TB Saracen UK Income Fund

Quarterly Review – December 2019

Signatory of: PRI Principles for Responsible Investment

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FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

	TB SUIF	MSCI UK All Cap (TR)	Relative
Q4 2019	12.6%	3.7%	+8.9%

Performance Summary

The Fund enjoyed a very strong end to the year with the shares rising by 12.6% 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 26.2% in value, well 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	Since launch*
TB Saracen UK Income B Acc	12.6%	26.2%	35.9%	40.8%
MSCI UK All Cap Index (TR)	3.7%	18.3%	20.7%	35.2%
Sector Average	7.2%	20.1%	19.6%	30.5%
Quartile Ranking	1	1	1	1

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

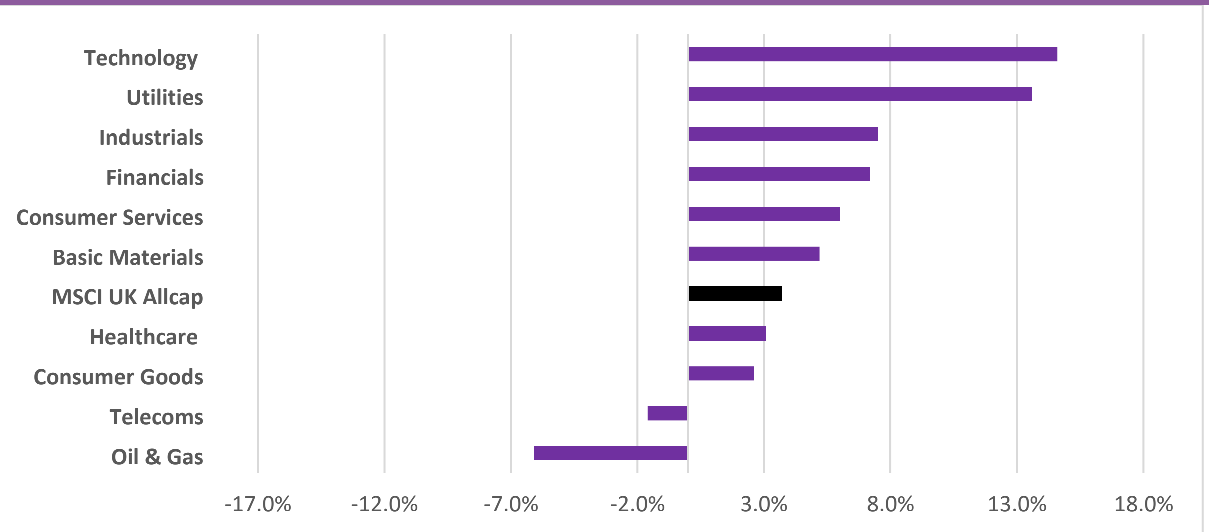
Market Overview

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.

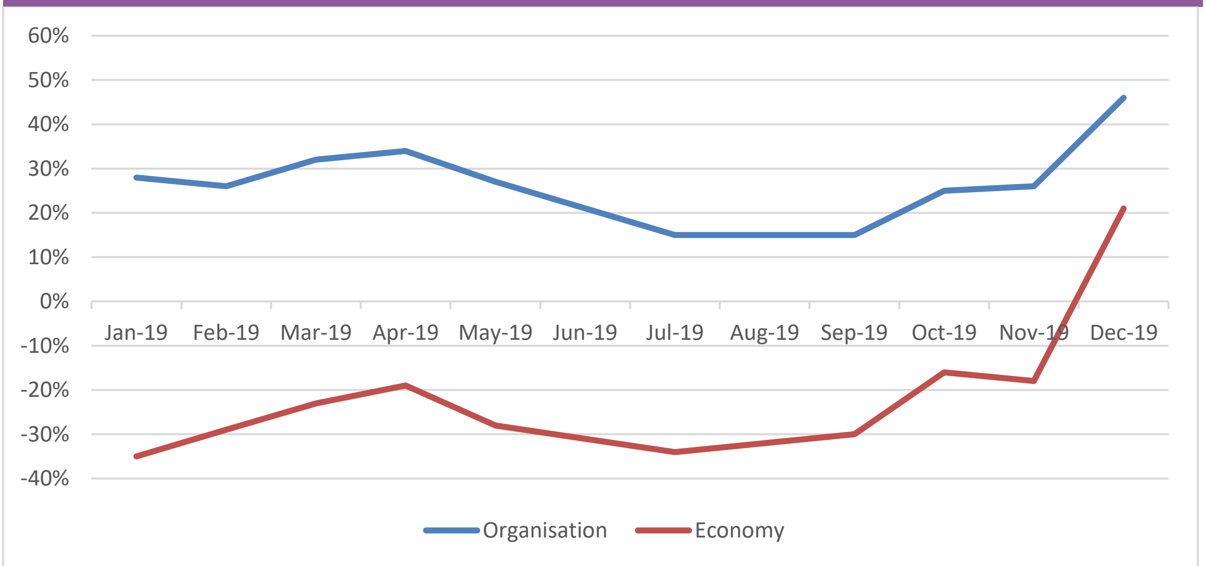
Across the pond the US market ended 2019 at an all-time high despite a slew of ongoing negative commentary. However, it is notable that this performance was driven strongly by a small number of the very biggest technology stocks in the market. It was therefore another poor year for active management 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

Directors Confidence Net % (Optimistic – Pessimistic)



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

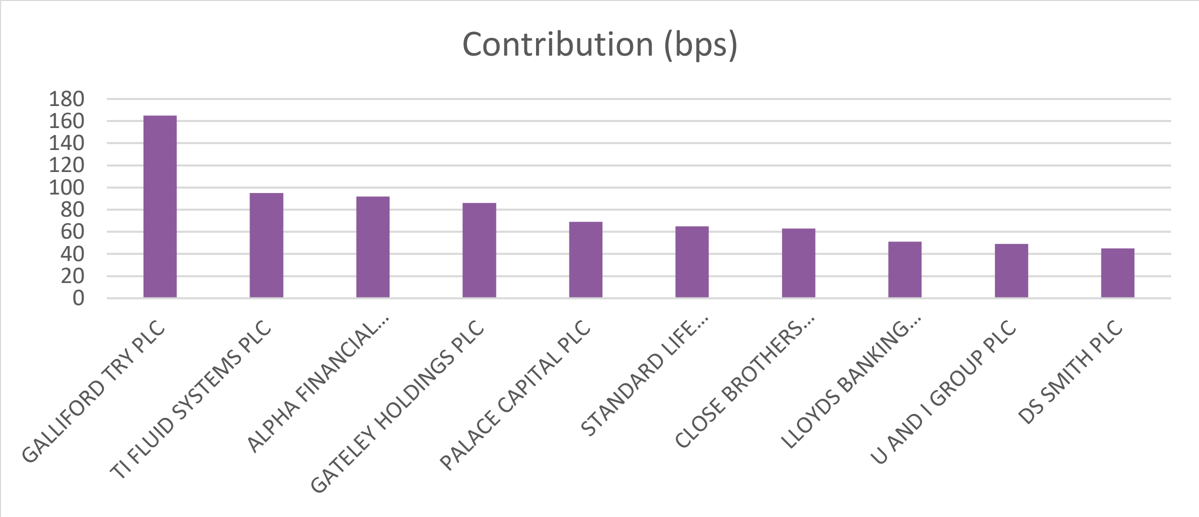
The portfolio has a 'multicap' structure with high exposure to small and mid-cap companies, which make up around 60% of the portfolio. This strategic positioning has been beneficial to our results over the years as well as offering considerable long-term flexibility. Despite a fairly volatile year for UK smaller companies in general we have continued to find value in this area of the market and view current concerns about market liquidity as a great opportunity. The focussed and differentiated nature of the portfolio means that the Fund has a high active share, currently at 89%.

Positive Contributors

It was a quarter where many things went right for the Fund, with our high exposure to domestic earnings and mid and small cap companies leaving us ideally positioned for the clear outcome in the December election. Our increased exposure to UK-centric sectors such as construction was particularly beneficial, with our holdings in Galliford Try, Ibstock and Eurocell rising by 35%, 27% and 22% respectively.

Our investments in small real estate stocks finally began to pay off, with Palace Capital rising by 18% and U&I bouncing by 15%. In general, our high exposure to financial stocks was positive with Close Brothers up 17% and Lloyds and Standard Life Aberdeen both rising by 15%.

The chart below outlines our largest contributors for the period overall.



After a fallow period for small companies over the summer we had a number of notable positives including Alpha FMC (+22%), Gateley (+21%), Superdry (+22%) and Headlam (+20%). The final positive trend of note was a broadly based recovery in some of our lowly valued, more cyclical businesses with TI Fluid Systems (+38%) being a key contributor.

All in all, it was a quarter when our patient, value-led approach finally began to pay off, with the historic under valuation of UK equities beginning to correct in the aftermath of the election.

Negative Contributors

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. There were a few stocks producing disappointing trading updates such as Synthomer and Imperial Brands. Despite this, they managed to deliver positive returns for the Fund.

Portfolio Activity

The fund has 29 investments which are spread across a variety of market capitalisations. As at 31st December 2019, the split of investment was 35% in large cap, 27% in midcap and 31% in small cap/other, leaving 7% in cash.

Purchases

There were no new stock purchases made during the quarter, and the portfolio was generally well positioned to benefit from more positive sentiment towards UK-centric businesses post the clear election result.

During October we increased exposure to a number of existing holdings, post some of the sharp declines we saw in valuations over the summer. These were mainly in domestically focussed businesses and included **U&I Group, Galliford Try, Halfords** and **Superdry**. These additions proved to be timely, with all of these holdings delivering subsequent rises in value, particularly post the election in December.

Sales

There were three holdings sold outright from the portfolio during the quarter.

Kin & Carta has attractive long-term recovery prospects but was sold when it became clear that rebuilding the dividend was unlikely to be a priority. The holding in **Bovis** was switched into Galliford Try ahead of their transaction as we deemed the Galliford 'rump' business to be materially undervalued. The holding in **Ibstock** was sold after a significant re-rating post the election, realising a substantial profit for the Fund.

In addition, we reduced the holdings in Standard Life Aberdeen and TI Fluid Systems, both of which enjoyed meaningful recovery in the latter part of 2019

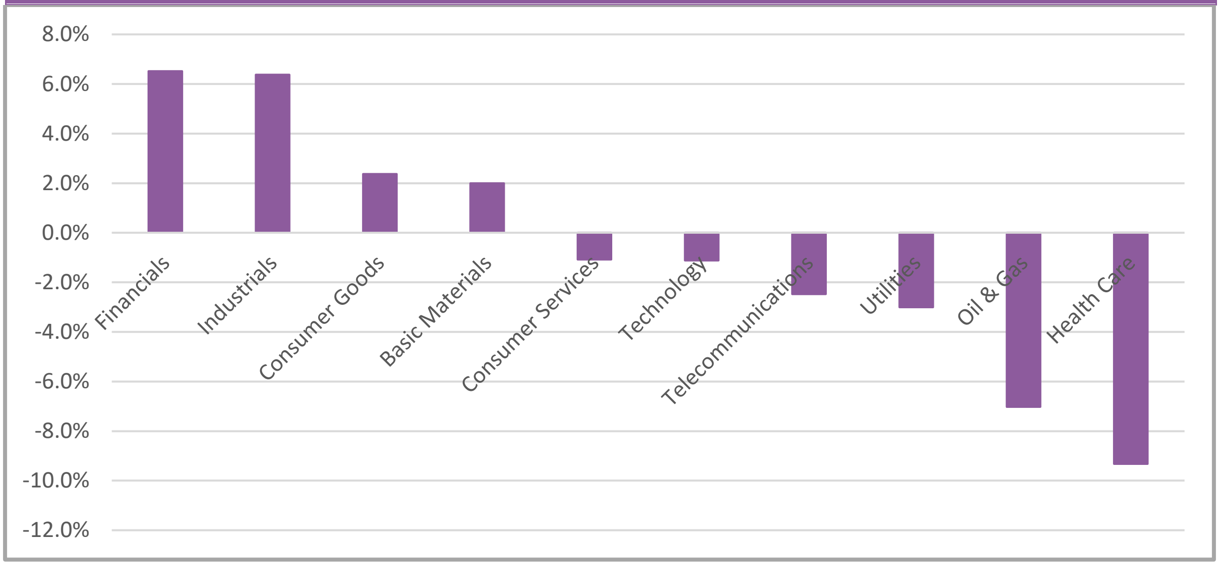
Portfolio Strategy & Themes

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.

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 Income : Sector Active Weights



The worst performing sectors in the UK over the quarter were Oil & Gas and Telecommunications. The Fund is underweight in oil with only modest exposure to the large integrated companies and we hold nothing in telecoms either. We also have no exposure to Healthcare, a sector where we find attractive levels of income difficult to find.

We have around one third of the portfolio in the financial sectors and see this segment as an important source of dividend income for the Fund. Our investments in banks are purely domestic (Lloyds and Close Brothers) and we see reduced risk here post the election. We still have meaningful exposure to asset management with Intermediate Capital continuing to produce excellent dividend growth for us. Standard Life Aberdeen is an acquired taste, but 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.

Our exposure in the industrial sectors 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 Income Fund aims to provide income exceeding 110% of the dividend income of the MSCI UK All Cap index and a total return which is superior to that index.

We have a focussed portfolio of 25-35 quoted UK companies, a 'best ideas' fund with a high active share, currently 89%. We generally ignore index construction considerations.

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 just under 60% of the fund and large companies 35%, with a cash balance of 7%. 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 either of the following categories:

High Yield (51% of portfolio)*

Businesses which are facing challenges at present but who we believe offer secure, high dividend yields. A typically uninspiring bunch of companies but there to do the heavy lifting for shareholders' income. At times companies in this group will cause us some heartache, often being reviled by others and being vulnerable to the risk of dividend cuts.

Dividend Growers (42% of portfolio)*

These are companies with essentially bright or improving prospects which can compound into high levels of dividend growth. They may offer modest yields at purchase but have the potential to become high yielding over the medium term. We hope that in due course they become the dividend stocks of tomorrow, whilst driving increased income to shareholders.

** as at 31.12.19, source Saracen Fund Managers. Note – balance of 7% in cash*

To summarise, the TB Saracen UK Income Fund looks to invest in companies with secure and (ideally) growing dividends. If we do this job well, they should be able to be held in the portfolio for many years, thereby minimising trading costs.

Fund Income

The Fund announced a final dividend of 3.22p per income share which was marked 'XD' on 2nd January 2020. Dividends per share for 2019 in total were 5.72p, which was an increase of 9% on the 5.24p paid in 2018. This was the second successive year of 9% dividend growth. The historic yield of the Fund is currently 5.0%, based on the income share price of 113.97p as at 31st December 2019.

The forecast portfolio dividend yield based on our current expectations is 5.4%. This assumes growth in income from the portfolio over the next twelve months of 3%, which should be slightly ahead of inflation. The forecast dividend yield for the UK market as a whole is just below 4.5% but future UK dividend growth is highly sensitive to sterling/dollar rates. Only 13% of the Fund's income is non-sterling denominated, significantly less than the index and most other equity income funds, leaving us far less exposed to an increase in sterling should it happen.

Given the already high payout ratio and significant dividend yield on offer from UK shares in general, we would expect overall dividend growth to slow in the years ahead. After several years of significant growth in the Fund's dividends to shareholders we expect only modest growth for 2020. As always, we shall attempt to grow income in real terms, but given the major increases in income seen during 2018 and 2019, this will be something of a challenge in the year ahead.

Outlook

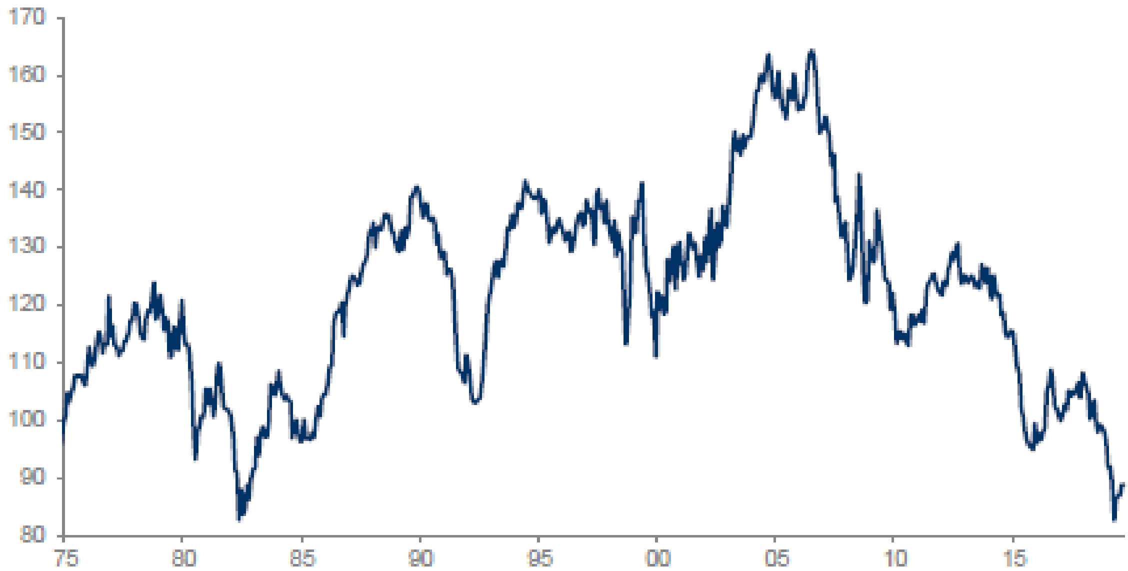
Since our last quarterly review, the world has moved on a bit. On the international front there are some signs of trade tensions between the US and China easing and, in the UK, the general election has come and gone. Our portfolio has been a beneficiary of the Conservative victory which, on the whole, 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

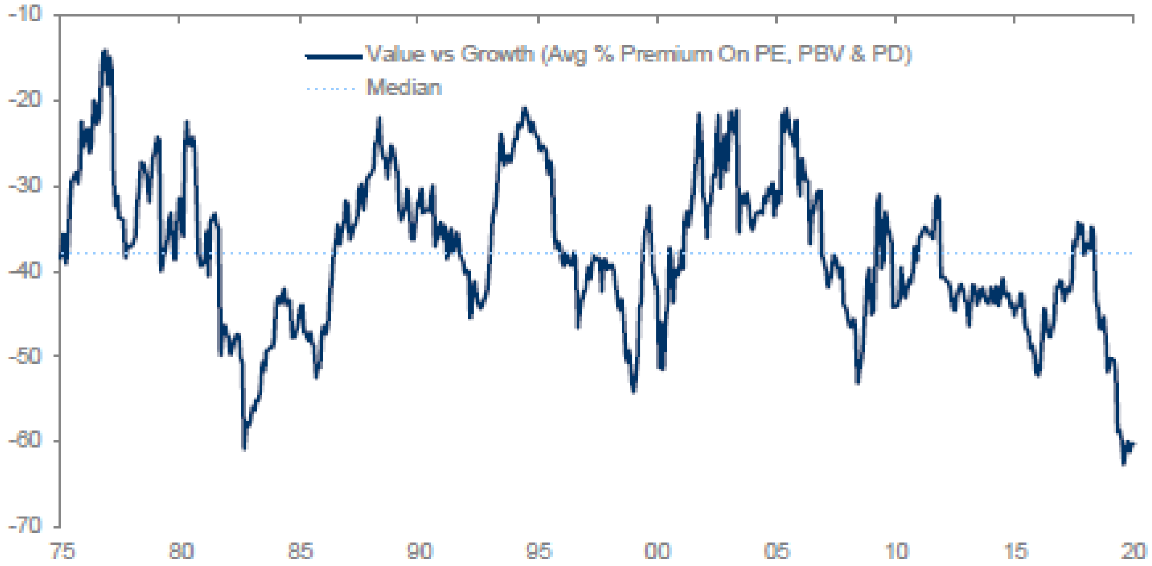


Source: MSCI, Morgan Stanley

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

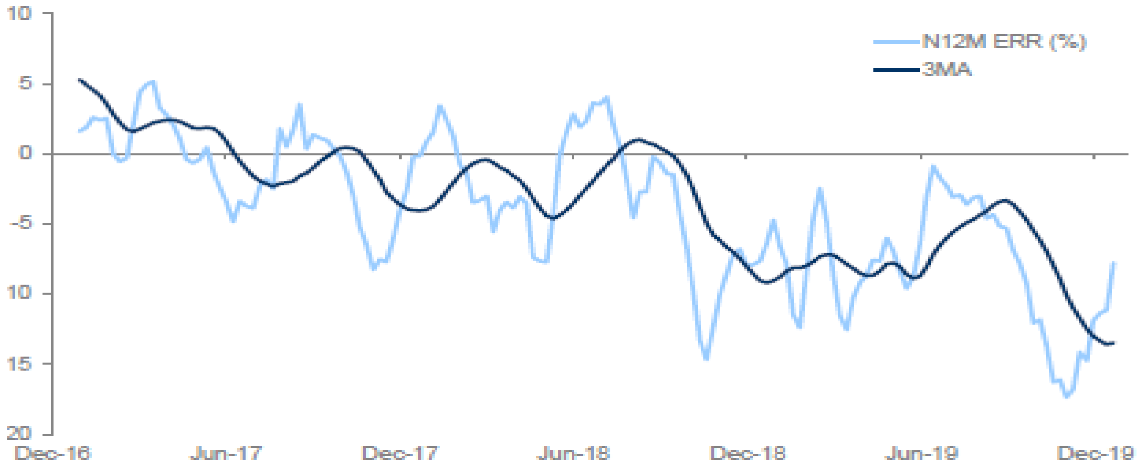


Source: MSCI, Morgan Stanley

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 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, IBES, Morgan Stanley

What does all of this mean for Saracen UK Income?

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. Despite significant headwinds (and long periods of doubt) we have stuck doggedly to our value-based principles, and this began to translate to improved returns towards the end of the year.

The huge disparity between value and growth/quality factors has begun to narrow but we still this trend as having a long way to go, and there remain a number of bubble-type characteristics in certain segments of the markets. Our core process and philosophy of focussing on value will not change and, although it can be testing having a portfolio and style that diverges significantly from a benchmark index, we are comfortable being part of a minority group in this respect, despite it feeling both lonely and painful at times.

The recent rally in sterling is positive for our strategy overall although there remains much to do if we are to see a positive and prosperous conclusion to the Brexit saga. Now that the election has improved political stability, we would hope to see increased takeover activity in the UK market going forward. We remain committed to having a significant exposure to medium and smaller companies in the long run and see ongoing opportunities here, as liquidity concerns continue to ask questions of larger funds.

Bond yields remain stubbornly low and this has been a headwind for many of our holdings in the financial sectors. However, we remain of the view that the low government bond yields on offer today will end in tears at some point and we believe that many of our portfolio companies offer a far better risk/reward profile for the income they offer. The UK equity market has been hugely out of favour with investors the world over in recent years and this has just started to reverse. Whilst the risks of a difficult Brexit outcome or a global recession are clear and present, we see good margins for error in many of our current investments. We are now seeing some of the potential value in many of our portfolio holdings being unlocked and we are optimistic that this can continue.

To conclude, 2019 was a challenging but rewarding year for TB Saracen UK Income and we were able to navigate a great deal of uncertainty whilst remaining true to our value principles. We believe that our flexible 'multi-cap' approach, combined with a focus on a high and growing income, give us a good possibility of continuing to achieve positive real returns over the long term.

Scott McKenzie, David Clark
9th January 2020