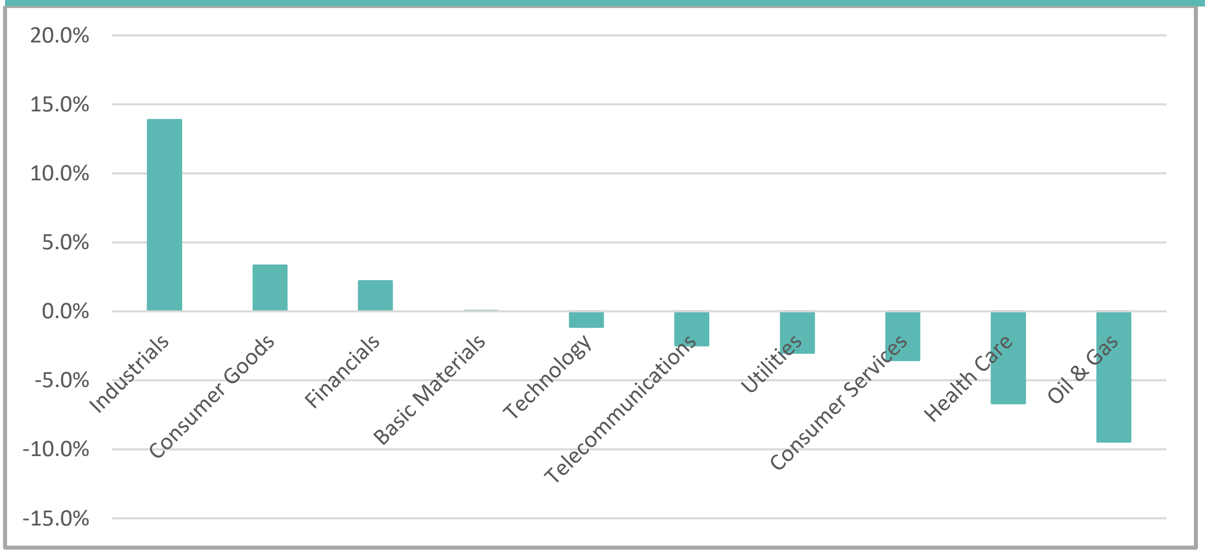
TB Saracen UK Alpha: Sector Profile



Source: Saracen Fund Managers as at 31.12.19

Given our strategic commitment to medium and smaller companies, we remain long sterling assets and short overseas earners compared to a broad UK benchmark. Our current portfolio positioning has therefore benefitted from the clear election result, which saw a recovery in sterling and a re-rating of domestic earnings during December. Hopefully we will now progress on to some kind of satisfactory conclusion to Brexit. Should a 'no deal' scenario be avoided then we would expect to see continued good momentum for the Fund in general.

TB Saracen UK Alpha: Sector Active Weights



Source: Saracen Fund Managers as at 31.12.19

The worst performing sectors in the UK over the quarter were Oil & Gas and Telecommunications. The Fund is underweight in oil with no holdings in the large integrated companies and we hold nothing in telecoms either. We also have modest exposure to the Pharmaceutical and Healthcare sectors where we struggle to find cheap stocks.

We now have a healthy weighting in the Financials sector, but most of our holdings are smaller, growing companies. We own only one bank (Barclays) and also hold Standard Life Aberdeen, where we see value on a sum of the parts basis. The balance of the financials exposure is in real estate, where we see considerable upside potential post the election in what is an unloved sector.

Whilst our exposure to 'industrial' sectors is significant it is mainly in smaller 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

We continue to have no investments in utilities as we dislike their levels of debt, albeit the risk of political interference has receded with the outcome of the election and the sector has bounced accordingly. We are still not tempted, however and we continue to expect further dividend cuts in this sector.

We have no exposure to consumer staples where we see significant valuation risks and low underlying growth. This was broadly helpful during the quarter with a number of these stocks falling in value.

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 31 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 72% of the fund with large companies only 21%. We have a cash balance of 7% 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 (37%* 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 (30%* 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 (26%* 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 December 2019, 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

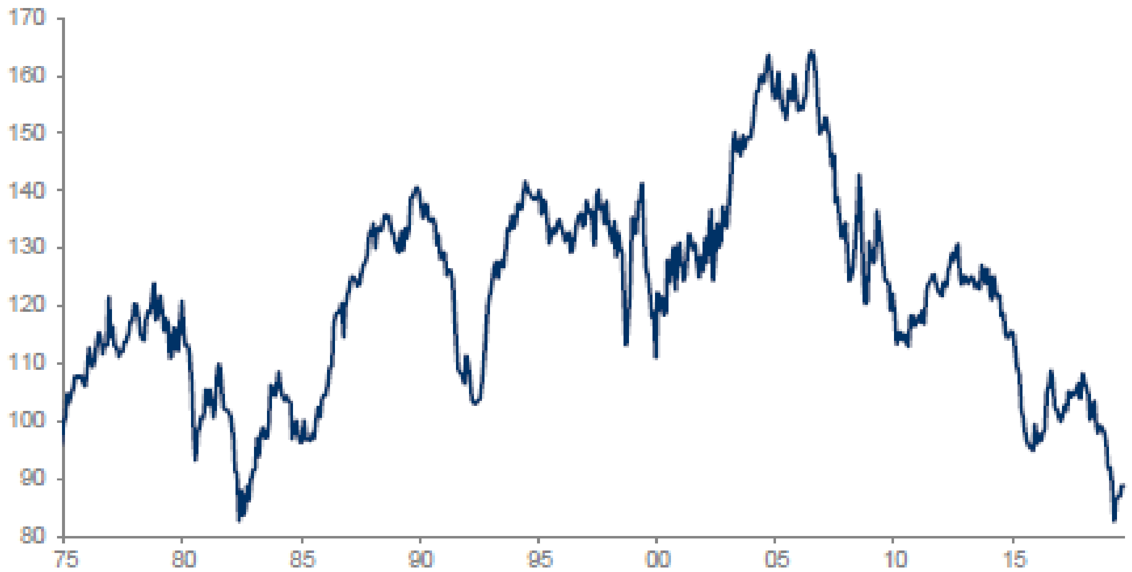
Since our last quarterly review, the world has moved on a bit. On the international front there are some signs of trade tensions between the US and China easing and, in the UK, the general election has come and gone. Our portfolio has been a beneficiary of the Conservative victory which, on the whole, we expected. What we did not expect was the scale of Labour's defeat. That the UK will formally leave the EU before the end of January 2020 now looks all but certain. This does not mean of course that we have heard the last of Brexit. Far from it. Now the hard work really begins in connection with the negotiation of the terms of trade and all the other myriad of details that have to be settled. Boris Johnson seems committed to making this all happen before the end of the year. It is a big ask and doubtless there will be many wobbles along the way.

After a 20% derating against their global peers over the last three years the recent improvement in UK equity performance has begun to address the significant under valuation of UK equities. As can be seen from the chart below both the FTSE 100 and the FTSE Small Cap indices continue to lag their medium-term average valuations as measured by the 12-month forward PE ratio. The same cannot be said for the FTSE 250 index which has become progressively more expensive as 2019 went on, having posted particularly strong performance during the final quarter. We continue to believe that there exist some excellent investment opportunities among UK smaller companies which have been left behind as a result of outflows from small cap funds and poorer liquidity in general in this particular asset class.

12 Month Forward PE Ratios : UK Indices

Source: Morgan Stanley Research

UK Value v Growth Price Performance

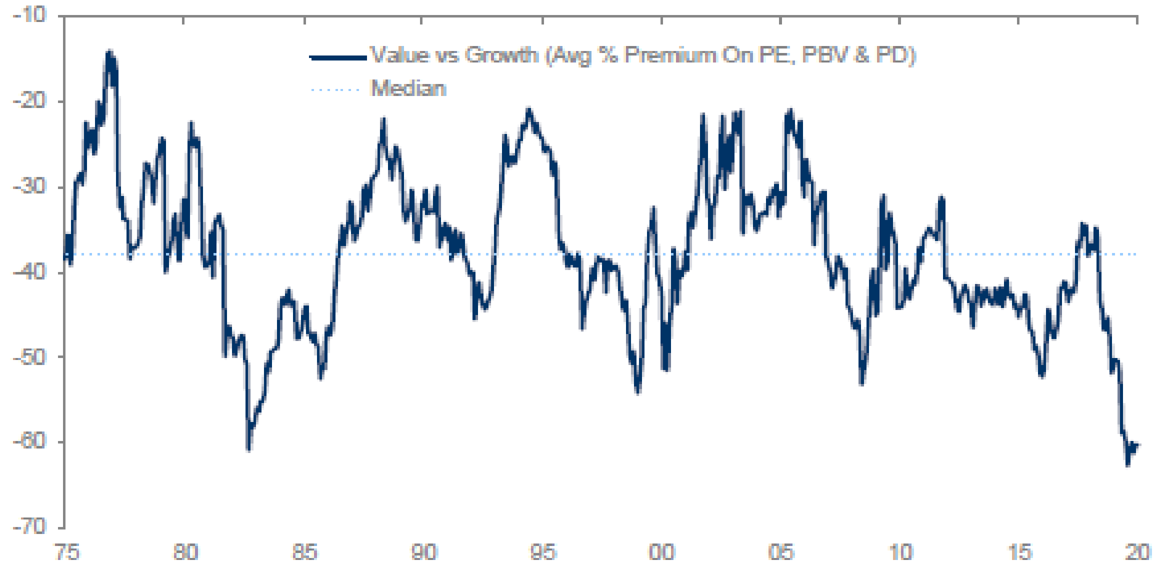


Source: MSCI, Morgan Stanley

As we have pointed out many times before, there is clear evidence that a value based approach to investment does work well over the longer term. There has been much chat in the financial press over the last quarter discussing whether the current ten years or so of growth share price dominance was coming to an end. Hindsight will be the truest judge of this, but we would be keen to point out, as the chart above demonstrates, that the recent bounce in value stocks is but a mere blip when viewed in proper historic context.

Indeed, when one looks a bit more closely at the comparative valuation data, it can be seen from the chart below that value stocks are still trading at a significant discount to growth stocks. It is likely that not all of this discount can be accounted for simply by the unpopularity of value strategies, with the premium currently paid for growth stocks akin to an almost universal worship at the feet of the gods of growth. We are as fond of a good growth stock as the next person, but not at any price and are very sceptical of some of the multiples that investors are being asked to pay for growth which may not be all that spectacular in any case.

MSCI UK Value v Growth – Valuation Premium

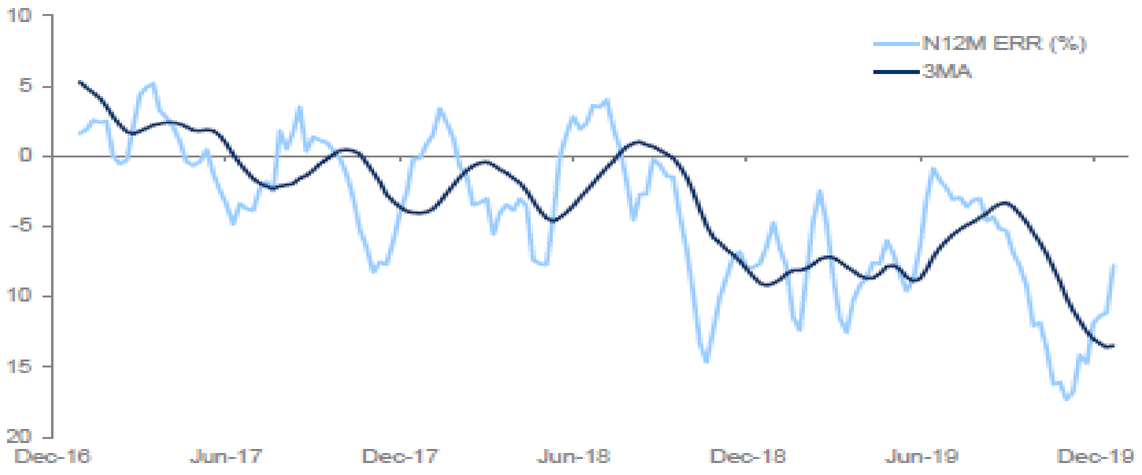


Source: MSCI, Morgan Stanley

Traditionally UK equities have exhibited a strong inverse correlation with sterling and a continued recovery in sterling may provide something of a headwind for performance in the UK. We believe that the UK Alpha fund would be somewhat insulated from this due to its heavy small and mid-cap bias, being much more exposed to domestic earnings and less susceptible to the vagaries of the currency markets.

Another point worth bearing in mind is that downgrades have been very much outnumbering upgrades in the UK market for a couple of years now as the chart below illustrates. Although that ratio has been improving over the last month or two, it is still in negative territory and, given the recent recovery in markets, we need to see evidence of better earnings trends going into 2020.

MSCI UK – Next 12 Months Earnings Revision Ratio



Source: MSCI, Morgan Stanley

What does all of this mean for Saracen UK Alpha?

After a tricky summer period the Fund enjoyed an excellent end to 2019 and therefore posted strongly positive returns for the year as a whole. This has meant that the huge disparity between value and growth/quality factors is no longer quite so extreme. The rally in sterling has led to a resurgence of interest in our smaller company investments. The extreme dislocations across asset classes that we identified in our previous reviews are no longer quite so extreme and there are ongoing signs of some bubbles now bursting.

We have been talking about this for some time and we are glad to see some signs of sanity returning to market valuations. At Saracen we have nothing against 'growth' stocks – indeed we are fans of them. Where we differ from the market mood is that we are simply not prepared to pay any price for that growth.

Valuation does matter and our core process and philosophy of focussing on value will not change. The third quarter of 2019 was a testing time for our portfolio, but we stuck to our guns and this has paid off with gusto in the fourth quarter. We remain comfortable deviating considerably from the benchmark index as we firmly believe that the pay-off is worth it. That said, we must be alert to any signs of 'value traps' and avoid them whenever possible.

Following the moves in the fourth quarter we have seen the valuations of some smaller and mid-cap stocks begin to look a bit toppy. To that end we have been taking a bit of money off the table and banking some profit. This is entirely consistent with our usual approach and we are content to recycle the monies into more obviously attractive investment opportunities.

Market sages and the newspapers are constantly reminding us that there is a huge 'wall of money' out there being held by private equity firms ready to swoop on oversold and undervalued assets. Recent estimates exceed $2.5trillion.

We expect takeover approaches to be something of a feature during 2020. Now that the Brexit question is at least partially answered and the political outlook more stable the UK is unlikely to remain a pariah for investment strategists to the extent that it has in the more recent past.

Our commitment to investing in medium and smaller companies remains intact but we must remain vigilant in applying our tried and tested investment process and guard against complacency after a strong 2019. The UK market is settling down in the post MiFID 2 environment with more understanding among all market participants as to how this is working in practice. What is clear is that there is less research being done in the small and mid-cap space, which presents opportunities for funds such as the UK Alpha Fund and organisations such as Saracen.

Whilst the Fund does not have a dividend objective the income on offer from UK shares remains very attractive relative to current abnormally low gilt yields and interest rates. Our ongoing priority is to maximise shareholder returns by remaining focussed but open minded in our approach and we believe that our flexible ‘multi-cap’ approach will continue to serve us well over the long term.

David Clark, Scott McKenzie
9th January 2020