HAVELOCK LONDON

July 2020

LF HAVELOCK GLOBAL SELECT

Q2 2020 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO 12.4×

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 3.0%

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

PERFORMANCE SINCE LAUNCH (%)

QUARTERLY RETURNS

QUARTER 2 2020	YEAR TO DATE
+13.9%	-9.9%
1 YEAR	**SINCE LAUNCH**
-4.9%	-2.0%

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 coronavirus crisis has led to increases in unemployment and falls in GDP exceeding anything witnessed since the second world war. Since I wrote my last quarterly update, in early April, global stock markets have re-couped much of their losses. This "recovery" has been centred on US technology companies, with the NASDAQ 100 index reaching all time new highs. Although index-level moves grab the headlines, there is a lot of dispersion "below the water line" amongst the share prices of individual companies. An illustration of this is that a mere seven companies now account for half the weight of the NASDAQ index and so dominate its movements.

Despite stress having receded in markets, I do not believe that the crisis has yet passed.

Firstly, the virus has not gone away. Secondly, we are not seeing enough economic activity resume to reverse the high levels of unemployment. Thirdly, governments and central banks have yet to finish their stimulus let alone decide how to fund or unwind it. Lastly, corporate debt levels remain at very high levels with respect to history.

Despite risk-aversion in investing looking increasingly like an old-fashioned concept, I believe that having a "margin of safety" is now more important than ever. It is thus that our resolve to hold a portfolio that we expect to be robust to a wide range of future economic scenarios remains as strong as ever.

We have had a busy quarter both in terms of managing the portfolio and continuing to develop our proprietary technology platform. In what follows I give a brief overview of our investment activity and finish with a "bottom up" look at one of the companies we have recently added into the fund.

Portfolio Update

The fund's unit price increased by 13.9% in the quarter.

The three largest contributors to the increase were the French telecom company, Iliad; the railcar manufacturer Greenbrier; and the airplane leasing business Air Lease. The first of these three is seen as a beneficiary of lockdowns and has simultaneously seen strong subscriber growth. The second two businesses were directly impacted by the crisis and were reversing steep losses made in the first quarter.

The three largest negative contributors to the change in unit price were Berkshire Hathaway; the specialist British engineering business Dewhurst; and the UK supermarket Sainsbury. The contribution from Berkshire Hathaway is mainly a consequence of prices having fallen since we increased our holding mid-quarter. Dewhurst management undertook a share repurchase at the end of the quarter and given their strong balance sheet I believe this to be disciplined capital allocation of the sort that we like.

A simple comparison of our fixed income and cash allocations at ends of Q1 and Q2 could leave you thinking there had been little (deliberate) activity in our portfolio. Much to the contrary we have been busy reviewing existing investments, identifying new ones, and reacting to disparities between market prices and our own valuations resulting in higher than normal activity levels.

By referring to a previous journal entry on our website titled 'What's inside your pie?', we're reminded that forcing yourself to be fully-invested in equities at all times is like tying one hand behind your back when it comes to managing the risk of financial loss. It means that your risk of losing money is entirely determined by your choice of stocks, without any other way to make this risk stable through time. Being able to hold some money in the safe harbour of government debt provides us with greater freedom to actively control this risk, whilst seeking the best long-term investment opportunities.

We introduced four companies to the portfolio in the last quarter.

We added the office furniture business Herman Miller. The company has an excellent brand, a track record of strong operating results and a conservative balance sheet. It is however exposed to the short-term ebbs and flows of the business cycle. Our valuation conservatively assumed that future operating performance would be weaker than history, but still left us believing that price falls presented an opportunity. In the spirit of eating what we cook I also bought a Herman Miller desk chair for lockdown comfort!

We added two new utility businesses. One of these companies has a large ownership stake in a US natural gas "midstream" transportation and processing business. The turbulence in energy markets has seen the value of this separately quoted business fall in the short-term, which has contributed to the parent company seeing large price falls. We believe that this represented an opportunity for our long-term investment approach.

Finally, we added a specialist, high quality Swiss Engineering business. It is a well-diversified business, albeit with exposure to some cyclical industries. Several board members have large ownership stakes, which is something that we like to see in an investment. It has a track-record of having improved its return on assets, which runs counter to the stereotype of boring industrial businesses having declining economics. It makes a guest appearance in the final section of this letter, albeit we do not name it as it is outside our top ten holdings.

All the companies that we added were the product of our data heavy process for identifying new investment opportunities.

Six companies were removed from the portfolio in the last quarter. Half motivated by concerns around their balance sheets, and half due to prices getting some way ahead of our valuations.

We removed the engineering business Costain following a review prompted by their surprise move to raise more equity capital and dilute existing investors. We removed Norwegian Cruise Line Holdings, where we had only a small fraction of the portfolio invested. Despite their management's first-class efforts to recapitalise the company I reluctantly decided that forecasting how quickly the cruise industry will return to "normal" was required to value the business, but outside my "wheelhouse" (pun intended). We also removed the UK utility company SSE. It is almost three years since we identified the company and it has been subject to an impressive turnaround effort. However, the amount of cash paid out to shareholders, at the expense of reducing its high debt levels, means that it would no longer meet our selection criteria and we replaced it with two new utility companies (see above) with substantially lower balance sheet leverage.

All three cases illustrate how concerns around quality will ultimately over-rule a cheap valuation within our allocation process.

Extreme price moves saw us sell the remaining three businesses; two retailers and one housebuilder. All three were companies bought or added to in Q1 and so by selling in Q2 we were "banking" the recovery expectations of others. Such short-term decisions are not normal for us but follow from our disciplined approach to using valuations to drive our actions.

During the quarter we have also reduced the size of holdings in energy and automotive companies. This is from the part of our portfolio that is based on entire industries that we think represent good value, but where we wish to limit company-specific exposure and so own between two and four businesses from within the target industry. These reductions happened in tandem with increases elsewhere, for example in an Asian paper manufacturing business.

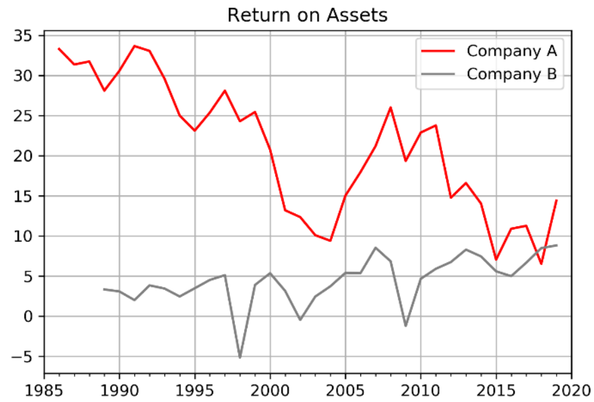
As portfolio activity has been higher than under more normal conditions it is a good opportunity to remind you that our investors will not be subjected to open ended liability with respect to transaction costs. Due to our charging structure, with a Total Charges Figure capped at 0.99% including transaction costs, any expenses due to increased activity over this threshold will be subsidised via us receiving a reduced management fee and not passed on to our Investors. This is an innovation that we are incredibly proud to stand behind.

Growth Windows or Value Ploughs?

Much ink has been spilled on the relative merits of "growth" verses "value" stocks. As there are around 90,000 public companies classifying them into one of two groups is, by necessity, always going to be a little vague! So much so, that I wonder if these labels convey as much meaning as many assume? Our ideal investment would represent both good value and have good growth prospects.

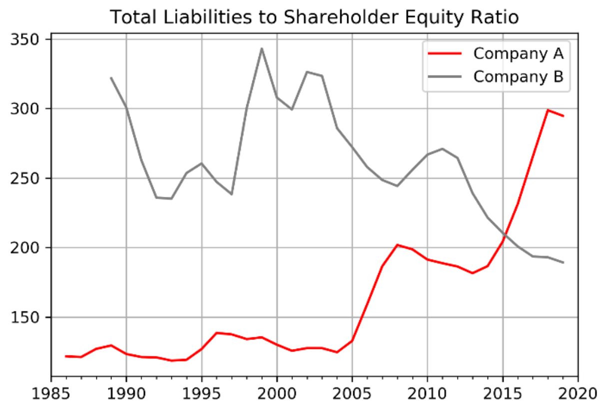
What follows is a tale of two businesses that for now I shall call "Company A" and "Company B". We are shareholders in one of these businesses, but not the other, and the story is intended to show you what we look for in an investment. Company A makes Windows whilst Company B makes ploughs.

Company A has a history of making high profits, but with the passage of time their business has become more "asset intensive" – they need more "stuff" to turn a profit. Company B has been comparatively much less profitable but improving. Despite Company A's magnanimous past, the companies now look to deliver similar levels of profitability from this perspective. This can be seen in the chart below that shows historic profits as a percentage of the value of assets used in each business (for anyone schooled in accounting, you will recognise this as the "return on assets" ratio).



Source: Havelock London calculations using Bloomberg data.

In recent history Company A has been increasing their borrowings, whilst Company B has reduced theirs. The falling profitability of Company A's underlying business has, in part, been compensated for by their increased use of leverage. By the opposite token Company B has decided to decrease their leverage. This is illustrated in the next chart that shows the size of each company's liabilities, relative to the amount of shareholder equity they employ.



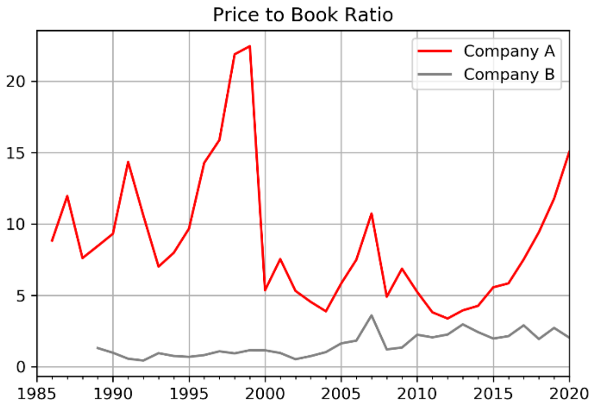
Source: Havelock London calculations using Bloomberg data.

In the last decade Company A has paid out almost all their profits in dividends and share buybacks whilst funding their growing asset base with leverage. By the opposite token Company B has reinvested more than half their profits back into growing their business. Company A has seen much higher revenue growth than Company B but the same is not true of their earnings growth. (I calculated this by looking at total profits in the last ten years, relative to the ten years prior. This avoids one extreme year causing a wonky reading and smooths out the impact of earnings volatility.)

LAST TEN YEARS	COMPANY A	COMPANY B
Profits Reinvested	4%	59%
Revenue Growth	115%	45%
Profits Growth[1]	95%	141%

Source: Havelock London calculations using Bloomberg data.
[1]Measured based on total profits in the last ten years, relative to total profits in the prior ten years.

The final piece of the story is a chart of the price to book ratios of the two companies. Company A has commanded a distinct premium valuation in comparison to Company B. This was well justified for much of history because their underlying business was so much more profitable, as illustrated by their superior return on assets. As of 2019 the two companies have more similar levels of underlying profitability, but we have seen that Company A has leveraged these returns by making much greater use of leverage. Company B on the other hand has reduced their use of leverage.



Source: Havelock London calculations using Bloomberg data.

Company A has a price to earnings ratio of 36.4 and Company B 12.6, so simplistically A is three times as expensive to buy as B. By most accepted definitions Company A is classified as a "growth" stock, whilst Company B is classified as "value".

Company A is a truly great business, but we would not invest in it at the current high valuation. We invested in Company B because of its respectable and improving profitability, its low leverage, and its reasonable valuation. On top of this the "value stock", Company B, has seen as good levels of earnings growth in the last ten years as the "growth stock" that is Company A. Clearly, the shortcoming of this exercise is that I am looking at the past, not what is expected in the future. Likewise, Company B's earnings have been more volatile. Nonetheless it gives me pause for thought on the use of "value" and "growth" labels and if this wide disparity in valuations is justified.

For anyone that has made it this far your reward is to know that Company A is called Microsoft (I told you that they made Windows). As Company B is not one of our top 10 holdings, we do not disclose its name.

I do not know if Microsoft will have higher or lower future earnings growth than the industrial company that we have invested in. That was not the point I wished to make. My message is that I believe that the labels of "growth" and "value" are a poor substitute for proper analysis and may not be as descriptive as they first appear. In this case the "tech" business looks to be as asset intensive as the industrial one, with similar levels of long-term profits growth. Furthermore, a great business, such as Microsoft, will only make for a great investment at the "right" price. The more an investment is seen as a "sure thing", and the higher the price moves, the lower the chances of the price being "right".

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The data in this document is sourced from the fund accountants as at 30.06.20 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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