TB Saracen UK Alpha Fund

Quarterly Review – September 2021

FOR PROFESSIONAL INVESTORS ONLY-

Retail investors should consult their financial advisers

David Clark
Investment Director

	TB SUAF	MSCI UK All Cap (TR)	Quartile
Q3 2021	+0.4%	+2.2%	4
1 Year	+58.3%	+28.1%	1
3 Years	+26.0%	+6.9%	1

Source: Saracen Fund Managers as of 30th September 2021

Macro Headwinds

Outlook

Central bankers have been telling us for some time that the spike that we are currently experiencing in inflation is transitory and will likely have worked its way through the system during next year. They may even be correct, but we are a bit sceptical of this. The government remains under pressure to keep up the infrastructure and other spending, employment markets remain tight, and monetary policy is as loose as it could be. As such, it would be remiss of us not to consider how we should structure our portfolio in the face of such headwinds. Equities are not really a hedge against inflation *'per se'* in the way that an index linked gilt would be, but cheap equities come with some built in protection.

There are some other, more technical, reasons why this may be a sound strategy. Low bond yields have been a key support for equity markets since the GFC. They have supported the decade long outperformance of growth and other long duration strategies. However, co-ordinated global growth, rising inflation, Central Bank tapering and the likelihood of rising interest rates suggest that bond yields will rise. Historically, rising bond yields have provided support for the more cyclical parts of the economy and also for 'Value' stocks. Therefore, we are keen on equities that offer a combination of strong fundamentals, attractive valuations and a positive correlation to rising bond yields.

David Clark
7th October 2021

Background

It is interesting to note that UK bond investors have pushed up 10-year break-even inflation rates implying that inflation could well exceed the central bank's 2% target by up to 1% annually over the next decade. It can hardly be a surprise that UK investors are having serious doubts about the 'transitory' inflation narrative that the Central Bankers have fed us.

Underlying pay growth has picked up and UK household medium term inflation expectations have increased according to surveys. Gas prices have risen leading to higher energy bills, the well-known shortage of HGV drivers and seasonable hospitality staff as well as a more general labour market tightness have all contributed to actual and expected increases in inflation.

It is not really a question of 'if' interest rates will rise but 'when' and 'by how much'. Across Europe this process has already started with Hungary, Norway and the Czech Republic having made the move as well as many more emerging market economies.

With such headwinds it has become apparent that market analysts, now that they have largely baked the post-pandemic recovery into their forecasts, are turning their attention to the potential problems with that recovery. As such we have begun to see a moderation of earnings revisions across the UK market in the last month or so which can be seen from the chart below.

MSCI UK – Next 12 Months Earnings Revisions Ratio

Source: MSCI, Morgan Stanley Research

In our previous Quarterly Report, we highlighted the inflationary pressures within the UK and also that the macro environment was becoming a little more difficult for equity markets as policy makers are discussing the tapering of QE measures. We also mentioned that many businesses paused their plans for capital investment after the Brexit vote. In fact, the return of investment capex growth has been stronger than we expected at around 17% to the end of September.

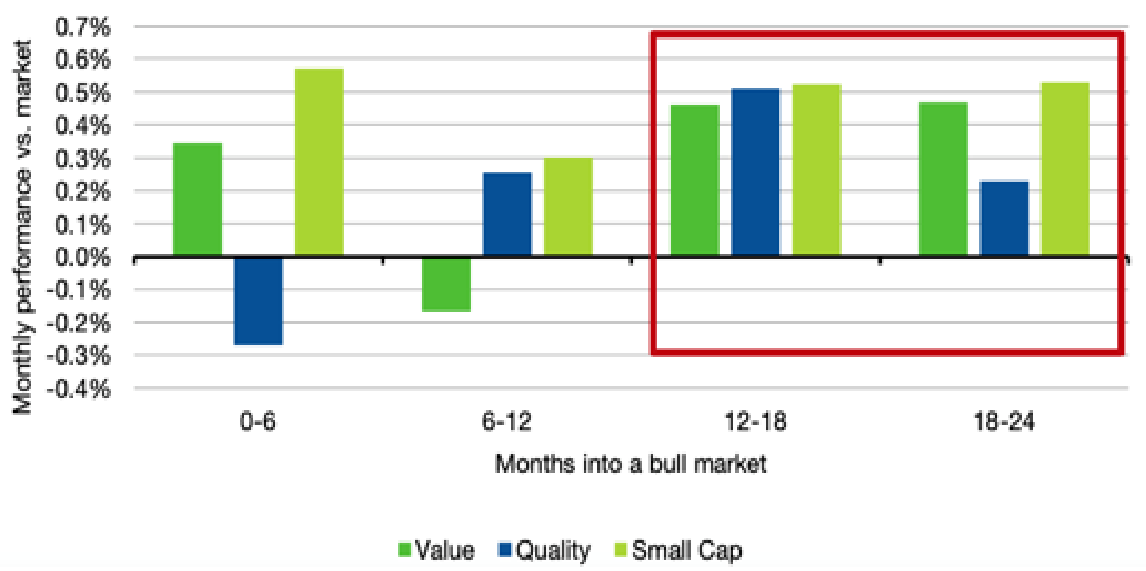
This reminds us that it would not do to become overly pessimistic. GDP growth in the UK will undoubtedly slow in 2022 but will remain strong overall and may be up to three times normal trend growth. The pandemic continues to be a substantial challenge to full recovery of the global economy but in the UK, as well as the US and the Eurozone the vaccine roll out should ensure that recovery will continue over the balance of this year and into next.

It is arguable we should have seen the spike in capex coming as investment growth post a recession is invariably the dominating force in the immediate recovery aftermath. According to Liberum, investment growth picks up about two quarters after the low point of a recession which, in the case of the current recovery, means that investment growth is strongest in 2021. The general tendency for investment growth is to decline in years 2 and 3 after a recession. As the spike in investment diminishes typically the running is taken up by consumption growth, starting out slowly then growing faster in years 2 and 3 as consumers become more confident about the stability of the economy and their ability to spend discretionary income.

The ECB and the UK's OBR have some pretty startling forecasts for consumption growth in 2022 (+7.0% and +11.1% respectively). Given the increase in energy costs that we have and will continue to experience as well as that fact that the Universal Credit changes will remove over £6bn from the UK economy and the inflationary pressures on goods and services we mentioned previously, these numbers seem on the optimistic side. That said, there can be little doubt that GDP growth will be material.

This begs the question as to how a portfolio such as ours should be positioned to benefit from such a recovery. The chart below would suggest that a bias towards quality, value small caps should pay off rather well.

Style Returns in the first 2 Years of a new Bull Market



Source: Liberum

Additionally, as Central Banks reduce their support for companies moving to contemplate and implement rate rises, UK share prices will become more dependent on an extended earnings cycle. In terms of sectors those more positively correlated to higher bond yields and inflation are the likes of Energy, Media, Technology Hardware, Retailers and not surprisingly, Banks.

It is perhaps worth mentioning too that Resource companies are likely to continue to do well as long as inflation remains an issue but if commodity prices normalise and raw material shortages are resolved it is hard to see the oil & gas and mining companies repeat their performance of 2021.

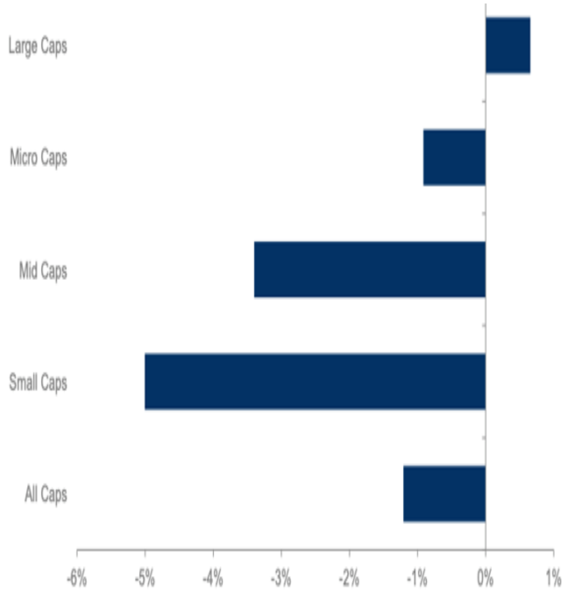
However, we still have one more quarter of 2021 to go. If, as Harold Wilson said, "A week is a long time in politics," then a quarter in stock market terms is an eternity and much can happen.

Portfolio Review

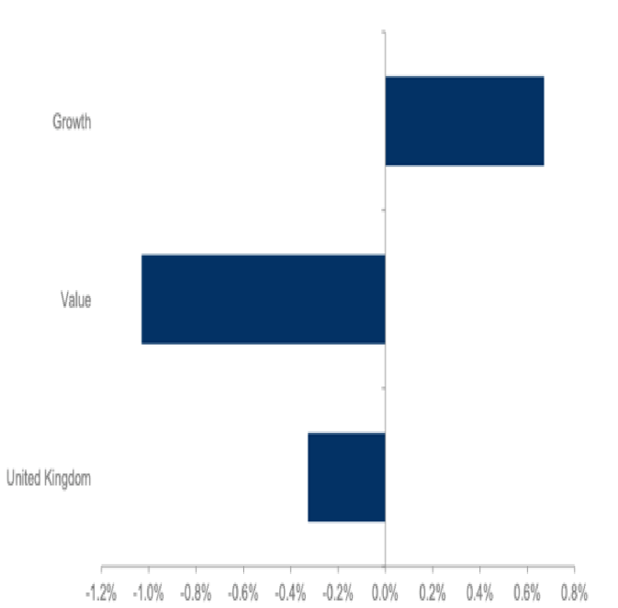
The portfolio had two poor months and one reasonable month in Q3. July was a poor month as the fund was particularly badly hit by its exposure to small cap stocks which fell sharply mid-month. In addition, 'Value' stocks gave up some of their performance which did not help matters. This trend continued into August and spread to almost every major region globally where growth stocks had a significant rally which meant that some of our investments were somewhat left behind, especially those in the Mid 250.

September was a little better for the fund though it was a turbulent month for markets with the FTSE100 falling by 0.4% and the Mid 250 falling by 2.7%. The end of the furlough scheme as well as the persistent surprises to the upside in inflation has concerned markets. The supply chain issues in the UK have affected some of our holdings but, overall, the quality of our holdings kept the fund's head above water during the month.

UK Size Perf Over Last Month



UK Style Group Perf Over Last Month

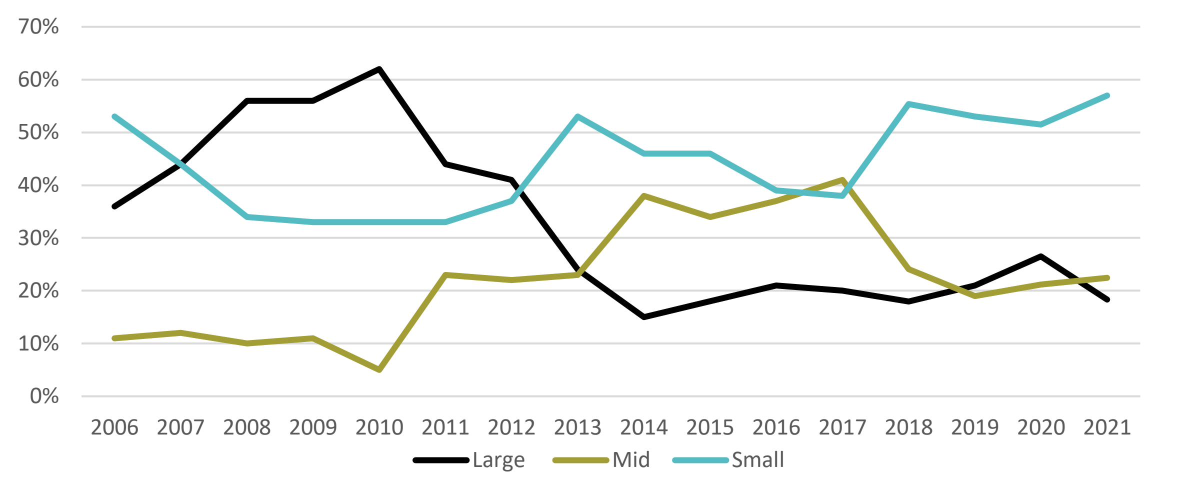


Source: MSCI, Morgan Stanley Research

The portfolio has a 'multi cap' structure with high exposure to small and mid-cap companies, which make up almost 80% of the portfolio. The focussed nature of the portfolio means that the Fund has a high active share at 94%. This strategic positioning has been beneficial to our results over the years as well as offering considerable long-term flexibility.

The Fund's flexible, multi-cap structure remains in place with a meaningful exposure to small caps at its core, currently at 57% of the Fund as illustrated in the chart below.

UK Alpha Fund Breakdown by Market Capitalisation



Source: Saracen Fund Managers as of 30th September 2021

Contributions

Top Contributors

Stock	Portfolio Weight	Contribution to Portfolio
Restore	3.19%	0.76%
Barclays	3.86%	0.45%
Chemring	3.45%	0.37%
Mattioli Woods	2.43%	0.27%
Premier Miton	4.04%	0.27%
STV	2.82%	0.26%
Brickability	1.80%	0.24%
DiscoverIE	2.52%	0.23%
Premier Foods	3.37%	0.23%
Synthomer	1.20%	0.20%

Source: Saracen Fund Managers as of 30th September 2021

Top Detractors

Stock	Portfolio Weight	Contribution to Portfolio
Halfords	3.33%	-1.10%
Johnson Matthey	3.61%	-0.48%
Gleeson (MJ)	3.16%	-0.47%
National Express	2.74%	-0.25%
Rio Tinto	2.22%	-0.25%
Tyman	3.98%	-0.25%
Smith (DS)	1.39%	-0.21%
DFS Furniture	2.88%	-0.21%
Intermediate Cap.	4.06%	0.15%
Marlowe	2.70%	0.14%

Source: Saracen Fund Managers as of 30th September 2021

Positive

- Restore: Subject to a bid from Marlowe who walked away. Underlying trading remains strong.
- Chemring: Trading strongly through the pandemic and have been consistently growing their order book.
- STV: Posted very strong results demonstrating consistent advertising recovery and an improvement in commissions for the Studios business.
- Brickability: Very well received maiden results and they also announced further earnings enhancing acquisition.

- Premier Foods: Reassuring trading update with profits at the top end of analysts' expectations.

Negative

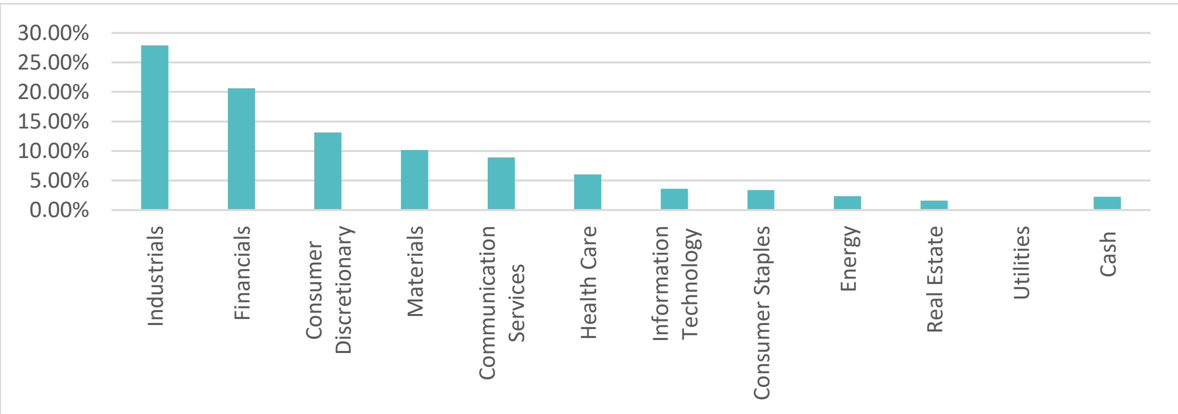
- Halfords: Trading well but have sounded a note of caution on supply chain constraints especially impacting the cycle business.
- Gleeson (MJ): Drifted along with all the Construction stocks during the quarter despite strong underlying trading and profitability.
- National Express: Despite a recovery in profits and a well-received merger proposal between the company and Stagecoach the shares have continued to languish.
- Smith (DS): Underlying fundamentals remain very encouraging, and the pricing environment is strong but there are some supply issues.
- DFS Furniture: Resilient trading with a strong order book and further savings announced as well as the resumption of the dividend.

Portfolio Activity

We made quite a few changes to the portfolio over the third quarter. In terms of sales, we exited completely our position in the chemical company Synthomer where we have enjoyed some terrific performance but felt that the valuation was becoming rather stretched. In addition, we also exited the property company U+I as we were of the view that the capital tied up in this stock could be more meaningfully deployed elsewhere. We also took some profits across arrange of companies during the quarter including Barclays, Intermediate Capital, Halfords, Abrdn, Kin + Carta and Alpha FMC. Restore was subject to a takeover bid from Marlowe causing a spike in the share price. We felt that the bid was opportunistic and unlikely to succeed and sold some stock into the bounce.

The only completely new holding to join the portfolio during the quarter was DS Smith, the packaging company where we have concluded that the stock is particularly undervalued given the improving pricing environment and the sustained and growing demand for their products.

Sector Breakdown



Source: Saracen Fund Managers as of 30th September 2021

UK Alpha Strategy

The UK Alpha fund is a multi-cap fund which is constructed from the bottom up. We do not manage it with any thought of generating income and consequently would normally expect the yield to be low. Typically, we invest only in stocks where we see a clear valuation anomaly and do not have any set targets as to small, mid or large cap exposure.

As it happens just now, although we would argue that the UK market is in general looking quite attractive on valuation grounds, we have even more reasons to be optimistic regarding the small and mid-cap segments of the UK equity market. These include, but are not limited to:

- Valuation: Small and mid-caps are trading at a discount to large caps on most metrics.
- Structural: Passive money is affecting the volatility adjusted returns of large caps more than small and mid-caps.
- Technical: The outperformance of small/mid-caps tends to be greatest during the 2 years of a post-recession recovery.
- Monetary: Current outlook for interest rates and economic growth both favour small/mid-caps.
- Historic: These are the usual reasons for small/mid outperformance – the companies grow faster, the key beneficiaries of M&A, more widely owned by management.
- ‘Skin in the game’, poorly covered by analysts etc.

This is why the fund is currently positioned the way that it is and is likely to be so until some or all of these factors are no longer the case. In addition, we keep our turnover to a minimum which is usually around the 30% mark per annum.

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 32 quoted UK companies making up a ‘best ideas’ fund with a very high active share, currently at 94%. 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 79.5%% of the fund with large companies at 18.5% and cash 2%

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. It is important to emphasise that we only ever invest in companies from the bottom up – we do not allocate to sectors, markets or any other arbitrary groupings. Each potential investment is judged on its own merits. That said, we sometimes find it convenient to consider our portfolio in terms of stocks with similar characteristics be that growth, cyclicality, deep value or a special situation of some sort.

Issue date – 7th October 2021