TB Saracen UK Alpha Fund

Quarterly Review – September 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
Q3 2019	-0.3%	0.9%	-1.4%

Performance Summary

It was a difficult summer for our strategy and, despite a good recovery in September, the Fund lost a little relative ground during the third quarter with the shares falling by -0.3%, which lagged the 0.9% rise from the MSCI UK All Cap index. This was also behind the increase of 1.0% in the IA UK All Companies sector (source: FE Trustnet). A summary of performance is shown in the table below.

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Cumulative Performance after all ongoing charges to 30th September 2019

	3 months	1 year	3 years	5 years
TB Saracen UK Alpha B Acc	-0.3%	-5.1%	28.5%	49.4%
MSCI UK All Cap Index (TR)	0.9%	2.0%	20.8%	37.0%
Sector Average	1.0%	0.0%	19.9%	36.6%
Quartile Ranking	4	4	1	2

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

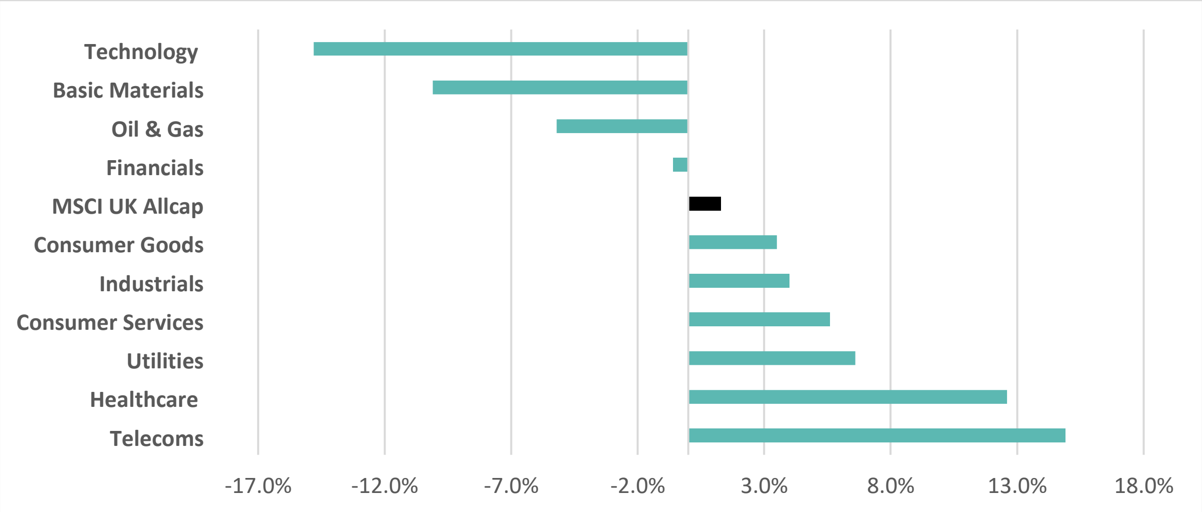
Market Overview

Whilst the UK market eked out a small positive return during the quarter the underlying pattern was a volatile one, with notable weakness in August offset by a good recovery during September. This pattern was repeated globally, with the MSCI World index returning 0.5%. There remains an ongoing tussle between growth and value styles, with growth investors having enjoyed over a decade of superior returns now. Closer to home we saw further underperformance from UK smaller companies, which remains a headwind for the Fund.

Total returns by capitalisation: 3 months to 30th September 2019	
FTSE100	1.0%
FTSE Mid250	3.3%
FTSE Smallcap	-1.0%

At a sector level, it was a very mixed bag, with a number of extreme variances. The clear leaders were generally defensive in nature with healthcare continuing its run of form and both telecoms and utilities recovering from long periods of underperformance. By contrast, the bull run in basic materials such as mining began to unwind in response to the US/China trade war and the financials sectors in general laboured once again, under further pressure from ever-decreasing bond yields. Despite the Saudi attacks the oil sector drifted as oil prices remained depressed and investors turned up the heat on ESG concerns.

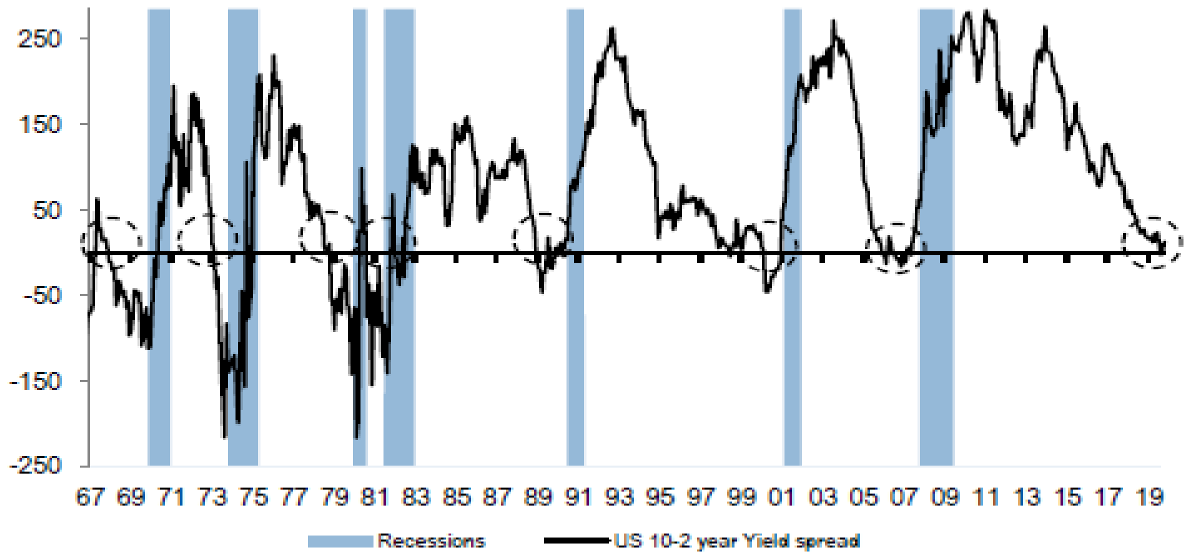
UK sector total returns: 3 months to 28th June 2019



Source: Bloomberg

As before, Brexit and global trade disputes remain huge concerns for investors, with both situations going from bad to worse, leaving the outlook particularly uncertain and difficult to navigate. The dramatic falls we have seen in government bond yields globally have continued, with inverted yield curves everywhere historically serving as an early warning of global recession. This has been compounded by weak survey data, with the recent very poor ISM manufacturing data from the US causing alarm across global markets.

US Yield Curves and Recessions



Source: Datastream, NBER, JP Morgan

For the fourth consecutive quarter, bond returns were positive and yields fell again in the key markets of the US, UK and Germany to 1.7%, 0.5% and -0.6% respectively. We have to acknowledge that we are something of a stuck record on this point, but the idea of investors lending to any of the current crop of political leaders in the UK at such rates gives us a cold sweat. Bloomberg currently estimates that around $15 trillion of global bonds now offer negative yields. There are far cleverer souls than us who can explain and rationalise such a phenomenon, but we struggle to see plunging economic growth and negligible inflation persisting for a long enough time period for the buyers of such assets today to get a positive return. By contrast, many equity markets offer high and growing dividend streams, something which, in the long run, should not be ignored.

Despite a wave of negative commentary the US market remains close to it's all time highs. However, there are early signs of sanity prevailing and valuation beginning to take centre stage again. This has manifest itself in the postponement of the WeWork IPO along with the miserable post listing performance of loss making 'unicorns' such as Uber, Lyft and Slack. In the UK market we have seen similarly troubled new issues such as Amigo, Funding Circle and Aston Martin Lagonda, all of which have collapsed in value shortly after floating. A number of highly rated market darlings such as Netflix, Fevertree and ASOS have also come back to earth somewhat, all of which suggests some signs of rationality returning to public markets.

However, we must acknowledge the deteriorating economic trends all around us. From a UK perspective, the Brexit saga and ongoing political crisis is now having a negative impact on the real world. Recent PMI survey data shows that the crucial services sector reading is now indicating negative economic growth prospects, joining the already weak manufacturing and construction indicators. It feels like there is now a high chance of recession in the UK.

All of this means that a satisfactory conclusion to the Brexit saga is increasingly vital to future prosperity, but it is hard to see a clear and positive way forward, both politically and economically. Given this highly uncertain and difficult background, sterling weakened a further 3.5% against the dollar over the quarter but was flat against the Euro, perhaps a reflection on the damage that both Brexit and weakening world trade are doing to Europe's prospects, with Germany in particular now showing signs of economic strain.

Portfolio Review

The portfolio has a 'multicap' 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. However, this structure has proven to be a headwind during the past year as UK smaller companies have fallen out of favour whilst the larger, more multinational businesses in the FTSE100 have performed relatively well. The Fund has no exposure to defensive sectors such as telecoms, utilities and healthcare and this was detrimental again during a period where bond yields fell to new lows. Lack of exposure to these three sectors accounted for all of the Fund's underperformance against the MSCI UK Allcap index during the quarter and more than offset good returns across other parts of the Fund. 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

Our best performers were a wide and varied group, consistent with our predominantly 'bottom up' approach.

Despite a broadly difficult background for investment in smaller companies we had a few successes. **STV Group** performed well, rising 12% despite ongoing concerns in the broader TV industry. In the industrials segment **Avon Rubber** was a highlight, rising 22% in response to a major acquisition whilst both **Vitec** and **Chemring** made good progress, rising by 10% and 7% respectively. Amongst larger industrial companies **Melrose** rose by 12% after good results and we benefitted from it being the largest holding in the Fund.

During the period we added to our UK construction exposure with a new holding in **Polypipe,** which got off to a good start**.** This was augmented by another positive return from **MJ Gleeson**, whilst the proposed merger of the housebuilding assets of Bovis and **Galliford Try** had a positive effect on the latter, which rose by 6% during the quarter.

Despite the ongoing headwind of falling bond yields there were some positives in our financials holdings, with **Intermediate Capital** continuing its strong momentum and **U&I Group** beginning to recover from a low base. We see considerable potential for corporate activity in the unloved UK property sector.

Negative Contributors

The lacklustre showing of the Fund during the period was dominated by some weak small company stock selection and our lack of exposure to certain sectors which delivered positive returns. Having no exposure to healthcare (mainly Astra Zeneca), telecoms (Vodafone) and utilities was costly to our relative performance, but we have no plans to change this positioning.

Of more fundamental concern was weakness in **Kin & Carta**, which had a disappointing profit warning, highlighting the period of transition the business is currently in. The shares fell by 22%. A delay to the results from **Clipper Logistics** caused great alarm and the shares fell 20%. We have bitten the bullet here and exited at a loss. In a similar vein another profit warning from **Dialight** was painful, with the shares falling 30% before we sold. In general, it has been a tricky environment for our smallcap portfolio with larger positions in **Alpha Financial Markets Consulting** and **Palace Capital** also continuing to drift**.**

The financial sectors remain a very mixed bag. **Prudential** was a major laggard, falling 13% in response to the unrest in Hong Kong and general malaise regarding the forthcoming demerger. **Mattioli Woods** also drifted on results and gave up 9%. Finally, **Wood Group** continues to be dogged by high levels of debt and somewhat complex reporting of results as well as considerable short selling. The company has much to prove going into 2020 and the shares fell a further 14%.

Portfolio Activity

The fund has 30 investments which are spread across a variety of market capitalisations. As at 30th September 2019, the breakdown of the portfolio by size was 23% in largecap, 22% in midcap and 49% in smallcap/other. The portfolio held 6% in cash at the period end.

Purchases

There were two new purchases made during the quarter.

Polypipe is a leading supplier of largely plastic building products and systems. Operations in the UK (90% of revenue) address a broad range of sectors including residential, commercial and civil building. The business is on a sound footing and is a clear market leader across most of its operations. The company has a resilient business model and flexible cost base which will allow it to deal with any dislocations in the UK markets. The company continues to make sound bolt-on acquisitions with good strategic and cultural fit as well positive financials. It is also a leader in environmental solutions, particularly in water and climate management.

Imperial Brands is the fourth biggest tobacco group in the world after BATS, PMI and Japan Tobacco. Globally they have a 13% share with a focus mainly in developed markets such as the UK, US and Europe. While these markets are seeing consistent volume declines price increases are protecting profitability, with overall growth flat.

The industry continues to battle with regulatory and legislative issues, particularly with regard to next generation products such as vaping. The low valuation of the shares reflects this considerable long term uncertainty and whilst Imperial is both ex-growth and deeply out of fashion, we believe that there is considerable upside in the share price, driven by disposals and debt reduction as well as possible corporate activity.

We also increased exposure to a number of existing holdings post some of the sharp declines we saw in valuations over the summer. These included financials, where we added to **Barclays** and **U&I Group** as well as businesses with recovery potential such as **Melrose, Equiniti** and **Superdry**. All of these positions began to rise in value during September.

Sales

Following a number of reviews over the summer, we made five outright sales during the period.

The first one was **Sanne**, where we were fortunate to bank a significant profit ahead of a profit warning. Our review had identified overvaluation after a strong run previously and the shares consequently fell by 30% after our sale. We also exited **Greencore,** which has enjoyed a re-appraisal of its prospects since the sale of the US business last year. We now believe that much of the value opportunity in the shares has been realised.

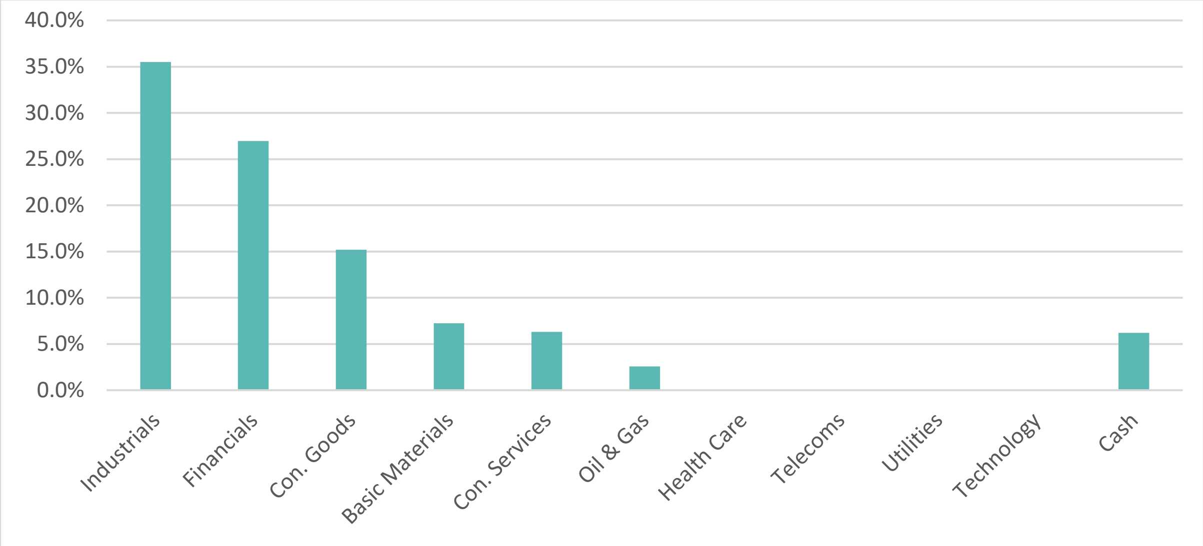
Our other sales were in the 'painful but necessary' camp, but we hope that they improve overall portfolio quality. **Clipper Logistics** was sold with a heavy heart, but the late arrival of the final results and generally poor investor communication led us to conclude that we were no longer comfortable as shareholders. **Dialight** also suffered yet another profit warning and the small position left us to exit with our wounds licked. We completed the sale of **Victoria** where some painful lessons were learned regarding excessive debt levels and acquisition led growth.

In addition to this we reduced the large position in **Gleeson** and sold some **Tyman**, where we saw some good recovery after its recent problems.

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.

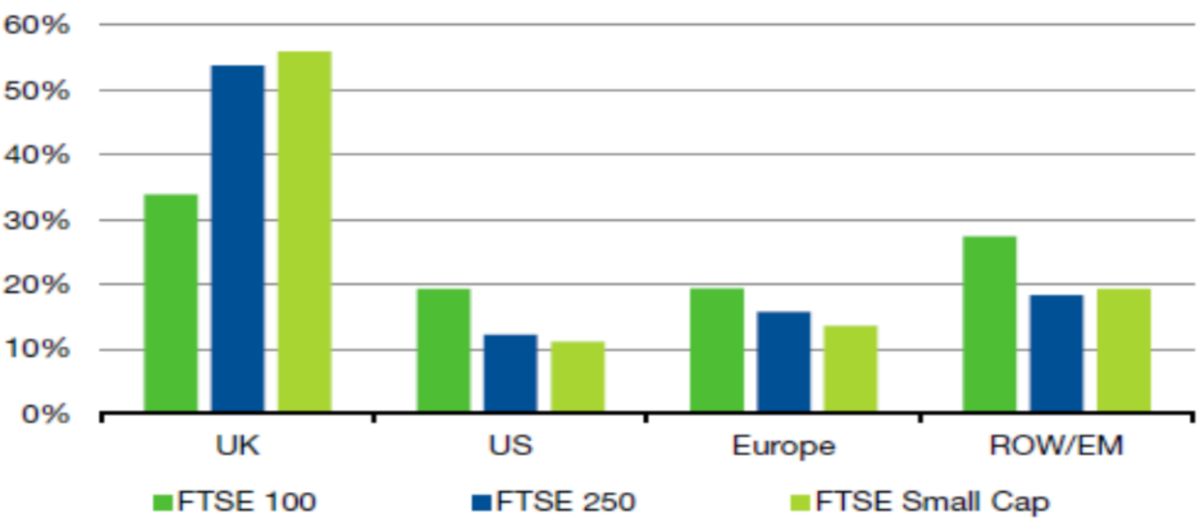
TB Saracen UK Alpha: Sector Profile



Source: Saracen Fund Managers as at 30.9.19

Given our strategic commitment to medium and smaller companies, in general we remain long sterling assets and short overseas earners compared to a broad UK benchmark. The chart below outlines the revenue mix by size index, demonstrating the high exposure to the UK economy that small and midcap investors generally have, compared to investing in the FTSE100. Our current portfolio positioning is therefore reliant on some kind of satisfactory conclusion to Brexit. Should a 'no deal' scenario be avoided then we would expect to see strong results for the Fund driven by an increase in sterling and a re-rating of domestic earnings. If this scenario does not come to pass then we hope that we already have a large margin for error in the valuations of many of our holdings.

Geographic Revenue Splits by Market Capitalisation



Source: Liberum, Datastream

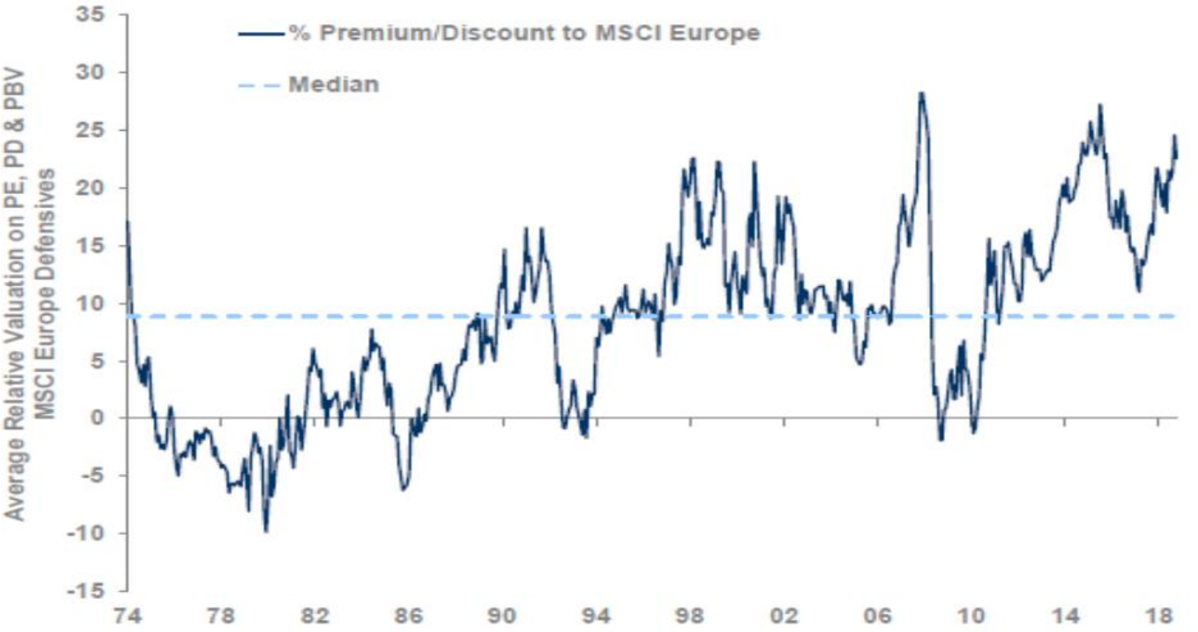
Our exposure in the industrial sectors is mainly in smaller companies with strong global market positions and positive long-term growth drivers. They are a wide and varied group of businesses and should prove to be a good antidote to the domestic exposure held elsewhere in the Fund but we must be vigilant regarding risks to the global economy in this segment.

At the end of 2018 we reported an increase in our holdings in the financials sector and we now have the highest financials weighting in the Fund for over a decade. Whilst the majority of our financials holdings are in smaller, growing businesses we have continued to add to the position in our only UK bank, Barclays, as well as increasing the holding in real estate business U&I. We see considerable upside potential in this unloved sector.

We have no investments in utilities where a combination of high debt and the risk of increased political interference leave us feeling underwhelmed. The same would apply to the telecoms sector where ongoing investment requirements are onerous. In both sectors dividend cuts have already been seen and we think more are likely over time.

In terms of sectors where we have low exposure, we continue to avoid the most defensive sectors of the market which we believe are both overpriced in absolute terms and heavily correlated to the current absurdly low (or negative) government bond yields. This would include consumer staples where we see significant valuation risks and low underlying growth. The chart below summarises our concerns fairly succinctly. We are happy to sit on the sidelines when valuations are so far away from the long term median.

European 'Defensives' Valuations



Source : MSCI, Factset, IBES, Morgan Stanley Research

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 30 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 71% of the fund with large companies only 23%. We have a cash balance of 6% 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 (38%* 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 (29%* 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 and we have 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 30th September 2019, source Saracen Fund Managers*

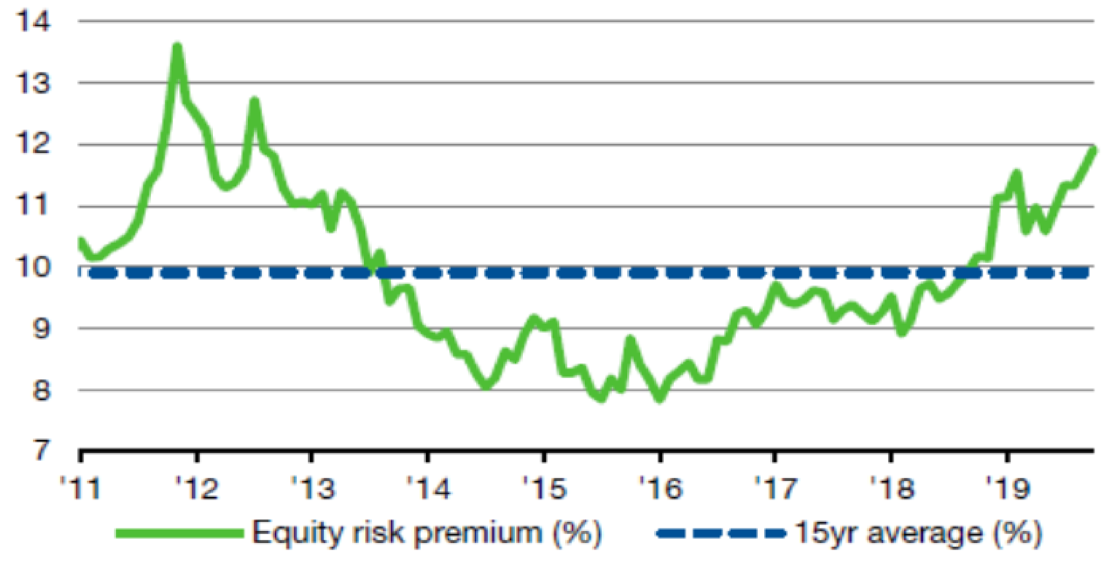
With this structure in place the Fund is designed to be style agnostic and is able to take advantage of both 'value' and 'growth' opportunities when they arise. At this point in time there are far more potential investments emerging in the former category than the latter.

Outlook

In our previous quarterly review we identified a number of dislocations which we found hard to fathom. Most of these have remained in place, albeit there are some early signs of shifting sands. We take some encouragement from the shorter term improvement in our results during September as investors began to focus on valuation at last.

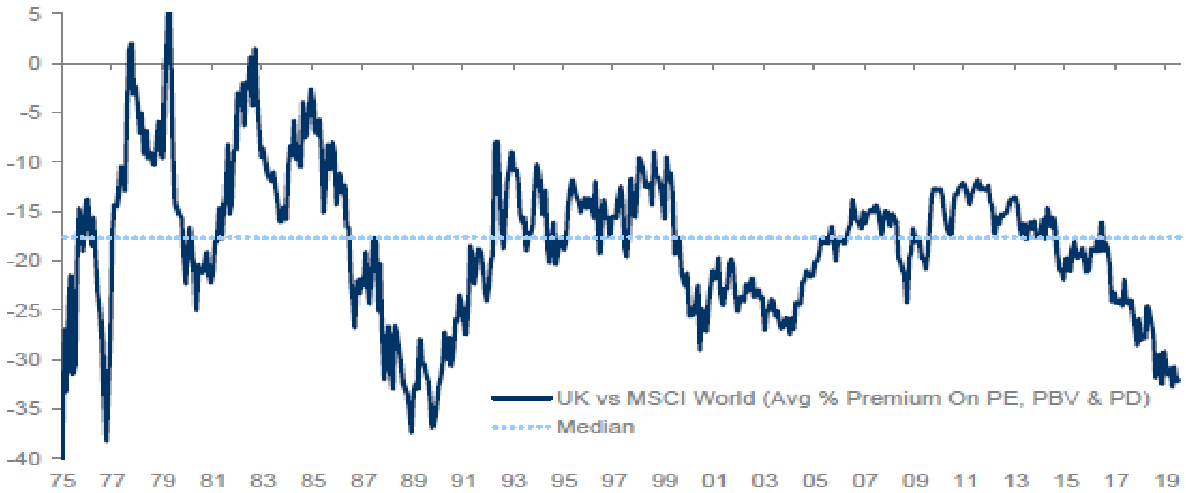
The outlook for investing in the UK remains somewhat cloudy, both politically and economically, but we are very much of the opinion that a lot of risk is already factored into equity prices today. The following charts look at the UK equity risk premium, which has risen by 50% since the Brexit vote in 2016, and the valuation of UK shares in a global context, where we have seen dramatic de-rating in recent years.

FTSE350 Equity Risk Premium



Source: Liberum, Datastream

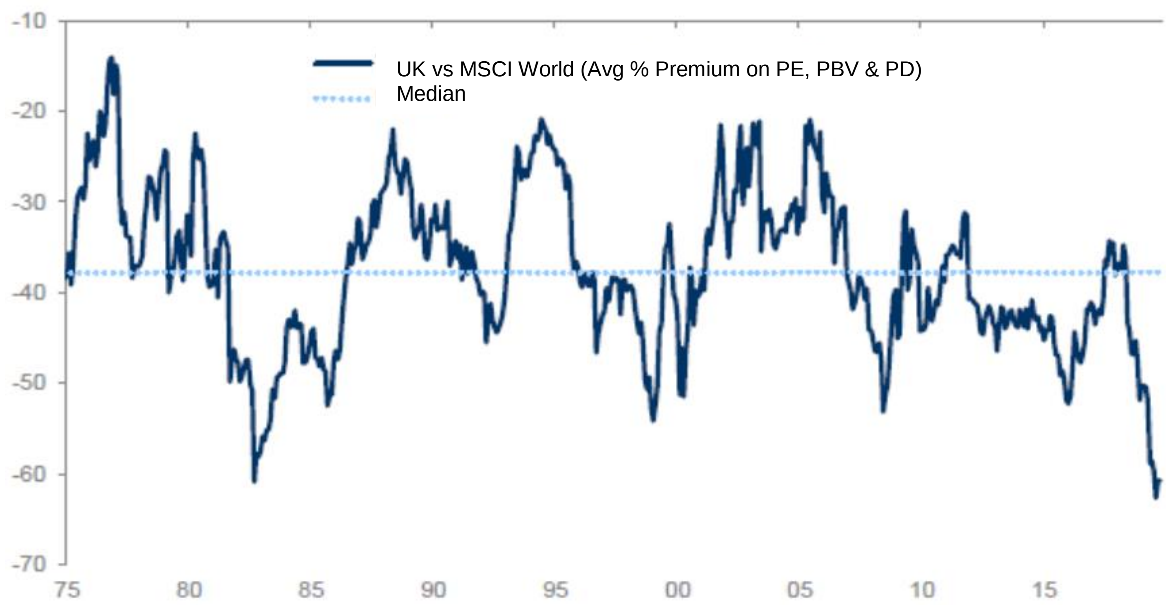
UK v MSCI World – Valuation Discount



Source: MSCI, IBES, Morgan Stanley

When one considers investment styles then the value investor is fast heading towards extinction with the past ten years in particular being a brutal battle for survival. Over the long run however, there is clear evidence that a value based approach does work, albeit it is now so long ago that many market participants have never witnessed it in the flesh. Whilst one should always expect to pay a lower price for lower growth and make an appropriate adjustment for the earnings risks inherent in value investing, the current valuation divergence is almost unprecedented in recent history as the following chart articulates.

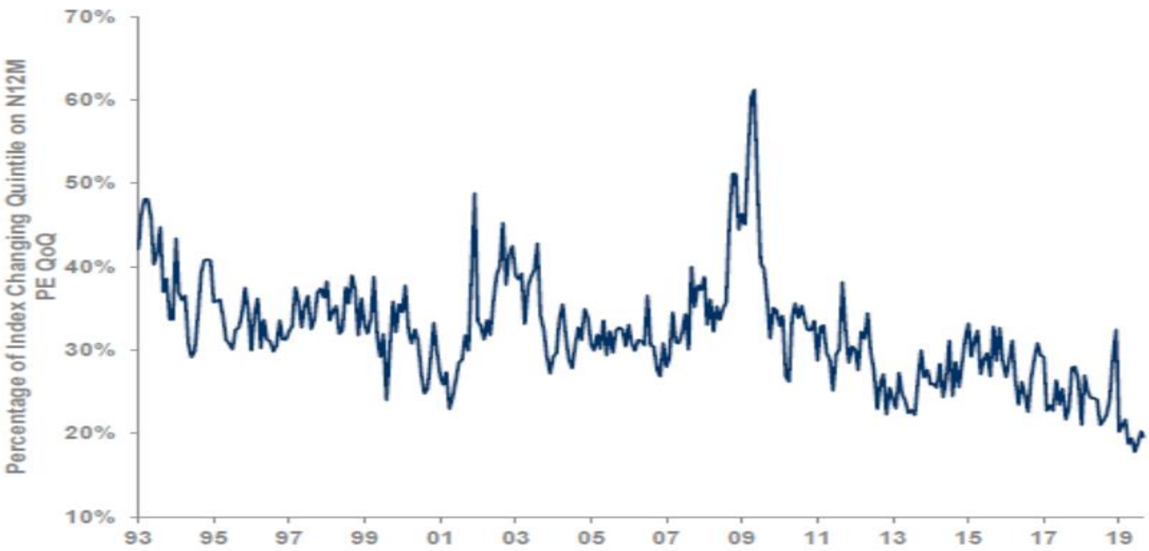
MSCI UK Value v Growth – Valuation Premium



Source: MSCI, Morgan Stanley

Related to this pattern is the absence of any sort of mean reversion trend emerging, with this measure now hitting a 25 year low point as shown below. This demonstrates the power of momentum in today's markets and the increasing gap between the 'haves' and the 'have nots'. There truly has been no hiding place or any sign of respite for the value investor.

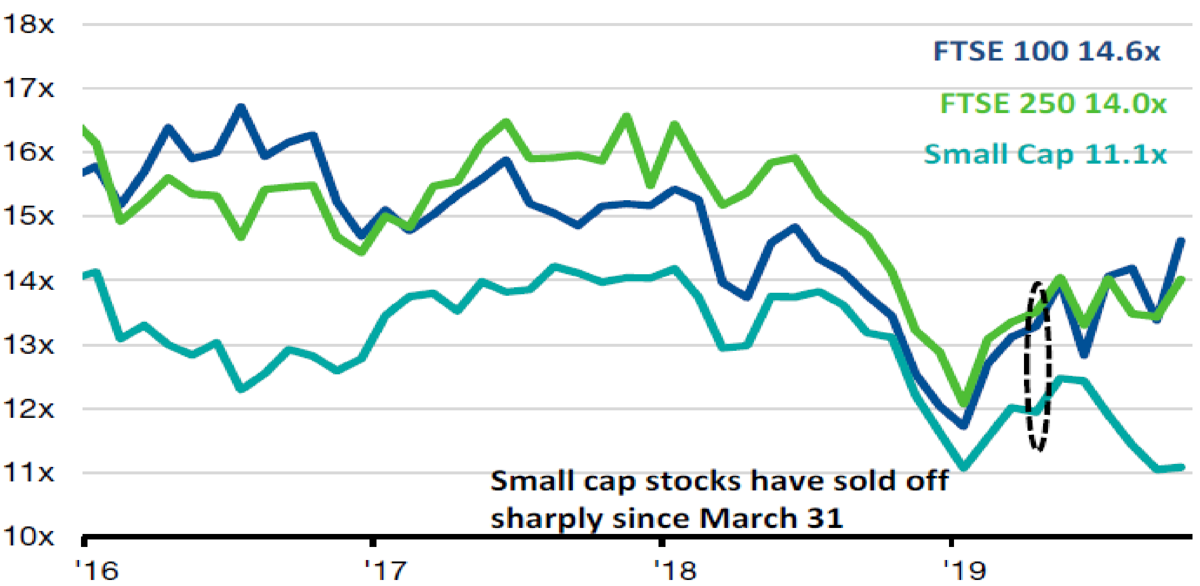
European Equity Mean Reversion Indicator



Source : MSCI, Factset, IBES, Morgan Stanley Research

Given that the portfolio has approximately 50% of it's value in UK smaller companies it is worth pondering on the opportunities that the current Brexit-induced paralysis may have created, with the discount on smaller company valuations widening over the past six months. This has been driven by outflows in smallcap funds and poorer liquidity in general in this specialist asset class, not helped by MIFID2 regulations either.

The Smallcap Discount – PE ratios



Source: Liberum, Datastream. Equally weighted, excludes investment trusts.

What does all of this mean for Saracen UK Alpha?

The Fund has laboured somewhat during the past year and this continued through the third quarter as the huge disparity between value and growth/quality factors continued to take its toll on our returns. The weakness of sterling has led to our smaller company investments remaining largely out of favour whilst ongoing trade wars and weaker global growth have been detrimental to some of our industrials holdings. The extreme dislocations across asset classes that we identified in our previous review are largely still in place, albeit there are early signs of some bubbles now bursting.

Our core process and philosophy of focussing on valuation 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. We continue to believe that valuation does matter but we must be careful to avoid the 'value traps' which are all around us.

We hope that there is significant potential value to be unlocked from many of our portfolio holdings and the recent signs of increased takeover activity in the UK market give us cause for optimism in that respect. With weak sterling and low valuations for domestic assets we are likely to see many more UK small and midcap businesses receive takeover approaches.

We have over 70% of the Fund in mid and smallcap companies and this part of the portfolio has found the going tougher of late as investors have reduced exposure to a less liquid asset class where Brexit concerns are acutely concentrated. Our strategic commitment to investing in medium and smaller companies remains intact but we must be ever vigilant in minimising any disappointments here. Post MIFID2 we see even greater potential for smallcap mispricing as 'sell side' research in this area diminishes.

All of this adds up to a market environment which is currently pretty hostile towards any sort of valuation-based process. We cannot predict when this will change, therefore our key objective in the short term is to keep our heads above water and deliver reasonable returns whilst awaiting better conditions for our style of investing.

Whilst the Fund does not have a dividend objective the income on offer from UK shares remains highly attractive relative to current abnormally low gilt yields and the UK equity market remains hugely out of favour with investors the world over. Whilst the risks of a difficult Brexit outcome or a global recession are clear and present we see significant margins for error in many of our current investments and those who await clarity tomorrow may well miss out on some meaningful investment opportunities today.

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 should serve us well over the long term.

Scott McKenzie, David Clark
8th October 2019

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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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Regulatory Status:
FCA Recognised: Yes
Scheme Type: OEIC

Issue date – 8th October 2019

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