HAVELOCK LONDON

October 2021

LF HAVELOCK GLOBAL SELECT

Q3 2021 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO 16.6×

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 (%)

QUARTER 3 2021	YEAR TO DATE
+2.4%	+16.9%
1 YEAR	**SINCE LAUNCH**
+30.1%	+30.2%
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 2.4% in the last quarter, taking the total increase since inception to 30.2%.

The largest contributor to performance in the quarter was the French telecom business, Iliad, following a bid by the company's founder to take the company private. He offered to buy out other shareholders at a 60% premium to the prevailing market price, which meant that we sold at a price close to our estimate of what the business was worth. We have owned shares in the company since 2018 and sold them on the last day of the quarter as part of a "tender offer". This caused an increase in the fund's cash holdings, which has since fallen as we redeployed the proceeds into our newer investment ideas during the first week of October.

Sticking with the theme of takeover offers, the fund had a holding in the British supermarket, Morrisons, which has been at the centre of competing takeover offers. Each time an offer was made to purchase the company, its share price moved above the offer price, due to an expectation that a higher bid would follow. This left investors with the decision to sell at a "premium" or hold on for a higher bid. We "hedged our bets" by gently reducing our holding during this time, up until the day before the winning bid was known. The net result of this was that Morrisons was the fourth largest contributor to the quarter's increase in unit price.

The second largest contributor to the unit price in the quarter was the Japanese property business, Daito Trust Construction, and the third largest was the British agricultural business, Wynnstay.

The largest three negative contributors to the change in unit price this quarter were the British chemical business, Johnson Matthey, the gold miner, Newmont Corporation and the digital lens manufacturer, Largan Precision. Both Johnson Matthey and Largan Precision were impacted by global supply chain disruptions. Johnson Matthey's largest division supplies catalytic convertors to car and truck manufacturers, who have seen their production volumes fall due to semiconductor shortages. Largan Precision's lenses are used by smart phone manufacturers, including Apple, who have again been impacted by semiconductor shortages.

Returning to the theme of takeovers, the US furniture business, Herman Miller, completed its takeover of competitor, Knoll, in the last quarter. Knoll was acquired for a price that was close to our own conservative estimate of its value, using a combination of debt and equity. The debt finance is at attractive fixed rates, which together with a realistic plan for cost savings, make us believe that the transaction will be beneficial for Herman Miller shareholders. The combined business will be known as MillerKnoll going forward.

Herman Miller's latest earnings report spoke about the difficulties of finding workers, increases in raw material costs and supply chain disruptions. We have increasingly seen many other companies that we invest in and follow warn about these same inflationary threats. In the case of Herman Miller, they are passing on some of this burden to customers, via price increases.

As I have written before, we are concerned that the massive amount of money created by central banks will prove inflationary. Observations from company management appear to be validating this concern. Although we do not invest based on macroeconomic forecasts or punditry, we fear that talk of "transitory inflation" will itself prove transitory. This means that we want to own businesses that we believe provide inflation protection. This is far easier said than done, and I suspect that many companies will find that they are more exposed than their management or shareholders realise. I certainly could not have foreseen that high natural gas prices, would impact fertiliser production, that would impact CO2 supplies, that would impact on the supply of Christmas turkeys!

Whilst not all the companies that we invest in fit the "inflation proof" brief, we believe that a significant number will be able to provide this protection. This might be because we think they will benefit from higher raw material prices, because we think they have pricing power or because we think there is a structural reason why their costs will not be as impacted as their income.

We continue to research new investment opportunities and have included three new holdings into the portfolio during the quarter. The first of these is a special situation where we invested in a small cap company far below its liquidation value. It is a "special" situation because the company has sold its operating business, and so its liquidation value is based on a balance sheet that contains almost nothing but a large holding of cash. It is opportunities like this that renew my belief in markets not being efficient!

The second new business is a high quality European industrial business that provides specialist machinery for the beverage industry. Our holding here is very small, as it is priced below our estimate of its intrinsic value, but not by a very wide margin. The third business is a high growth European food-production business. The company operates in a high growth industry, has a management team with a strong track record and a very clearly articulated plan for how they will continue to grow. Again, the size of our holding is relatively small, but I expect that we will add to it over the remainder of the year.

Look through earnings

In my first update, written in the third quarter of 2019, I outlined a simple approach that we would use to estimate the "look through earnings" of our portfolio. I have reproduced this explanation below.

"The focal point of our investment approach is to use data to make long-term forecasts of company profits. The fund predominantly invests in companies, and movements in their share prices feed through to cause changes in the fund's unit price. We believe these price moves will reflect the underlying company economics in the long-term but may show substantial deviations in the short-term, as they reflect the ebbs and flows of investor sentiment. For this reason, we want to also provide a simple metric to track the underlying profits of these companies. What follows below is an explanation of this Warren Buffet inspired metric.

Imagine that as at the end of the quarter you bought £100 worth of shares in the companies that the fund owns, in the exact same proportions that it owns them. If this group of companies decided to pay all their previous year's profits to their shareholders, then you would have received a grand total of £8.30 in your bank account. I call this a "look through earnings yield" of 8.3% (8.3/100). This concept is more normally stated as a "price earnings ratio", where a price of £100 and earnings of £8.30 give a ratio of 12.1 (100/8.3).

Currently only 80% of the fund's capital is deployed in company shares. This means that of £100 invested in the fund today only £80 will be spent on buying shares, and so the "look through earnings yield" would be 8.3% x 80% which equals 6.6%. As of the end of the quarter the fund unit price was 105p. This means that each unit in the fund equates to 6.93p (105p x 6.6%) of "look through earnings".

How does this compare to now? As of the last day of the quarter the fund's look through earnings yield was 6%, it was 89% invested in company shares and its own share price was 130.2p. Following the method outlined above, this then equates to 6.95p of look through earnings.

Despite the increase in the fund's unit price, the look through earnings of our current portfolio appears not much higher than two years ago. This needs to be set within the context of the world having just emerged from a major crisis, and the historic earnings of some companies having been impacted as a result. I believe that the current earnings power of our portfolio is understated by this backwards looking measure.

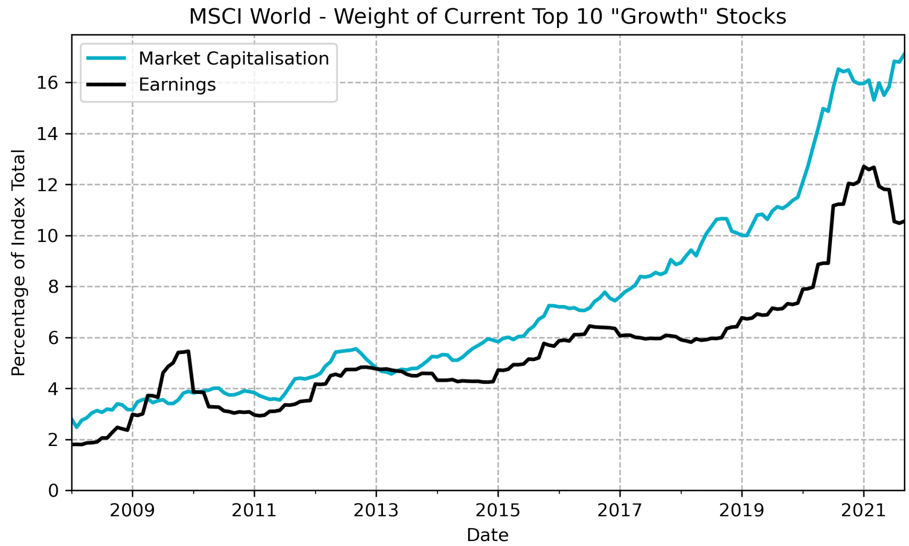
It remains our objective to deliver investment growth over 3-5 years. To this end we are happy to own businesses with "lumpy" earnings purchased at attractive prices, as opposed to paying a premium to own businesses with much "smoother" earnings. Based on what I am seeing in the businesses we own I expect our look through earnings measure will increase over the course of the next year, as the worst impact of the pandemic drops out of the historic accounting numbers.

For us to be doing a good job you should expect to see the earnings power of our portfolio grow over time, as it is the underlying profits of the businesses that we invest in that will drive value creation. I hope that by tracking the look through earnings it will give our investors more insight into this, than by just looking at the fund's unit price figure in isolation.

Stealing from the poor to give to the rich

I have written before about my concerns over the optimism that is required to justify the valuations of many popular "growth" stocks. The analysis that follows will further explain why I have these concerns.

The chart below shows the total market capitalisation of the ten largest "growth" stocks, as defined by the MSCI World Growth index. Their total value is expressed as a percentage of the regular MSCI World index. Hence, if you were to purchase a MSCI World tracker fund you would currently have around 17% of your money invested into these ten large businesses (as an aside this compares to UK stocks having a circa 4% weight in the index).



Source: Havelock London calculations based on Bloomberg data.

The second, black, line on the chart shows the percentage of earnings that these ten companies represent. Hence, their earnings, or profits, currently represent around 10.5% of the total earnings of all the companies in the MSCI World index.

How should we interpret this disparity between the current market value of these companies and their earnings?

The share price of a company, in theory, represents expectations about its future cashflows to shareholders. Hence, the disparity between the two measure tells us that the consensus view of market participants is that these ten large businesses will grow their earnings at a much faster rate than the other 1,590 companies in the index. This is possible, but given that they are the largest growth companies, it is surely a tall order?

For the curious reader, the table below shows the ten largest constituents of the MSCI World Growth index that were used to produce the chart. Together with their total market capitalisations, the table also includes the total value of shares sold by company insiders in the last 12 months.

Company	Market Capitalisation	Insider Sales (last 12 months)
Apple	$2,361 Bn	$442 M
Microsoft	$2,211 Bn	$197 M
Alphabet	$1,852 Bn	$1,312 M
Amazon	$1,644 Bn	$9,750 M
Facebook	$918 Bn	$1,170 M
Tesla	$793 Bn	$245 M
Nvidia	$517 Bn	$128 M
Visa	$495 Bn	$26 M
Nestle	$318 Bn	$16 M

Sources: Bloomberg & MSCI

Although the value of shares sold by company Directors appear small relative to the companies' market capitalisations, the proceeds are concentrated in the hands of a very small number of beneficiaries. This represents a transfer of money between purchasers, who will have included retail investors and pension savers, and the people who have an intimate knowledge of these businesses. This leaves me thinking that the empowerment of retail investors could, in fact, be stealing from the poor to give to the rich, rather than the other way around!

As long-term investors, company valuations matter to us, as a great business will only make for a great investment at the "right" price. We cannot know that these businesses will not live up to current lofty expectations, but our approach is to avoid investing when we think the price paid requires undue optimism. Our core objective is to make sure that our portfolio is robust in a range of future scenarios. By managing the risk of financial loss in this way, we believe we can increase our chances of delivering superior long-term compound returns.

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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 30.09.21 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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The Key Investor Information Document (KIID) and prospectus are available in English from:

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