HAVELOCK
LONDON

January 2020

LF HAVELOCK GLOBAL SELECT

Q4 2019 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO 13.8×

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 3.7%

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

PERFORMANCE SINCE LAUNCH (%)

QUARTERLY RETURNS

QUARTER 4 2019	YEAR TO DATE
+3.5%	+15.3%
1 YEAR	**SINCE LAUNCH**
+15.3%	+8.7%

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 3.5% in the last quarter of 2019, taking the total increase for the year to 15.3% and since the fund's inception to 8.7%. Pleasingly, the fund generated positive returns in each quarter of 2019.

The French telecom company Iliad was the largest positive contributor to the increase in fund unit price during the quarter, which contrasts with having been the worst performer in the prior quarter. In a display of frustration at the languishing share price, the company's founder, Xavier Niel, made an undertaking to buy back 20% of the company's shares at a significant premium. This transaction is due to complete in January 2020 and has, so far, had the desired effect of lifting the company's share price. The Japanese automotive company, Subaru, was the largest negative contributor to the change in fund unit price. The company was the second-best performer in Q3 2019. The company cut its earnings forecast during Q4, citing assembly line shutdowns as a result of Typhoon Hagibis, currency movements and an increase in "quality related costs".

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Over the course of 2019, the stand-out largest positive contributor to the increase in fund unit price was the British homeware retailer Dunelm. The company is still part-owned by its founding family and has a history of strong operating results together with impressive sales growth. The company previously purchased a loss-making online retailer, which it has integrated into its own business to provide an on-line sales channel. This strategy negatively impacted profits in the short-term but is now showing signs of having been a successful investment for the business going forward. Our valuation model was built based on a set of conservative assumptions about the future, at a time when the market price appeared to reflect an undue level of pessimism. Our approach to portfolio weightings means that the fund's holding in Dunelm has reduced over the last year, as the share price has moved towards our own valuation of the business.

The second largest contributor to the increase in fund unit price is the American airplane leasing business, Air Lease Corporation. You may well have flown in a plane that they own in the last year, but you would be unlikely to have known it. Their business model is based on owning a large portfolio of modern fuel-efficient planes and leasing them to the world's major airlines. Although it is a relatively young company it was set up by two long standing industry veterans. Our valuation model was built based on having collected almost 30 years of data of the operating track-record of this management team.

The third largest contributor to the increase in fund unit price was the British construction business Morgan Sindall, the fourth largest contributor was the Korean semiconductor and electronics business Samsung. The fifth largest contributor was the British specialist manufacturing business, Dewhurst. They are a world leading manufacturer of vandal proof pushbuttons, and if you have used a lift or public transport in the last year you are likely to have had direct contact with their products!

The worst contributor to the fund unit price in 2019 was the apparel retailer GAP. The company has had a difficult year with falling sales, reduced margins and the threat that import tariffs will disrupt their supply chain. These difficulties culminated in the CEO leaving, with a member of the company's founding family now acting as CEO on an interim basis. Our valuation model is conservative, to the point that it assumes the business shrinks in size, but that its history of capital allocation discipline will continue.

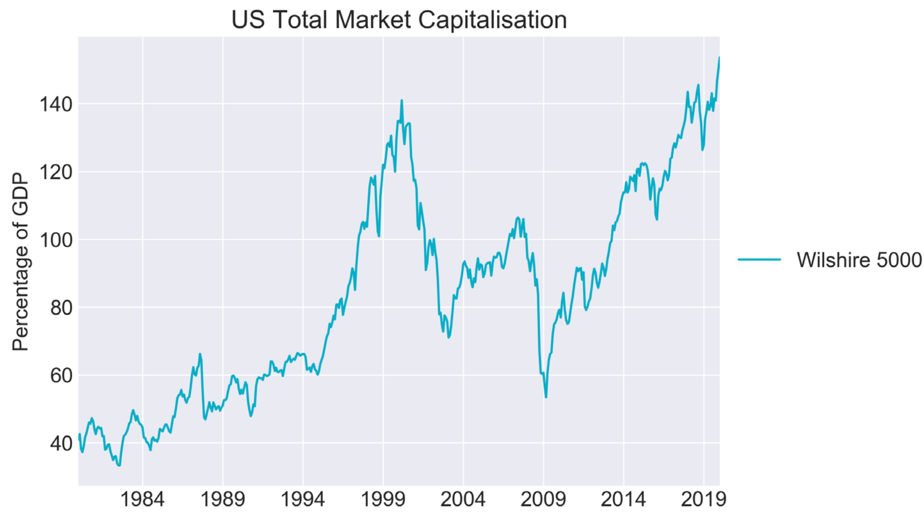
The second worst contributor over the course of the last year was the British construction business, Costain. The company delivered profit "warnings" on two occasions over the course of the last year, however, is still on track to deliver positive profits. Our valuation model for the company assumed that it will see such occasional one-off surprises, as this has been a recurrent feature of the industry that it operates in. This is however of little comfort when such write-offs occur. Going forward the business has no net debt and has recently sold some legacy foreign property assets that represents a clean-up of its balance sheet.

The fund's allocation to cash and fixed income instruments was 30% as of the last day of the month, only as a result of a significant inflow on the penultimate day of the year. This cash was deployed following the Christmas – New Year holiday window, with the result that the weight in equities is back at its prior level of 80%.

A perpetual motion machine?

Many global stock markets ended 2019 on fresh highs. The chart on the following page shows the ratio of the total value of US public equities to the size of the US economy (as measured by GDP). According to this metric, the US stock market looks more expensive than at any point in the last forty years.

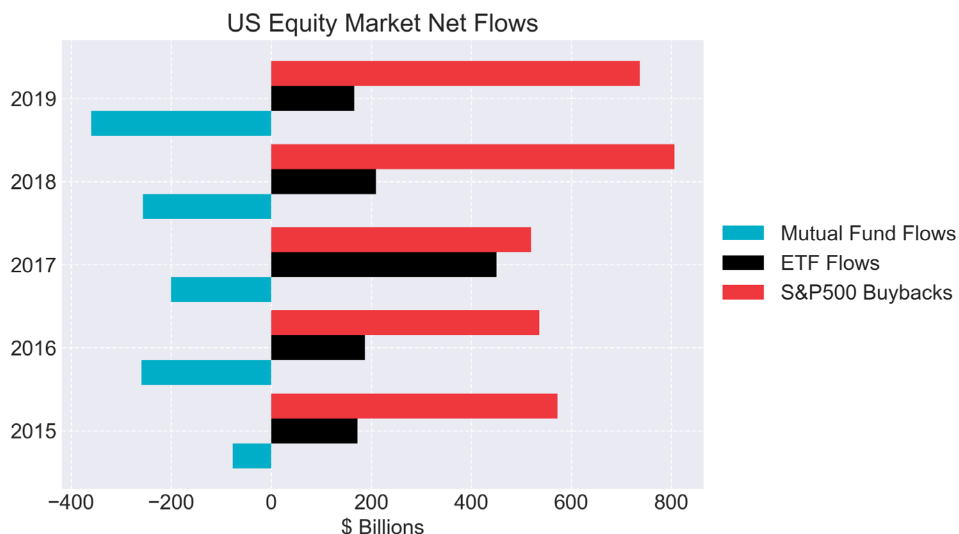
Why are prices so high? The simple answer is that stock prices rise when there are more buyers than sellers. My sense is that the unbridled euphoria seen in the dot-com years is absent in today's markets, which begs the question, who is it that is buying equities?



Source: Havelock London calculations based on: (1) GDP data from the Federal Reserve Bank of St. Louis; (2) Wilshire 5000 Total Market Index from Bloomberg.

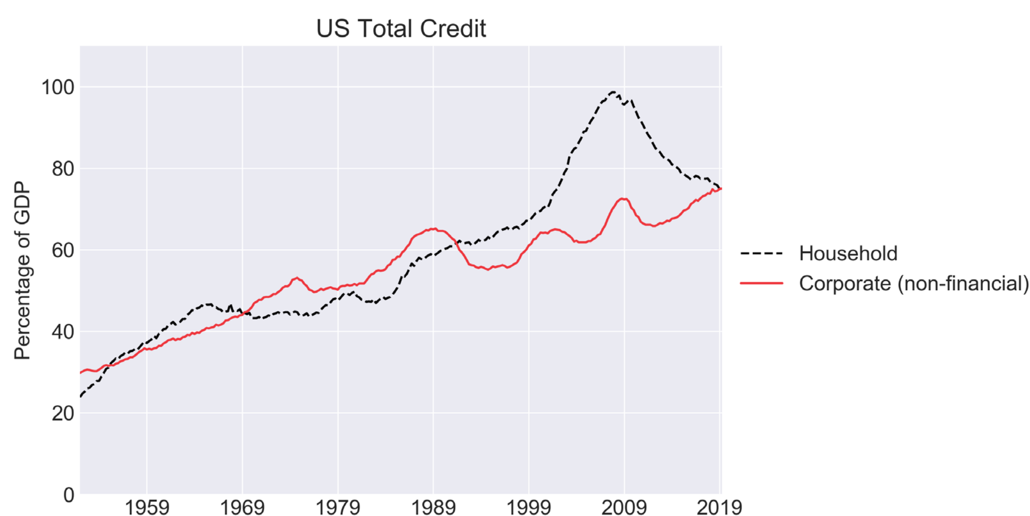
The chart below shows three major sources of buying activity for the whole US stock market. The data for US mutual fund and US Exchange Traded Funds (ETFs) comes from the Investment Company Institute[1] and represents the net amount of money used to purchase stocks via these two types of investment vehicles. The data on buybacks represents the total money spent by S&P500 companies on purchasing their own shares and is a form of capital being returned to shareholders.

The most apparent feature of this chart is that companies purchasing their own shares has been a major and persistent source of buying demand in recent history. The second noticeable feature is that there has been a persistent trend towards money leaving US mutual funds and flowing into ETFs, which is associated with money moving between the "active" and "passive" investment styles.



Source: Havelock London calculations based on: (1) Flow data from the Investment Company Institue; (2) Buyback estimates from S&P Dow Jones Indicies.

The next chart shows total credit to companies and households for the US, expressed as a percentage of GDP. Whilst household indebtedness has fallen since the credit crisis, corporate indebtedness is the highest that it has ever been in the last 65 years. Taken together with the previous chart, it tells us that companies have, on average, been taking on more debt in order to buy back their own shares. This is suggestive of the high stock prices that we see being at the expense of public companies becoming more highly leveraged.



Source: Havelock London calculations based on: (1) GDP data from the Federal Reserve Bank of St. Louis; (2) Total credit data from the Bank for International Settlements.

Ten years ago, in the aftermath of the credit crisis, I would not have forecast that by 2019 Greece would be able to borrow money at negative interest rates. A decade of low rates and relaxed credit conditions have clearly helped push the prices of all assets higher as the prospect of earning low returns from keeping money in the bank encouraged investors to search for more "lucrative" opportunities.

The nature of credit is that a lender must trust that a borrower will repay her, with interest charges being set to account for the risk that this does not happen. History suggests that the availability of credit moves in cycles; periods of relaxed lending standards tending to lead to more unsound loans, which in time lead to greater losses, fears of further loss and periods of stricter lending conditions. Owning a part-share of a business, via the stock market, is strictly speaking not a loan, but in the broader sense you are "renting out" your money in the expectation of sharing in the company's profits. Hence, I see this "credit cycle" as providing the "mood music" against which all investors operate.

Given that companies have been borrowing more money than ever before could it be that there has been a degradation in the quality of lending?

I believe that the actions of very many investors are guided by how real the fear of losing money appears, and that this fear will be the most likely catalyst of falling asset prices in the future. Put simply, I do not think low central bank interest rates, alone, provide a guarantee that asset prices must keep moving higher. If the fear of losing money becomes more real for investors, I believe that it will become a more powerful force in markets than the actions of central bankers.

In my opinion the trend towards passive investing has come at the expense of a shift of power to public-company executives, and away from investors. This has been accompanied by an increase in corporate leverage, as a result of assuming more debt to buy back shares. With valuations at high levels there is, in my view, a risk that some share buyback programs will turn out to have been an expensive way for management to boost earnings per share (being the metric that many management teams have their pay linked to).

There is nothing to say that these trends will not continue, but I believe that it is dangerous to assume that public markets have become a risk-free "perpetual motion" machine.

Our approach to the threats that I describe is two-fold. Firstly; we look for relatively low-leveraged public companies, where valuations do not rely on an undue level of optimism and they have a record of making disciplined capital allocation decisions. The fund's current equity holdings produce a dividend yield of 3.7% per annum, which partially evidences our commitment to these objectives. Secondly; we currently hold a fraction of the fund in cash-like and fixed income securities. This represents both a form of risk control, limiting the fund's exposure to falling equity prices, and a source of dry powder that can be quickly deployed when the general level of risk aversion increases in markets.

This approach worked well for the fund during the market declines in the last quarter of 2018, with its allocation to equities being increased over this period. With the benefit of hindsight 2019 was a year when caution was not rewarded, and clearly our results would have been better if we had of gone "all in" on equity markets. We can only make this observation in hindsight and are quietly satisfied with our balanced approach and the consequent risk adjusted return since launch (our return since launch has been achieved with a volatility of returns that we estimate at 8.7% annualised).

In the face of high asset prices, and a prolonged period of easy credit, we continue our journey believing that this is an appropriate moment in history to exercise caution. We do not have a crystal ball that can foretell the future, but our use of data provides a crutch to lean on that tethers our actions to reality. Our approach remains to willingly embrace exposure to those risks that we understand and try to avoid expose to those that we don't. Onward!

[1] Investment Company Institute. For the most up-to-date figures about the fund industry, please visit www.ici.org/research/stats.

This is the opinion of the author at the time of writing and it may change. The company examples used are for illustrative and information purposes only. There is no guarantee this information is correct or up-to-date. This is not a recommendation or investment advice and you must not use it to make investment decisions.

The data in this document is sourced from the fund accountants as at 31.12.19 unless otherwise specified.
The data used to calculate the financial ratios of the equity allocation is sourced from Bloomberg.

INVESTMENT RISKS

The value of investments in LF Havelock Global Select (the fund) may fall as well as rise. Investors may not get back the amount they originally invested. Investments will also be affected by currency fluctuations if made from a currency other than the fund's base currency. Past performance is not a reliable indicator of future results.

Potential investors should not use this document as the basis of an investment decision. Decisions to invest in the fund should be informed only by the fund's Key Investor Information Document (KIID) and prospectus. Potential investors should carefully consider the risks described in those documents and, if required, consult a financial adviser before deciding to invest. The fund can invest more than 35% of its value in securities issued or guaranteed by an EEA state listed in the prospectus.

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

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