HAVELOCK LONDON

October 2020

LF HAVELOCK GLOBAL SELECT

Q3 2020 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO 16.5×

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 3.2%

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 2020	YEAR TO DATE
+2.1%	-8.0%
1 YEAR	**SINCE LAUNCH**
-4.7%	+0.0%

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

We celebrated the fund's 2nd birthday in August and were pleased to deliver another positive quarter of performance. The fund now has six positive quarterly returns over the eight full quarters in which it has been operating, with the two negative quarters coming during general market selloffs. It remains our objective for the fund to be robust in a range of scenarios and the markets have not disappointed in putting this to the test.

The COVID-19 pandemic continues, and as I wrote this update the news broke that President Trump had tested positive for the virus – throwing yet further confusion into the US election process. In the last three months there has been a stream of positive news on the prospect for a vaccine, and it appears that this is the most credible catalyst for a quick return to "normal" life.

The recovery in the general level of global stock markets continued throughout July and August but halted in September. We remain cautious about the disparity between indices, such as the S&P 500, reaching new highs whilst the economic climate appears so fragile. With that said the share prices of many companies are well below where they were at the start of the year and we believe this provides fertile ground for our long-term investment approach.

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Portfolio Update

The fund's unit price increased by 2.1% in the quarter.

Berkshire Hathaway was the largest positive contributor to the increase in the unit price, followed by the Swiss specialist engineering company Bucher and the Chinese paper manufacturer Nine Dragons. The largest negative contributor was the Swedish bank Handelsbanken, followed by the German healthcare company Fresenius SE and the regional US bank Prosperity Bancshares.

Our largest single holding in the fund remains Berkshire Hathaway and its appearance as a top contributor this quarter is mirrored by having had a negative impact in the prior quarter. The company's famed value investor CEO, Warren Buffett, celebrated his 90th birthday in August – having spent half a century "in the saddle". Neil and I look forward to trying to match this record and will report back to you on this in 2068.

Two new companies have been added to the portfolio during the quarter.

The first addition is a "real estate investment trust" that owns a portfolio of high-end American hotels. Their business has been squarely impacted by the current crisis, with revenues grinding to a near-halt. Setting the current crisis aside it is a high-quality business with a conservative balance sheet and an investment grade debt rating. Our valuation model is focused on the value of the property that they own which, whilst highly uncertain, is we believe understated in their accounts.

Part of the motivation for this research was the belief that prime properties in Manhattan, San Francisco or coastal Hawaii have the potential to be inflation proof assets. We do not know that Central banks printing money will lead to inflation – but we want to have protection in the scenario that it does.

The second addition is a British Wealth Management business. We have been tracking this company for more than a year and following a large fall in its share price we believe that it represents good value. It has a very conservative balance sheet and has enacted a transformation in the last five years that can be seen in its financial results.
The company is an example of where our quantitative analysis of the company's accounts is corroborated by qualitative information. Our analysis suggests that the business has become more efficient – by way of example having seen healthy profit growth whilst not growing head count. We believe that general concerns about the economy and Brexit have led to an unfairly pessimistic view of its future by others.

Director's share dealing is a recurring theme within this quarter's letter. We removed GAP from the portfolio – in part because the newly appointed CEO sold down one third of her shareholding. At the same time, the company's Chief Legal and Compliance Officer sold around three quarters of hers. These sales coincided with the company's share price converging towards our quantitative valuation of the company, which itself had been revised down during the crisis. Given our structured approach to allocation we were already targeting a smaller holding, but the Director share sales were of sufficient concern that we decided to completely sell the investment. It remains an impressive business – but owing to the crisis looks increasingly like a turnaround situation that I feel unqualified to have a strong opinion on.
In what follows I provide some more detailed commentary for several specific investments in the fund.

Bucher Industries

Bucher Industries is a specialist engineering business that manufactures agricultural equipment, road sweepers, glass bottling machines and much more besides. The common link between their different divisions is their expertise in hydraulic systems. The picture below shows an example of the equipment made by their agricultural division, the Kuhn Group, which in this case is used for planting seeds in the ground. Their innovation in this type of machinery is not just focused on increasing crop yields, but also on making improvements to soil health that support more sustainable farming practices.

Courtesy: Bucher Industries

We invested in the company earlier in the year, with the COVID panic in markets allowing us to take advantage of a large fall in their share price. The company announced their half-year results in August, with orders for new machinery being around 20% lower than in the previous year. Since the results were announced the company's share price has rebounded, which reflects our view that the current crisis does not have an obvious large, long-term impact on their business.

Our human-and-machine approach to investing requires us to build a valuation "model" that, based on data, estimates what we think the business is worth. In this case our model assumes that the company will continue to grow by profitably reinvesting. To this end I was happy to see them purchase road sweeper and citrus juicing machine manufacturing businesses in the last year.

Herman Miller

The fourth largest contributor to the increase in fund unit price this quarter was the office furniture company Herman Miller. The company makes high quality products, but like Bucher, the onset of the COVID panic saw heavy falls in their share price. In this case these concerns appear more justified since a permanent move away from office working would risk disrupting their business. In case office furniture is a distant memory for you, I include a picture of Herman Miller's wares below as a reminder!

Courtesy: Herman Miller

I was very happy to see Herman Miller's ex-CEO and Chairman spending more than half a million dollars of his own money to buy shares, in a display of confidence in the business that he is responsible for overseeing. The company released their quarterly results in September, with revenues unchanged and profits increased versus the same period last year. Although their contract furniture sales in North America were lower, they saw an increase in home office sales. I am clearly not the only one who decided to treat myself to a new Herman Miller chair at home during the lockdown.

The share price moved over 30% higher after the release of Herman Miller's results, in a sign that market participants were taken by surprise. I see this as a lesson in not presuming to know how short-term events will impact a business. Things are not always what they seem.

Handelsbanken

The share price of Handelsbanken fell in the quarter to make it the largest negative contributor. Concerns around low interest rates and borrowers defaulting on loans have weighed on investor sentiment towards the entire banking sector. As an aside the weight on financial companies is one of the biggest differences, alongside technology, between the MSCI Value and Growth indices. Hence, the relative performance of the popular definition of "value" and "growth" is dominated by the relative performance of financial and technology companies.

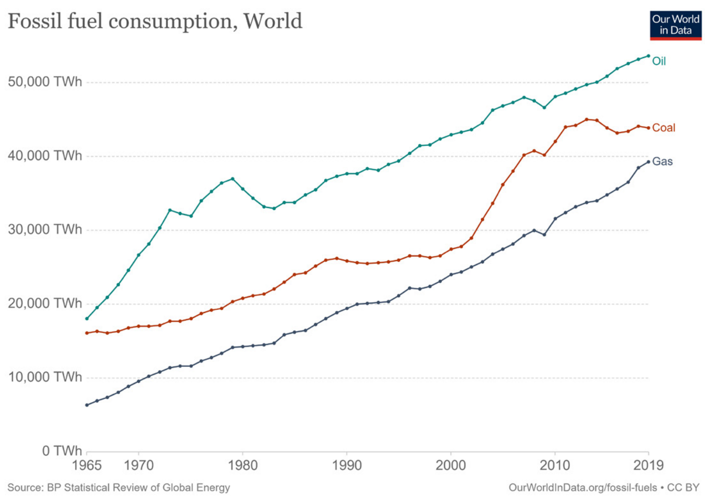
There were two specific developments in Handelsbanken's business that weighed on the share price. Firstly, the Swedish regulator told the company that they had to use a "standard" risk model in assessing the capital required for their UK banking business, instead of a custom in house one. This resulted in the company requiring more regulatory capital. I view this as a "technical" issue rather than a real risk. The chances of their UK customers defaulting on loans is not impacted by the choice of a mathematical risk model and the company's conservative approach means that they still have an excess over the minimum regulatory capital.

The second development is that Handelsbanken announced they will be closing around half of their branches in Sweden. This is big news as the business has a reputation of relationship banking that prides itself on its local presence. They want to reduce costs and will be simultaneously investing in further "digital transformation". I see this as a bold move – something that will not be lost on the company's board and management.

The entire banking industry has seen declining profitability in the face of low interest rates and continued disruption from technological change. I have no way of knowing that this will be the right strategy for Handelsbanken, but it appears well considered and so I applaud the CEO's willingness to make a hard decision. Our valuation model is based on the company delivering a long-term return on shareholder's equity at its current low levels. This leads to a belief that the current share price gives us an ample margin of safety if we are wrong.

Diversified Oil and Gas

The fund is invested in four large diversified oil and gas business, that if counted as one would represent the largest negative contribution to the fund's unit price this quarter. Sentiment on the oil and gas industry within financial markets has been exceedingly negative, both owing to environmental concerns and the large drop in demand that has led to falling oil prices. I believe that this sector has been another key driver of poor performance within "value" portfolios. We live in a world that is powered by fossil fuels where increases in living standards have come hand in hand with an increase in per-capita energy consumption. The chart below shows how fossil fuel usage has risen in the last 50 years.



Acknowledging that we own such companies feels deeply uncomfortable at this point in history – despite living in a country where almost every household is dependent on and continues to benefit from their products. I think it is right that oil and gas companies are under pressure to help society meet the goals of the Paris Agreement – but I equally do not believe that it is an industry that will be "wished" or disinvested out of existence.

Data for the MSCI World Energy Sector index shows that the aggregate market price of the companies in it, is the lowest it has ever been in the last 25 years relative to the accounting value of their net assets (or book value). This clearly does not mean that it cannot go lower, but I struggle to reconcile this with a world that has so far to go in its transition to clean energy.

We have supported shareholder-led votes at the fossil fuel companies we own which are intended to make these companies do more to recognise the issues around climate change. I also talk in more detail below about another company that we own – whose products are responsible for a large impact in CO2 emissions and is working on alternative energy technology. All of this is to say that we wish to be responsible investors whilst not over-simplifying the complexity of the issues that our society faces around climate change.

Freewheeling?

At the start of the year we invested in Johnson Matthey, a specialist materials company known for producing catalytic convertors that improve car and truck emissions. We surfaced the company in a "quantitative screen" because of its strong historic operating performance and low valuation. We were attracted to the business because it has a long history of being well managed and profitably reinvesting shareholders' capital.

The company has been seemingly out of favour with stock market participants because of the feared decline in internal combustion engine vehicles that use its catalytic convertors. This is not, however, its only line of business and it has a 200-year-old history of using research and development to find new opportunities. Given that horses were not fitted with emission control technology, its 19th century profits clearly came from other sources! To this end it is in the early stages of commercialising products both within hydrogen fuel cell and battery technology.

The table below compares Johnson Matthey to another company that aspires to develop hydrogen fuel cell technology, called Nikola. The company is named after Nikola Tesla, who was an early pioneer of alternating current electricity, and is also immortalised by the name of the car company. The Nikola company has received a lot of press coverage this year since it was accused of misleading and fraudulent practices. Fittingly the accuser was called Hindenburg Research[1].

USD MILLIONS	NIKOLA	JOHNSON MATTHEY
Revenue	0	18,659
- of which hydrogen related	0	131
Net income	-99	326
Research and development expense	43	255
Number of years in business	6	203
Number of employees	300	13,600
Market capitalisation	6,776	5,779

Johnson Matthey has an embryonic hydrogen fuel cell business, with its products already in use in Chinese hydrogen powered buses. The company made a recent presentation on this endeavour, highlighting that it has annual revenues of around £100M. Alongside the hydrogen business, the company has also commenced construction of a battery materials plant in Poland and are clearly planning for a future that has fewer catalytic convertors in it. By comparison Nikola's entire revenues in the last 12 months were $36,000.

[1]The Hindenburg was a hydrogen airship that caught fire leading to a tragic loss of human life.

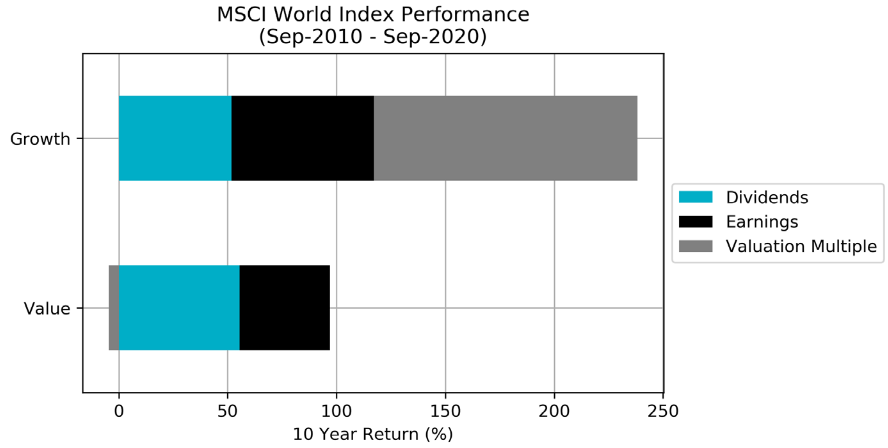
Our rationale for investing in Johnson Matthey is based on their business success to date. I do not know what the likely success of hydrogen fuel cell technology is, but I do know that the company has deep expertise and a long track record of successful innovation.

Despite Nikola's market price having fallen by more than a half it is still more highly valued than Johnson Matthey. I believe this is an extreme example of speculative excess that suggests Nikola's future is as assured as Johnson Matthey's demise. Nikola's shareholders appear optimistic that growing this business will be an easy ride. We do not believe that you can freewheel towards success, without having a realistic and informed opinion on the value of what you are buying. Call me old fashioned, but I prefer evidence over optimism.

Yet More Value vs Growth

The final piece of this quarter's letter is bonus content for the more motivated reader. A Havelock quarterly letter would not be complete without me trying to contribute to the ongoing debate about the relative merits of "growth" and "value" investing. Despite all previous efforts on this subject I still feel that I have more to give!

The chart below looks at the total return of the MSCI World Value and Growth indices in the last ten years broken down into three distinct components. The overall sum of all three components represents the return that an investor would have earned if they had invested in these indices ten years ago. The first component shows the part of this total return that is explained by having received and reinvested dividends after tax. The second component shows the return that is explained by just increases in company earnings[2]. The third component shows the return that is explained by changes in the price earnings valuation multiples applied to the companies in the indices (I.E. how expensive are they).



Source: Havelock London calculations based on Bloomberg data.

With the benefit of hindsight an investor in the MSCI World growth index would have made higher returns than an investor in the value index in the last ten years. If price earnings ratios had remained unchanged in this time, the growth investor would have made 20% more than the value investor – which is material. However, the massive expansion in the price multiples of companies labelled as "growth" means that the actual difference in returns would have been a whopping 146%.

[2]We calculate this component by looking at total profits in the last ten years relative to the total profits in the ten years before that. We do this as we believe it makes for a more sensible calculation of earnings growth that smooths out the vagaries of a single year. We have no reason to think that it biases the end result above.

What do these results tell us and what does it mean for the future?

Firstly, I think that it is unlikely that there will be a repeat performance of the expansion in "growth company" earnings multiples that we have seen in the last ten years. I believe that there is a significant risk that these earnings multiples might instead contract – which if they do will act as a drag on future performance. This is good for value investors as I believe it has the potential to tilt the odds in our favour.

Secondly, it is true that the growth index returns would still have been higher than the value index even if there had not been an expansion in price earnings multiples. The underlying performance of the "growth" companies really were better in the last ten years. This is not however an imputable law of markets and the labels of "growth" and "value" suggest that it is easier to identify which companies will experience high future profit growth than I believe is actually the case. Clearly my aspiration as a value investor is to be identifying companies that will be successful in growing their profits whilst not over-paying for the privilege in sharing them.

I will end by wishing you all good health and look forward to updating you again in three months' time.

Matthew Beddall

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The data in this document is sourced from the fund accountants as at 30.09.20 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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