HAVELOCK LONDON

January 2021

LF HAVELOCK GLOBAL SELECT

Q4 2020 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO 19.8×

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 3.1%

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

PERFORMANCE SINCE LAUNCH (%)

QUARTER 4 2020	YEAR TO DATE
+11.3%	+2.5%
1 YEAR	**SINCE LAUNCH**
+2.5%	+11.4%
2020	**2019**
+2.5%	+15.3%

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

A positive return in 2020 seemed like a "pipe dream" when I wrote in my first quarter letter:

"The fund's unit price decreased by 21% this quarter, resulting in a 14% total decline since the fund's inception. This is not a comfortable opening line but reflects the reality of the sudden mood change in markets brought on by the threats of Covid-19."

I am now delighted to report that the fund's unit price rose by 11.3% in the final quarter, taking the total increase for 2020 to 2.45%. In a year when the majority of our global "value" peer group were unable to deliver positive returns, this is particularly pleasing and builds upon the 15.3% returned in 2019. It was also the seventh quarter of positive returns out of the nine full quarters in which the fund has been operating.

The largest five positive contributors to the change in unit price last year were the French telecoms company, Iliad, the Swiss engineering business, Bucher, the British housebuilder, Taylor Wimpey, the American office furniture company, Herman Miller and the British agricultural business, Wynnstay. The largest five negative contributors were the British engineering business, Costain Group, the Cruise ship operator, Norwegian Cruise Line, the clothes retailer, GAP and the diversified energy companies Exxon Mobil and Royal Dutch Shell. The final section of this letter provides more details on key drivers of the fund's performance.

Bubble, bubble, toil, and trouble!

There continued to be a buoyant mood in markets in Q4 — helped by the positive clinical results, and subsequent approval, of several vaccines for COVID-19. This was despite many northern hemisphere countries facing substantial "second waves" of infections.

Following the announcement of the Pfizer vaccine trials on 9th November many companies perceived to be most impacted by the pandemic saw large share price gains. By way of example one of our portfolio companies, Host Hotels, saw its share price increase by 30% in a single day. I believe that the link between company share prices and their underlying business conditions is often "fuzzy", and market moves such as this only serve to reinforce this belief. Whilst the vaccine news is undoubtedly positive, for many such companies I thought the size of the reaction was disproportionate. It felt that many market participants were rushing "from one side of the boat to the other" to buy up companies that would benefit from a return to normality.

Observing markets in the last year has, more generally, served to strengthen my belief that short-term price movements are dominated by emotion more than detailed analysis. It has felt that the link between "Wall Street" and "Main Street" has become particularly stretched (not that the history books suggest they have ever moved in lockstep). My conviction that there is a risk of an asset price bubble has strengthened over the last three months. I believe that this bubble is particularly focused in the US on companies that are perceived to be "high growth" or have dominant technology franchises.

What is the case for us witnessing a bubble?

- The total value of all public US companies relative to US GDP is "off the charts" with a ratio of 1.9×. During the "dot com bubble" this ratio peaked at 1.4×[1]. This is a metric favoured by the famed investor, Warren Buffett, and is at the highest it has been in 50 years. The extent to which this ratio has "spiked" in the last two years gives me cause for concern.
- There has been a frenzy of companies raising capital on the public markets. Much of this activity has been via "Special Purpose Acquisition Companies" (SPACs) — which are a way of raising money from investors with less scrutiny than a traditional Initial Public Offering (IPO). It is the first year in history that US companies have raised more than $100Bn in IPOs, with more companies having been made public than at any point in the last 20 years.
- From a "bottom-up" vantage point the valuation of companies such as Tesla or Nikola look, to my eyes, hard to justify. The ascent in Tesla's share price has been so rapid that it appears, to me, to have the hallmarks of a speculative mania. The company has a market share of global car sales of circa 0.7%, but it is now worth more than the combined value of its eight largest competitors . For a discussion of Nikola see my last quarterly letter.
- There exists a compelling "this time it is different" story. The cornerstone of this is low interest rates and very "accommodative" monetary policy, that pushes investors to justify paying higher prices for assets in the search for yield. There appears to be an acceptance that interest rates will be low for a long time into the future, that Central Banks will support asset prices and that this can be achieved without any other adverse economic consequences.

[1]Chart shown in the Appendix below.

- There appears to be a growing public euphoria for share trading. Google Trends data for North America shows that google searches for "share" during 2020 have been higher than at any point since 2004 when the data begins. Bubbles are always accompanied by stories of making "easy money" that stoke up a "fear of missing out". I believe that podcasts, YouTube channels and such like are providing the means to disseminate these stories and encourage retail speculators.
- Whilst more difficult to quantify, it appears that sentiment in the markets is not being impacted by bad news in the way that might be expected. A bad unemployment number or surge in virus cases seems to be taken as a sign that there will be more stimulus – which will be good for markets. By the opposite token good news that is positive for the economy is also taken as good for markets. I do not see how this can continue and am concerned that many investors are being lulled into a false sense of security by the "heads I win, tails you lose" environment.

What about the opposing view?

For each of my points above there is an opposing view.

- There is no fixed law governing the overall size of the US stock market relative to the general economy.
- The frenzy of IPOs could be rationalised by the continued move to a digital economy creating many new worthwhile investment opportunities.
- Companies, such as Tesla, could be argued to have such strong technological advantages that they offer sufficiently high long term future growth to justify their current valuations.
- Low interest rates could remain for many years and, despite the massive monetary expansion, may be accompanied by economic stability – for reasons that may not be obvious.
- The public enthusiasm for stock markets could turn out to be not such a big deal, or perhaps a rational consequence of more individual pension saving or even a lack of any other worthwhile investment options in their view.
- We could be at the cusp of a continued disruptive technological revolution, meaning that the prospects for the future are great irrespective of the minutiae of 2020.

I think it will be clear which side of the debate I lean towards. When I look at the evidence collectively, I believe that there is a real risk that we are seeing a bubble in some asset prices.

What are you going to do about it?

Our approach to protecting our client's money from this threat is two-fold:

- We look to own relatively lowly-leveraged public companies, where valuations do not rely on an undue level of optimism. Our approach keeps us away from owning companies where high valuations can only be justified by forecasts of their businesses seeing high growth for a long time into the future.
- We currently hold a fraction of the fund in cash, both as 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 risk aversion increases in markets.

It is my belief that forcing yourself to be fully invested in equities 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 investments, without any other way to make this risk stable through time. We believe that if our risk of financial loss is consistent through time it will in turn help increase our long-term compound return.

[2]https://www.bakermckenzie.com/en/newsroom/2020/12/ipo-report-2020
[3]https://wolfstreet.com/2021/01/02/tesla-finally-almost-hit-500000-deliveries-2-years-behind-its-2016-promise-for-a-global-market-share-of-0-7/
[4]https://trends.google.com/trends/explore?date=all&geo=US&q=shares

Our investment mantra is that we wish to own a portfolio that will be robust in a range of scenarios. This is because there are many factors in financial markets that we cannot realistically expect to forecast. This balanced approach has served us well since we launched the fund, but risks making us, at times, look needlessly cautious. In the scenario that financial markets are not adequately reflecting the economic impact of the pandemic, I think this caution will be justified.

Despite my concerns of an asset price bubble, I see evidence that there are many companies that do not require optimistic forecasts to justify their current prices. Increases in market prices have not been unilateral for all companies. For this reason, I believe that a valuation focused approach to investing offers both an opportunity for profits and a way of side-stepping the most egregious speculative excess.

Year End Performance Review

The top contributor, Iliad, runs established mobile phone and broadband networks in France, under the brand name of "Free", and has more recently launched an Italian mobile phone business. The image above shows customers in one of their stores – a distant memory for those of us in lockdown. They are the fourth largest mobile phone operator in France and have recently grown to be the fourth largest operator in Italy. The company was busy last year on multiple fronts, having sold their portfolio of cell towers, seen a strong up take in fibre-broadband subscribers and acquired a Polish mobile phone business. This leaves Iliad as the 6th largest European mobile phone operator.

The increased demand for home internet bandwidth during the lockdowns has clearly helped Iliad's business. When customers move to use their fast fibre-based service the company no longer needs to pay a fee to utilise the copper cables of the incumbent phone company, which benefit their profit margins. It is a cash-generative business, and we are happy to see this cash being reinvested into growing the business.

We went into 2020 with Iliad as one of our largest investments and almost all the share price gains came in the first half of the year. We have trimmed the size of our holding in response to the share price moving closer to our valuation of their business. We continue to own it in the belief that it is a good business, albeit not looking as tantalisingly cheap as when it first caught our attention.

Taylor Wimpey is a national house builder and a household name in its home market in the UK. With all other things being equal I prefer to be a long-term owner of a business and so the extent to which we have bought and sold shares in the company this year feels like an uncomfortable, but necessary, deviation from this pure intention. Forgive me.

By the end of January, Taylor Wimpey's share price was so far ahead of our valuation that we sold our entire holding. The share price subsequently fell by almost 50%, such that by the end of March we were buying back what we had earlier sold. It then recovered to the point that we saw better opportunities elsewhere and sold our holding for a second time in June. By September, the share price fell substantially, again, by circa 33% which saw us again buying the company's shares. Following this the price increased by circa 50%, such that we sold our holding for the third time in the space of a year.

Your expectation should be that we invest for the long-term, but the purity of this intention will always be kept in check by our valuation of a business and associated "sell discipline". Our process driven approach to investing means that when something starts to look expensive, and we see better opportunity elsewhere, we will move towards the exit. In the case of UK housebuilders, they have all benefited from the Government's help to buy scheme – it is evident in their profit margins. Our valuation of Taylor Wimpey is somewhat conservative because it assumes that this support will not continue.

Wynnstay is one of two UK Agriculture businesses that the fund invested in during last March. Both companies have diversified businesses, but their mainstay is producing animal feeds. Both also have almost no analyst research coverage owing to their small size. This is something that I believe works in our favour since under-researched companies offer more scope for us to see what others do not.

The image above shows part of Wynnstay's fleet of grain lorries – which were painted to celebrate the company's centenary. Both agriculture businesses are exposed to the ebbs and flows of the weather, as their main customer base is farmers. They came to our attention following a warm winter that had caused a drop in profits. Both made the top ten list of contributors to increase in unit price last year. Our thesis of looking beyond the vagaries of a single year's weather plays well both to our strength in using data and our longer-term outlook.

The investment in these agriculture businesses also speaks to our approach of wanting to be robust in a range of future scenarios. They are part of a cluster of businesses that we think are both reasonably priced and likely to be relatively insulated from a general economic downturn – the need to eat being something of a given. Furthermore, I believe that if we see higher inflation, agriculture businesses may offer some protection. As 2020 ended we did indeed start to see increases in global food-commodity prices – time will tell if this is part of a bigger inflationary trend.

Costain was the single largest negative contributor to the funds change in unit price. The company's decision to raise fresh capital during the crisis was not well received by the market. I personally learnt from this experience. Whilst we invested in the belief that the businesses had a strong balance sheet, it became clear that much of their headline cash holdings were held in "project bank accounts" ring-fenced for specific clients. This exaggerated the strength of the balance sheet. I believe that the best investors never stop learning – and this is a lesson that will be etched into my memory.

The second largest negative contributor was Norwegian Cruise Line Holdings. Clearly the cruise industry was impacted by the COVID pandemic. One of the reasons why I liked their business is that they used advanced ticket sales as a major source of free finance. It turns out that many cruise customers pay in advance, which provides a useful source of free funds in what is an asset intensive business. The overnight shut-down of their business thus not only impacted revenue but left a hole in their balance sheet that needed filling.

We made the decision to sell our holding in Norwegian, in part because I did not feel well placed to forecast when they would be able to resume cruise operations – which was needed to be able to value the business. I was happy to sit out this dance and focus my energy elsewhere.

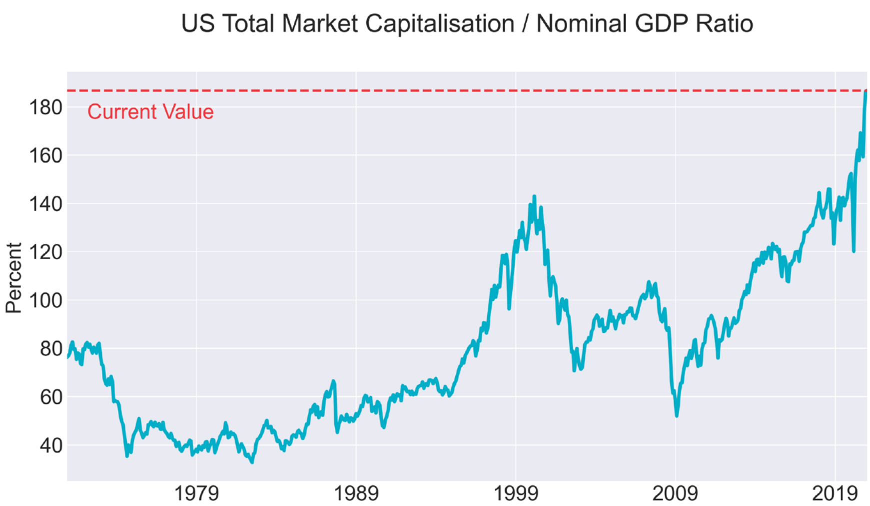
The largest contribution to the increase in unit price in the final quarter came from our investment in an airplane leasing business. The company rents planes to many of the world's major airlines – priding itself on owning a modern and fuel-efficient fleet. Although the planes they own were mostly grounded by the pandemic, most of their customers continued to make lease payments. Unlike Norwegian, we felt that the disruption was less of a threat to the balance sheet and did not radically alter our ability to value the business. This is a company that we were invested in throughout the entire year and so the final quarters gains, were recouping losses made earlier in the year.

In a similar vein to cruise ships and airplanes, we invested in a business last year that owns a large portfolio of luxury hotels. This was another top ten contributor for the year. Whilst their income was severely impacted by the pandemic – I was attracted to the quality of the assets that they own coupled with their relatively conservative balance sheet.

My most entertaining end of year observation involves another business that I believe to be under researched. The company is a small specialist engineering business that has two classes of shares; voting and non-voting. The founding family own the majority of the voting shares. With both share classes receiving the same dividend and the founding family having a voting majority, it leaves me wondering why any investor should have preference for one class over another. Yet in 2020 the non-voting shares (that we own) fell by 22% whilst the voting shares rose by 22%! I am unfazed by the impact on the fund's unit price, not least because the shares are thinly traded. I believe that the current steep discount of the non-voting shares is something that will (as it has before) revert.

This story provides me with an example of how, in my opinion, financial markets can at times defy common sense. We move forward into 2021 with the portfolio of businesses that the fund holds being at a discount to our estimate of their true value. We continue to gently react to movements in market price – increasing holdings in those companies that we think are cheap and reducing holdings in companies that we think have become too expensive. In comparison to this time last year, I believe that the businesses we own are, in aggregate, higher quality. I also feel that they span a more diverse range of industries.

APPENDIX



Source: Havelock London calculations based on: (1) Wilshire 5000 Total Market Index; (2) US Bureau of Economic Analysis nominal GDP data.

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The data in this document is sourced from the fund accountants as at 31.12.20 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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