HAVELOCK LONDON

October 2019

LF HAVELOCK GLOBAL SELECT

Q3 2019 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO 12.1×

The market value of our current company holdings in relation to to their earnings over the past year. This provides an indication of the number of years of company profits that equates to the current market price of our equity assets.

DIVIDEND YIELD OF EQUITY ALLOCATION 4.3%

The dividends of our current company holdings over the past year, in relation to their current market value.

PERFORMANCE SINCE LAUNCH (%)

QUARTERLY RETURNS

QUARTER 3 2019	YEAR TO DATE
+1.9%	+11.4%
1 YEAR	**SINCE LAUNCH**
+4.8%	+5.0%

This performance information refers to the past. Past performance is not a reliable indicator of future results. This information is denominated in GBP: returns may increase or decrease as the result of currency fluctuations.

COMMENTARY

The fund's unit price increased by 1.9% in the last quarter, taking the total increase since inception to 5.0%. The UK utility company, SSE, was the single largest contributor to the increase in fund unit price this quarter, with the announcement of a new suitor to purchase their consumer facing business helping to lift their share price. If successful, this will allow them to focus on their strategy of developing and owning renewable power generation and energy infrastructure assets in the UK. The company has moved away from coal-power generation in the last decade, with the associated balance sheet write-offs weighing heavily on its past results. Our valuation model assumes that the recent pattern of exceptional costs will not continue, but has relatively modest assumptions about future profits. All UK utility companies face elevated political risk, but in our view the transformation of SSE's business will make it better placed to navigate these challenges.

J Sainsbury and Subaru tied for the prize of being the second largest contributor to the increase in fund unit price this quarter.

The Japanese automotive manufacturer, Subaru, is one of three companies that the fund holds within our automotive investment "block". The company had suffered some production line quality problems earlier in the year, but more recently reported record sales in the US. There is good reason to be concerned about the immediate prospects of the auto industry, but much bad news is already contained in company share prices. Like SSE, our valuation of Subaru is based on relatively modest assumptions about its future profitability. Furthermore, unlike many other auto companies it has a strong balance sheet with no net debt, such that it should be well placed to weather a protracted storm.

The biggest negative contributor to the fund unit price this quarter was the French telecom company Iliad. The company has been investing heavily in two expensive new business initiatives; building a mobile phone business in Italy and connecting French homes to high speed fibre broadband. This has resulted in a rapid increase in the company's debts, as well as having weighed on recent earnings. The scale of the company's ambition is impressive, with their existing fibre infrastructure being accessible by 11.5M French homes[1]. To put this in context BT's current "longer term plan" is to reach 15M British homes in the middle of the next decade[2]. The desire from investors to see short-term results from Iliad's investments, contrasts with the flotation of several high-growth-but-no-profits "tech unicorns". Perhaps investor sentiment towards Iliad would be higher if the company made no profits at all!

The Voting Machine

The often quoted phrase is that in the short-term the markets are a voting machine, and in the long-term they are a weighing machine. The fund's unit price fell during the start of August, only to rapidly recover at the start of September. My opinion is that this was driven more by the voting machine than by any material changes in company fundamentals. The price moves that we witnessed in August and September appeared to be part of a broader theme, with commentary in the financial press talking about a reversal of "momentum" alongside a rally in "value". Put simply, this means that those companies who had seen their share prices go up strongly prior to August, saw their share prices fall. Likewise, those companies that prior to August looked undervalued (based on measures of historic profits or the value of their assets) saw their share prices rise.

My view is that these moves had the hallmarks of a group of investors all rushing to squeeze through the exit door. As I wrote in our journal last month[3] we see evidence that the prices many investors are currently willing to pay to own the most fashionable high growth companies look extremely high with respect to history. My view is that if this enthusiasm were to reverse, then we will see the prices of these "momentum" companies fall further.

We undertook some rebalancing for the fund at the end of August, with our data-driven approach allowing us to have a mechanical reaction to these price moves. The fund's holdings in several companies were increased, based on their share price having inexplicably moved away from our estimate of intrinsic value. We believe that this structured approach to investing will help us behave rationally at times when others may not.

Look Through Earnings

The focal point of our investment approach is to use data to make long-term forecasts of company profits. The fund predominantly invests in companies, and movements in their share prices feed through to cause changes in the fund's unit price. We believe these price moves will reflect the underlying company economics in the long-term but may show substantial deviations in the short-term, as they reflect the ebbs and flows of investor sentiment. For this reason, we want to also provide a simple metric to track the underlying profits of these companies. What follows below is an explanation of this Warren Buffet inspired metric.

Imagine that as at the end of the quarter you bought £100 worth of shares in the companies that the fund owns, in the exact same proportions that it owns them. If this group of companies decided to pay all their previous year's profits to their shareholders, then you would have received a grand total of £8.30 in your bank account. I call this a "look through earnings yield" of 8.3% (8.3/100). This concept is more normally stated as a "price earnings ratio", where a price of £100 and earnings of £8.30 give a ratio of 12.1 (100/8.3).

Currently only 80% of the fund's capital is deployed in company shares. This means that of £100 invested in the fund today only £80 will be spent on buying shares, and so the "look through earnings yield" would be 8.3% x 80% which equals 6.6%. As of the end of the quarter the fund unit price was 105p. This means that each unit in the fund equates to 6.93p (105p x 6.6%) of "look through earnings".

Look through earnings calculated in the way described is the metric that we wish to track. Furthermore, we want to be judged by how it grows over time.

Onward!

We move forward into the final quarter of the year with the fund still holding a relatively high level of "dry powder" in the form of cash and short dated government bills. This is based on the view that current market valuations look very high with respect to history, especially so amongst certain high-growth and high-quality companies. As investors we do not take comfort from travelling with a crowd and believe that this approach will help us achieve our goal of long-term capital appreciation.

[1] Iliad 2019 half yearly report (https://www.iliad.fr/finances/2019/CP_030919_Eng.pdf)

[2] https://www.ft.com/content/2fafb366-b4f3-11e9-8cb2-799a3a8cf37b

[3] https://www.havelocklondon.com/commentary/one-year-on/

The data in this document is sourced from the fund accountants as at 30.09.19 unless otherwise specified.
The data used to calculate the financial ratios of the equity allocation is sourced from Bloomberg.

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CONTACTS

The Key Investor Information Document (KIID) and prospectus are available in English from:

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