HAVELOCK LONDON

April 2021

LF HAVELOCK GLOBAL SELECT

Q1 2021 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO **21.0×**

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 **2.6%**

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

PERFORMANCE SINCE LAUNCH (%)

QUARTER 1 2021	YEAR TO DATE
+11.0%	+11.0%
1 YEAR	**SINCE LAUNCH**
+43.7%	+23.6%
2020	**2019**
+2.4%	+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

What a difference a year makes, in markets at least. The start of 2021 could not have been more different for the fund than the same period last year. The unit price increased by 11% in the first quarter, against a backdrop of optimism that COVID vaccines would help move the world towards some sense of normality. Positive sentiment in markets has been directed towards companies who will benefit from an end to lockdowns, which includes many of the businesses that we have invested in.

Most of the companies we follow have reported their annual results in the last two months, which has kept me busy reviewing each of them in turn. This forms part of our approach of understanding these businesses and allows us to update our valuations in response to the latest set of financial accounts. It also provides an opportunity to reaffirm, or otherwise, our commitment as an investor in each company we own.

Alongside monitoring our existing investments, we have researched and included three new companies in the portfolio. All three are technology related businesses, one producing electronic components, one specialist hardware for the TV industry and one an online consumer finance business. We completely sold our holdings in two industrial businesses (one British and one American), following strong increases in market price that left them looking expensive relative to our assessment.

The largest contribution to the increase in unit price came from the UK agricultural business, Wynnstay. Our thesis when we invested was that sentiment towards the company was too focused on short-term economics which are heavily impacted by the weather. Business conditions did indeed improve from this time last year, despite the UK having experienced the lowest wheat yields since 1981. This led to a sharp increase in the company's share price. The company has also made two acquisitions this year, which offer the prospect of helping it grow by increasing market share.

There was a near-tie for the place of 2nd, 3rd, 4th, and 5th largest contributor to the unit price increase. The four companies in question were UMB Financial (a regional US bank), Johnson Matthey (a specialist British chemical business), Berkshire Hathaway (the famed US conglomerate) and Daito Trust Construction (a Japanese real estate company). The two largest detractors to the change in unit price were the French telecom business, Iliad, and the Bermudian insurance company, Hiscox.

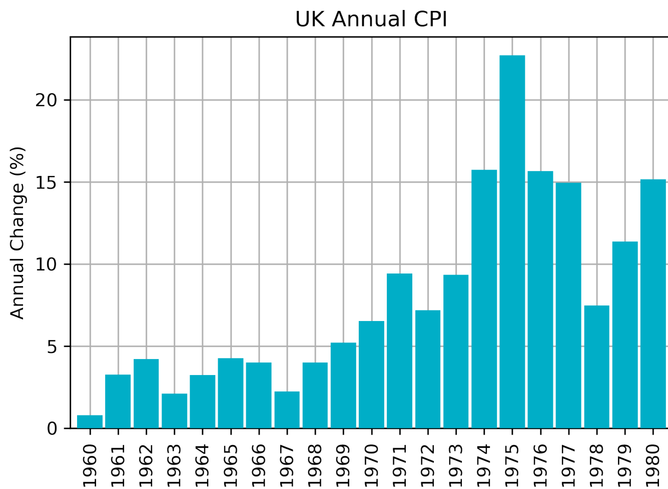
I believe that it pays to remember that the roll call of "winners and losers" is based on movements in market price which reflect sentiment in the financial markets as much as changes in business conditions. Conglomerate companies, composed of multiple distinct business divisions, are one such part of the market that are out of favour with many investors. It appears that sentiment towards many of them is often dictated by their weakest division.

We increased the size of our shareholding in the two German conglomerates, Henkel and Fresenius SE, this quarter. We have been invested in both businesses for the last two years. While both companies have had their challenges, I believe that current sentiment towards conglomerates has allowed us to become part owners in their spread of high-quality businesses at prices that are more attractive than if each division were a separate listed company.

Inflation in the 1970s

There is growing concern that the amount of money that central banks and governments are injecting into their economies will cause higher inflation. The sheer magnitude of this was deftly put into context by ex-US Treasury Secretary Larry Summers, who cited the size of the US stimulus package as, at least, 3 times the estimated decline in economic output. These concerns have driven increases in long term interest rates this year which have in turn created more headlines on the risk of inflation.

The last major inflationary period for developed countries was in the 1970s. Fifty years is long enough ago that I thought it merited a look through the history books to understand more about what investors experienced at that time.
The UK faced dark days in the 1970s, with a protracted banking crisis, falling property prices, a run on the currency and high inflation. The country was forced to borrow a then record amount from the International Monetary Fund. High inflation led workers in many industries to strike in protest over pay, leading to the country operating a three-day working week and rubbish piling up in the streets. On an inflation adjusted basis the British stock market fell 38% in 1973 followed by a 67% fall in 1974.



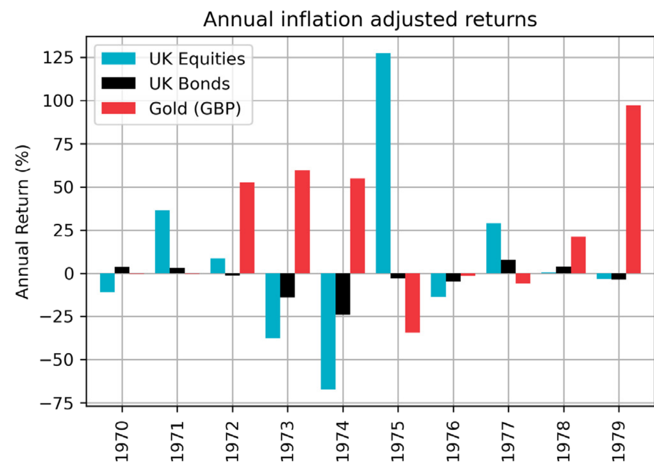
The chart (left) shows the annual change in the UK consumer price index for the 1960s and 1970s, which make the years of high inflation clearly visible. During the 1960s this inflation measure averaged just 3.3% per year, providing little clue of what was to come in the years ahead.

Source: Bank of England

I have approximated the experience of a British investor in the 1970s with data for the FTSE All Share Index, UK 10-year government bonds[1] and gold prices expressed in British pounds. The chart (right) shows the annual returns of each of these assets, expressed after the impact of inflation.

Source: Bloomberg, Bank of England & Havelock London calculations

[1]Historic bond yield data was used to estimate the returns from investing in bonds. Details available on request.



	Before Inflation			After Inflation		
	UK Bonds	UK Equities	Gold (GBP)	UK Bonds	UK Equities	Gold (GBP)
1969	100	100	100	100	100	100
1970	110	96	106	104	89	100
1971	124	139	116	107	121	99
1972	131	161	185	106	132	152
1973	125	116	312	91	82	242
1974	115	56	532	69	27	374
1975	137	141	471	67	62	246
1976	152	143	537	64	53	242
1977	187	206	585	69	68	227
1978	208	222	752	71	69	275
1979	224	240	1569	69	66	543
1980	242	324	1678	64	80	498

The table on the left shows the value of £100 invested in each of these three asset classes during the 1970s, both before and after inflation (as measured by the UK CPI data shown above).

Source: Bloomberg, Bank of England and Havelock London calculations

Bonds

When the impact of inflation is considered a bond investor would have lost around one third of their purchasing power in the 1970s. The UK 10-year government bond rate moved from around 9% to 14% which caused bond prices to fall. However, the high level of interest rates compensated for this as the semi-annual interest payments provided investors with a sizeable income.

The UK 10-year bond rate is currently around 0.85%, which means that investors are much more vulnerable to increases in interest rates than in the 1970s. If rates were to move to 3% over the course of the next decade, I estimate that bond investors would make no money before inflation. The current low level of interest rates combined with the threat of higher inflation make me believe that investing in Government bonds risks both loss of capital and purchasing power in the decade ahead.

Equities

The losses that UK equity investors endured during the 1970s are truly eye-watering. From 1972 to 1974 the UK stock market fell by around two thirds. Could this happen again? I believe it much less likely, firstly, because investing in fixed income securities is so much less attractive due to low interest rates and, secondly, I think the dire economic conditions that the UK faced in the 1970s are not comparable to the present day. One should also note that once the "dust settled", an investment in UK equities did make higher returns across the full decade than UK government bonds.

What does feel comparable to the present is that equity investors in the 1970s were drawn to large growth stocks (I have written before about this so-called "Nifty Fifty" boom). The next piece of data that I share requires more in the way of explanation – bear with me.

To look at the relative performance of "value" and "growth" in the 1970s I need to move to use US stock data. This is because such data is not available "off the shelf" for the UK stock market. I use data calculated by the US academic, Kenneth French. There is no unique way to define "value" or "growth" and so what follows is an over-simplification of the true meaning of the two approaches.

	US Value	US Growth
1969	100	100
1970	114	91
1971	122	113
1972	142	136
1973	129	107
1974	95	74
1975	146	98
1976	221	112
1977	231	103
1978	254	111
1979	322	127
1980	417	173

Source: Kenneth R. French

The table on the left shows the value of $100 invested in hypothetical "value" and "growth" portfolios that were formed based on the size of a company's underlying cash-flow relative to its market value. This is a simple measure of how expensive each company was at any point in time. The "cheapest" 30% of the US companies form the "value" portfolio and the most "expensive" 30% form the "growth" portfolio.

This is a hypothetical result that does not include transaction costs and so the total level of returns is higher than an actual investor could have achieved. This short coming, however, applies to both in equal measure. It suggests that returns from holding a value-oriented portfolio significantly outpaced those of a growth portfolio during the high inflationary period of the 1970s.

Gold

With the benefit of hindsight UK investors would have been best served in the 1970s by "running for the hills" and putting all their wealth into gold. It is not however practical to invest on the basis that civilisation ending doom is always around the next corner and I do not think that gold can be relied upon to always be the inflation hedge of choice. It has little in the way of utility and so its scarcity value is derived from investors forming a consensus that it is worth owning.

Putting a large chunk of your wealth into an asset that produces no yield, such as gold, is clearly not without risk and I believe that a better takeaway message from the 1970s is that scarce physical assets might also provide some protection from high inflation.

Applying the lessons of the 1970s to the present day

The last decade has been particularly kind to balanced portfolios that are composed of government bonds and growth stocks, as the combination of falling interest rates and rising earnings multiples has created a massive tailwind for many investors. I believe that this experience will not be repeated in a high inflation environment. Unlike in the 1970s, bond investors receive very little in interest payments today, and so are highly exposed to prices falling as interest rates rise.

History rarely repeats – but it does rhyme. At Havelock we do not attempt to make investment decisions based on macro-economic forecasts, but we do want to ensure that we hold a portfolio that will be robust in a range of scenarios. I believe that there has been a significant increase in the risk of inflation in the next decade due to the extreme levels of fiscal and monetary stimulus.

This threat of higher inflation is focusing my mind on how the companies we invest in would fare in this scenario. The cornerstone of our defence against inflation is owning shares of well-run businesses purchased at realistic prices. I specifically believe such a value-oriented approach has the potential to help counter the threat of inflation. This is borne out by data from the inflationary period of the 1970s and comes at a time when investors are willing to pay hefty premiums to invest in "growth stocks". On top of this we want a significant portion of the businesses we invest in to offer some defensive characteristics against inflation – such as exposure to scarce real assets.

I believe that any investor who feels company valuations can be safely ignored is placing themselves at risk of future disappointment.

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. Every attempt is made to ensure 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 31.03.21 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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