HAVELOCK
LONDON

July 2021

LF HAVELOCK GLOBAL SELECT

Q2 2021 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO **22.1×**

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 **2.8%**

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

PERFORMANCE SINCE LAUNCH (%)

QUARTER 2 2021	YEAR TO DATE
+2.8%	+14.1%
1 YEAR	**SINCE LAUNCH**
+29.7%	+27.0%
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

The fund's unit price increased by 2.8% on the quarter, taking the year-to-date increase to 14.1%.

The largest contributor to the increase in unit price this quarter was the British business, Morgan Sindall. The company has several different divisions, with the most profitable being construction, infrastructure and building fit outs. This sees them undertake large projects such as building roads, bridges, and school buildings, as well as fitting-out empty building interiors to make them into useable spaces. It is likely that you will have seen their name on one of their vehicles or building sites as they have a large presence in the UK.

The construction industry is tough to operate in as margins can be very slim. Against this backdrop the company's financial discipline has helped it to stand apart from competitors. Their management team have maintained a strong balance sheet with a laser like focus on cashflows that is helped by only pursuing high quality projects tendered for at realistic prices. Our original investment thesis was that the potential for government infrastructure spending meant that the company was not as exposed to fluctuations in the British economy as its share price appeared to imply.

The company has twice released trading updates this year stating that conditions are running ahead of expectations, resulting in their share price having seen several large increases. Although these have happened over a relatively short period, it is gratifying to see their business flourish in line with our original thinking. I look back on this investment as being a good business purchased at a great price.

The second largest contributor to the increase in unit price was the German medical conglomerate, Fresenius SE. The company operates private hospitals, manufactures generic drugs, and has a 32% stake in a large diabetes treatment business called Fresenius Medical. The company has faced several challenges within each of its businesses this year that I judged as temporary rather than structural. They gave me no reason to alter our long-term valuation model of the business, and I believe the short-term focus of others allowed us to increase our holding at favourable prices.

Companies unloved by the stock market because they are conglomerates are a recurring theme within the portfolio. At their worst, conglomerate businesses can be a sprawling mess, governed by complex bureaucracy with poor capital allocation discipline. Where we find a company that has a history of disciplined capital allocation, with a small number of business divisions that we can understand, we are happy to tread where others might not.

Conglomerates have tended to move in and out of fashion within financial markets. Fresenius' management understand full well that the structure is currently unloved and have indicated that they will explore breaking the business up if they feel it continues to be shunned by investors. Whilst valuations are, of course, subjective, this sort of messaging from a sensible management team increases my confidence in our own valuation model.

The third largest contributor to the increase in unit price was the British supermarket, Morrisons. The company operates in a tough industry, with increased competition having applied substantial pressure to their profit margins. Valuing their business presents something of a quandary to an investor, as focusing on the profits from their income statement would tell a different story to the net value of their balance sheet assets. Put simply they own a lot of interesting "stuff" but make a meagre profit from these assets. With such a business it risks being worth more when dismantled, than as a going concern.

Whilst we receive dividend payments from our investments, as a value investor, we ideally would also benefit from price appreciation as the outside world moves to agree with our assessment of value. The latter source of return requires an act of faith that sooner or later the world will see what we do.

The reason for the substantial increase in Morrison's share price is that it has been subject to several takeover offers by private equity buyers. The company's management have accepted one of the offers and it is on a glide path to becoming a privately owned business. We could not have foreseen this as the catalyst for the value we saw being recognised by others, let alone have hoped to "time" it. The new buyers have indicated that they do not plan to dismantle the company, but clearly, they will want to find a way of unlocking the "untapped" value within the business.

The largest detractor from performance in the quarter was the European telecoms business, Iliad. We have been an investor in the company since September 2018, but the size of our holding has been altered in this time in response to large rises and falls in their share price. The catalyst for the company's recent large share price falls was the announcement that they wanted to continue to invest in building their fibre optic network, and so would push back their free cashflow targets. Whilst many investors have taken this as bad news, I am happy to see them step-up reinvestment in the business as the management team have a successful track record of growing it.

We added two new investments into the portfolio during the quarter. One of them is a high quality European industrial conglomerate. The company has similarities with several other businesses that we have invested in, and so evaluating it felt well within our circle of competence. The second new investment is a gold mining business.

In the last 18 months we have undertaken two research projects into the subject of inflation and the inflation hedging characteristics of gold. To cut a very long story short I believe that it is uncertain if we will see high levels of inflation and if we do it is uncertain if gold will act as an effective hedge. However, there are clear reasons to be concerned about the risk of inflation because of the large and record monetary expansion that we have witnessed in recent history.

The principal reason for our investment in a gold miner is that we wish our portfolio to be robust in a range of future economic scenarios. If we do see very high inflation and a subsequent reaction in the gold price, such as happened in the 1970s, then this will help us achieve this goal.

Turnover for the last six months was above our long-term expectation, as we rebalanced towards those investments that we perceived as most attractive. When large market moves make us believe that better opportunities exist elsewhere, we will not hesitate to be more active. We move into the second half of the year with the portfolio at a smaller discount to our intrinsic value estimate than at the start. However, given the rebalancing activity the discount has not narrowed by as much as the strong performance would suggest.

Our research continues to uncover interesting opportunities, albeit not to the same extent as this time last year. We remain as committed, as ever, to doing a good job overseeing the fund and thank our investors for their continued trust in us.

Investing in a low return world

In response to the global pandemic central banks and governments have delivered record amounts of economic stimulus. Much of this has taken the form of increasing money supply via buying financial assets, following which asset prices look high relative to their history.

As observed by famed investor Howard Marks, a world with high asset prices is a world of low future returns. This is most easily understood by a traditional bond investment that pays a fixed coupon; higher prices clearly equate to lower income yields. The same argument applies elsewhere when asset prices increase by more than their underlying economics or earning power.

What we do not know is if asset prices are now at a permanently higher plateau, and lower investment returns are the new norm, or if we are witnessing a spectacular "everything bubble" that will create financial pain when prices "normalise".

Where does this leave investors?

The easiest response is to do nothing and knowingly, or otherwise, accept that future returns will be lower. I believe this is the path of least resistance, and thus the one that most investors will take.

To try and avoid lower future returns, I see only three credible options:

1. Take less risk in the hope that asset prices are cheaper in the future.
2. Take more risk in the hope that the status quo holds, and you earn a higher return.
3. Try to do something "clever" to make a higher return with no additional risk.

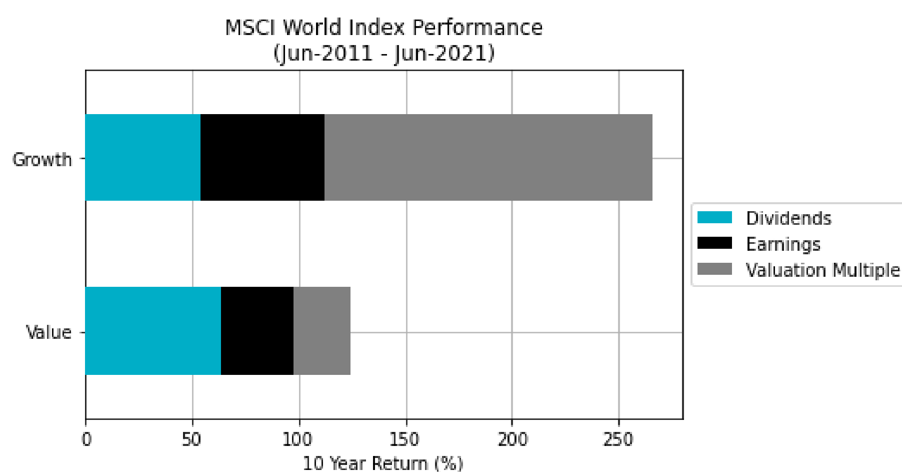
Doing Nothing

In investing, doing nothing, is often a good strategy. It allows you to side-step the latest fads, avoid acting on emotions and helps ensure that returns are not eaten up by transactions costs.

In the last decade I believe many investors have navigated towards owning a portfolio dominated by "growth" stocks and government bonds. These have both been the "gifts that keep giving", however I believe they are destined to produce lower returns in the future.

In the case of government bonds, and fixed income investments more generally, we have experienced 40 years of falling interest rates. This provided a tail wind that helped increase bond prices (since they move inversely to interest rates). In the last decade UK 10-year Gilt yields have fallen from around 3% to 0.5%. I calculate that for investors to receive a similar return in the next decade, as in the last, 10-year UK interest rates would have to fall from 0.5% to around -4%. I think this is possible, but unlikely.

So called "growth" stocks have also benefited from a tail wind in the last decade, with their prices moving to be much higher multiples of their underlying earnings. The price to average 10-year earnings ratio for the MSCI world growth index almost doubled in the last decade, moving from 25× in June 2011 to 48× in June 2021. I do not think that such a doubling is likely to happen again in the coming decade.



Source: Havelock London calculations based on Bloomberg data.

The chart above is an updated version of our analysis from my September 2020 quarterly letter and shows our estimate of the performance drivers of the MSCI world growth and value indices in the last 10 years. This makes clear the impact that earnings-multiple expansion has had on the performance of "growth" stocks.

Taking less risk

Taking less risk is most easily achieved by holding more cash or other short-dated "safe" investments. If asset prices fall, then you can swoop in and buy at prices lower than today, locking in a higher return. If asset prices do not fall then, you will clearly have forgone the returns that holding "riskier" assets would have provided.

I suspect that some investors will proceed on a "do nothing" basis, expecting that they can quickly switch to a "take less risk" strategy as and when they think asset prices are falling. This strategy sounds appealing but is hard to achieve as major turning points in markets are rarely well sign posted.

Taking more risk

Taking more risk is most easily understood in fixed income markets, where the interest rate you earn is set according to the perceived risk of the borrower not meeting their payment obligations. Orthodox theory in financial markets builds on this to say that more generally the rate of return you earn is dictated by the risk you are willing to take.

One clear mechanism for the risk/return trade off in equity markets is that when a company increases its leverage via borrowings it increases the upside for shareholders, but also the probability of them being "wiped out" if there is a bump in the road.

Doing something "clever"

What most investors would ideally like, is to find a way of side-stepping the orthodox relationship between risk and returns, to make a higher return without a corresponding increase in risk. The financial services industry is always keen to meet this desire and so there is never any shortage of products making such claims.

Given that there is no unique way to define risk it is often the case that doing something "clever" will result in swapping one risk for another. For example, the private equity industry touts the prospect of higher returns than public equity markets, but it comes with the risks of lower liquidity and higher leverage.

I am front of the scepticism queue when it comes to "clever" financial products. However, I believe that owning "high quality value" stocks is currently presenting investors with an opportunity to earn higher future returns with less risk.

I see evidence of this from a "top-down" perspective because as shown above "value" stocks have not experienced the earnings-multiple expansion of "growth" stocks, and so I see them at less risk of a corresponding multiples-contraction. More importantly I continue to see evidence from a "bottom-up" view, where our research leads us to companies that we judge as high quality, having longevity of earnings power and being available to purchase at a more reasonable price than many more popularly owned companies.

Put differently, I believe that in the current market environment there is still merit to being selective about which companies you own. Whilst, equity prices are high on average, I believe that their increase relative to underlying earnings has been concentrated far more in some corners of the markets than others. Relative to many other "clever" investment products on offer, I find the argument for a "value" strategy to be reassuringly straightforward.

Investing in a low return world

The above reasoning leads to my mental model for investing in a low return world, that I set out in the 2-by-2 matrix below.

		Conviction that asset prices remain high	
		Low	**High**
Tolerance of low returns	**Low**	Do Something "Clever"	Take More Risk
	High	Take Less Risk	Do Nothing

I have mapped the four possible actions for investors to two simple questions about their outlook. The strength of an investor's convictions in the above two questions should dictate their behaviour. Very few investors, myself included, will hold convictions so strong that they pursue only one of these four options to the exclusion of the others.

At Havelock, we have relatively low conviction that asset prices will remain permanently high and a low but not-at-all-costs tolerance of low returns. This means that our approach should be skewed towards the top-left part of this matrix if we hope to achieve our goals.

The cornerstone of our approach is to hold assets that we think are reasonably priced and do not require too much optimism about the future. This requires us to understand and value each business we invest in, and I put this in the "doing something clever" category. We do assume general equity market risk and allow ourselves to hold some cash "dry powder", so there are also elements of "do nothing" and "take less risk" in our approach. More specifically we attempt to limit the losses we will make during a large fall in general equity markets to be less than most broad market indices.

Why am I telling you all this? I believe successful investors find ways of reducing the complexity of markets to allow logical reasoning about where they think they are and where they want to be. There is no unique way to do this, but I thought I would lay out my stall for how I think about the challenges of investing in a low return world.

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The data in this document is sourced from the fund accountants as at 30.06.21 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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