January 2022

HAVELOCK LONDON

LF HAVELOCK GLOBAL SELECT

Q4 2021 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO 14.0×

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 3.0%

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

PERFORMANCE SINCE LAUNCH (%)

QUARTER 4 2021	3 YEARS
-1.4%	+36.1%
SINCE LAUNCH	**2021**
+28.3%	+15.2%
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 change in the fund's unit price for the year was 15.2%, of which 2.8% came from dividend payments. This compared to a 13.6% return for the IA Flexible sector, in which the fund resides.

This time last year I wrote:

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, equity markets continued to appear full of ebullient sentiment. Central Banks underpinned market prices, as they funnelled "printed" money into the financial system on an unprecedented scale. Their actions risk many participants consciously, or otherwise, having a sense of invincibility and belief that equity markets only ever deliver double-digit returns.

The MSCI World Index increased, in GBP, by 21.7% in 2021 and was up by 23.4% when the impact of dividends is also considered. This strong performance was heavily driven by a handful of large US technology companies – the 10 largest "growth" stocks now accounting for around 18% of this index.

We think that labelling a company as either "value" or "growth" is an oversimplification (as we have written about previously), but it is a convenient prism through which to view the market environment that we are in. The data suggests that the strong performance of "growth" stocks last year was driven far more by what people are prepared to pay, than by their actual earnings growth. By way of example, the MSCI World Growth Index has a price earnings ratio of 37.9, which is 2.3× that of the MSCI World Value Index's ratio of 16.6. In the last two decades this ratio averaged around 1.4×, showing just how elevated the growth "premium" has become.

It is against this backdrop that our performance should be judged. In a market environment where rising prices become detached from underlying company earnings, our results may fall short of the most ebullient parts of the market. It happens that this ebullience, as measured by valuation ratios, has helped prices of some of the largest companies in the major stock market indices, which in turn helped these indices deliver such impressive annual returns.

With all else being equal the more you pay for an investment, the lower its future returns, and so the more stretched the valuations of the popular "growth" companies become, the stronger the argument for looking elsewhere. We currently see lots of quality businesses that appear overlooked by many investors, and so despite our concerns see no shortage of opportunity.

We went into 2022 with our equity holdings having an average price to earnings ratio of 14×. This ratio falls to 12.4× when historic earnings are replaced with Bloomberg's average analyst forecast earnings for the year ahead. This leaves us in a position of holding a diversified portfolio of good quality businesses, at prices that do not require undue optimism about their future.

Year End Performance Review

The top five contributors in descending order of their impact on the annual change in the fund's unit price were:
- The US conglomerate, Berkshire Hathaway.
- The British agriculture business, Wynnstay.
- The British construction business, Morgan Sindall.
- The US regional bank, UMB Financial.
- The British supermarket, Morrisons.

Berkshire Hathaway has been a core holding of the fund since inception and has had a large weight in the portfolio due to our view on its valuation, its heavily diversified nature, and its defensive balance sheet. The company's share price has risen almost 50% since the fund started.

Wynnstay, Morgan Sindall and UMB Financial are all companies that are under-researched due to their size, something that we believe helped sow the seeds of opportunity for us.

Wynnstay was a top five contributor for the second year running, as its share price has had an 18 month "recovery", following a tough year in 2019 for the agriculture industry. The higher levels of inflation that we are seeing has translated into higher "farm gate" prices for agricultural commodities. This has been favourable for Wynnstay's business, in part because it encourages farms to make investments that increase demand for their goods. It is an example of a holding that we believed would benefit from higher level of inflation, and it has been gratifying to see this thesis play out in 2021.

Morgan Sindall benefited from a step change in sentiment towards the business, as the construction industry moved from almost complete shutdown during the pandemic, to a rapid resumption of activity. It is a responsible company, that prides itself in treating its subcontractors and employees well. This approach paid off, as it helped it avoid the worst effects of labour shortages. It's strong balance sheet and discipline when tendering for contracts further supported its recovery from 2020.

UMB Financial, like most US banks, has benefited from the strength of the US economy. The actions of the US Fed have meant that loan default rates have been low. In addition to this the US Paycheck Protection Program, which sup-ported small businesses with loans during the pandemic, provided many US banks with a low-risk additional source of income. The company also received a "kicker" after it helped to float a company called Tattooed Chef, in which it had a large shareholding.

The top five detractors, also in descending order, were:

- The British chemical company, Johnson Matthey.
- The German health care business, Fresenius SE.
- The Japanese utility company, Tokyo Gas.
- The European conglomerate, Schouw & Co.
- The German consumer products conglomerate, Henkel.

Henkel has been a long-standing holding in the portfolio. It has three business divisions selling adhesives, home care and beauty products. By March 2021 its share price had staged a full recovery from its pandemic lows, but it since gave back most of these gains. The company has seen respectable sales growth but has faced currency headwinds and margin pressures from supply chain disruptions. Under the direction of a new CEO, the business is undergoing a turnaround, moving the focus from cost-cutting to investing for growth. Like many of our holdings the company has a dominate controlling shareholder, which we believe provide a good influence on the long-term health of the business.

Schouw & Co is a Danish conglomerate that was added to the portfolio in 2021 and is described in more detail within the Portfolio Changes section below. It was added into the portfolio in June, which meant that unlike many existing holdings the subsequent fall in price was not offsetting gains made in the first half of the year.

Tokyo Gas is a Japanese utility business, that supplies customers with Gas and Electricity. Following the deregulation of the Japanese utility market it has seen a falling number of gas customers, but has at the same time been growing its electricity business. The company also suffered from falling demand for gas by industrial users during the pandemic. It has seen its share price fall by more than its profits, in part because of concerns that it will be hurt by Japan's targets for renewable energy production. Despite the negative sentiment towards fossil fuel business, the replacement of coal power with natural gas, has been one of the major sources of CO2 output reduction in recent history.

Fresenius SE is a German health care conglomerate. It is not to be confused with Fresenius Medical, the listed dialysis business, in which it has a one third shareholding. Investor sentiment towards the company has deteriorated, in part because of challenges at Fresenius Medical, in part because of COVID disruptions to its private hospital business and in part due to general cost pressures. It feels as though the share price falls are running a long way ahead of the scale of the challenges it has faced in the last year, and we see it as a high-quality business available at an attractive price.

Johnson Matthey is a British chemicals business, known for producing catalytic convertors. The company has a history of reinventing itself and had been laying the groundwork for building vehicle battery and hydrogen businesses. In the final quarter of the year the company announced that they would shut down their battery materials unit, as they felt that it was unlikely to produce an adequate return. This was followed by a share price fall that saw the company's market value drop by more than twice the balance sheet impact of the closure.

The public failure of Johnson Matthey's battery business was a disappointment, but it was driven by the capital allocation discipline that attracted us to the business. The company has organised their catalytic convertor business as a "cash-cow", which they expect will return more cash in the next decade than the company's current entire market value. The company undertakes more than just catalytic convertor production, with an embryonic hydrogen business that has its technology in use in commercial vehicles. Our view is that the concerns about disruption to its core business are more than reflected in the current price.

Portfolio Changes

We estimated the turnover in the portfolio for the year as 24.8%, which was slightly above the level that we would expect to average in the longer-term. During the year, we removed eleven companies from the portfolio and added seven.

The holdings in both **General Motors** and **Toyota** were sold down, based on their prices rising above our valuations. Both companies have used their balance sheets to provide their customers with finance to purchase cars, which makes us more cautious in the way that we value these companies. We continue to like both businesses but judged the risk/reward not compelling enough to still own them.

We sold the holding in the British supermarket, **Morrisons**, in response to the company being taken into private ownership. We also decided to sell down our holding in its competitor, **J Sainsbury**, as the recovery in its share price left it close to our valuation. Like the car companies, J Sainsbury has a consumer finance division, which together with the challenges in the Argos home goods business, made us cautious in how we valued the company.

The holding in **Iliad**, the French telecoms company, was also sold in response to it being taken private. Along with Morrisons this created some enforced turnover in the portfolio. We like the Iliad business but did at least sell the shares close to our estimate of what the business is worth.

The holding in the British construction business, **Morgan Sindall**, was sold down, because it moved to a significant premium to our valuation. It is a well-run business but operates in an industry with "tough" economics. The company benefited from strong conditions for the construction industry in the last year, but our assessment is based on a belief that this cannot be relied on to continue. The construction industry has thin margins, which make it particularly vulnerable if the current high levels of inflation persist.

Host Hotels is an American Hotels "Real Estate Investment Trust" (REIT) that we purchased during the depths of the COVID pandemic. It owns a portfolio of high-quality properties, that were integral to how we valued it. We sold our holding because its price increased above our valuation. This valuation was, again, cautious due to the uncertainty over how quickly its economics will return to pre-COVID levels, which are particularly sensitive to the resumption of business travel.

We sold four smaller holdings: **Goodwin**, **Greenbrier**, **Krones** and **Moneysupermarket**. The first two were industrial businesses that we started exiting in 2020 because they were at a premium to our valuation.

Krones, is a German business that manufactures machines for beverage bottling plants. We like the company but due to its share price rising strongly during and after the time that we researched it, we did not establish a meaningful sized holding. Given the small size of the holding, we then decided to sell it after it moved to a premium to our valuation.

We added Moneysupermarket to the portfolio in 2021 with a small weight, but subsequently decided that it did not meet our investment criteria. It is uncomfortable to admit that this idea was so short lived, but it does illustrate how we continue to study a company even after investing in it, and that this can cause us to change our views.

We added two technology companies at the start of the year.

The first is a Canadian business called **Evertz Technologies**, that is majority owned by its CEO and its Chairman who undertook a management buyout in 1997, before floating it in 2006. The company makes specialist equipment for both traditional and streaming broadcasters. The combination of a high-level of management "skin in the game", it being under researched, its specialism, its high R & D spending, and its discipline of returning capital to shareholders are all reasons that we like the business.

The second technology company is the specialist Taiwanese lens manufacturer, **Largan Precision Technologies**. This was our first experience of investing in Taiwan, and so we proceeded with more than the normal level of caution. There has been much written about the apparent discount of "emerging market value stocks", which motivated us to look in Taiwan. With that said I think the "emerging" rubric is an insult to a country with such advanced manufacturing capabilities.

We started to build a holding in the Danish conglomerate, **Schouw & Co**, mid-year. It is a conglomerate business that has a small and longstanding head office team overseeing investments in a small number of specialist industrial businesses. Like other holdings it has a single large shareholder, who allow the management to prioritise long-term growth over short-term earnings. The company featured in our worst five performance detractors, with its share price having fallen following management comments on inflationary cost pressures.

The management of Schouw communicate clearly and openly to shareholders, which is not always a given in public companies. They have been very clear that they are prioritising service levels to their customers over short-term earnings, which means that they are experiencing higher supply chain costs. Although no business strategy is a sure thing, we support them prioritising the long-term health of the company over the short-term pressures of the stock market.

We added the British company, **Whitbread**, to the portfolio. Their main business is the Premier Inn hotel chain, which operates in the UK and is being expanded into Germany. The company's financials are a challenge to analyse because it has spun off its Costa Coffee chain, returned capital to shareholders, been heavily impacted by COVID, made a rights issue, and expanded into Germany all within the space of a few years. This makes it more difficult to value the company, which we think puts us at an advantage. The company have tried to make an opportunity of the crisis, by pushing ahead with their German expansion. This is something we view positively.

US Gold Miner, **Newmont**, was also added to the portfolio. 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 see continued high inflation and a subsequent reaction in the gold price, such as happened in the 1970s, then this will help us achieve this goal. If we do not, it is anyway an operating business that we expect to deliver a reasonable return on shareholder capital.

The UK listed cash-shell, **Logistics Development Group**, was also introduced as a new holding. This is a listed vehicle that has sold its entire operating business, has no material debts and a large cash holding. Its shares have been trading at a substantial discount to its accounting value, which is composed almost entirely of cash. It is a special situation that is different to our typical holding and an example of how value opportunities can have multiple guises.

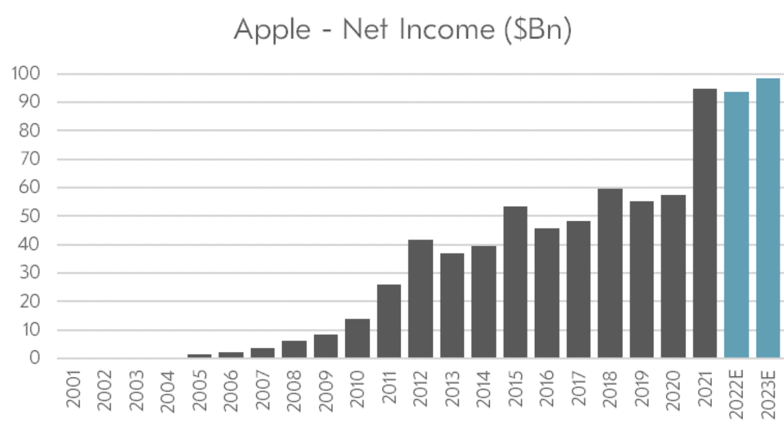
In the final quarter we added holdings in **Bakkafrost** and **Hexpol**. The former is a Faroese farmed Salmon business and the latter is Swedish and makes specialist rubber compounds. Both are examples of businesses that we think are cheap and where our valuation is based on an expectation of continued earnings growth. This demonstrates how we see the distinction between "growth" and "value" as simplistic, since it is the interplay between the two that makes for an attractive investment.

A disproportionate number of the companies that we have mentioned are British businesses. This is, in a big part, because we believe that the UK market looks like good value relative to other developed markets. Some of the business, such as Whitbread and Wynnstay, are domestic, but others, such as Johnson Matthey and Hiscox, are global businesses. It is not apparent to us that a strong distinction is being made between the two groups.

Could one bad Apple spoil the whole barrel?

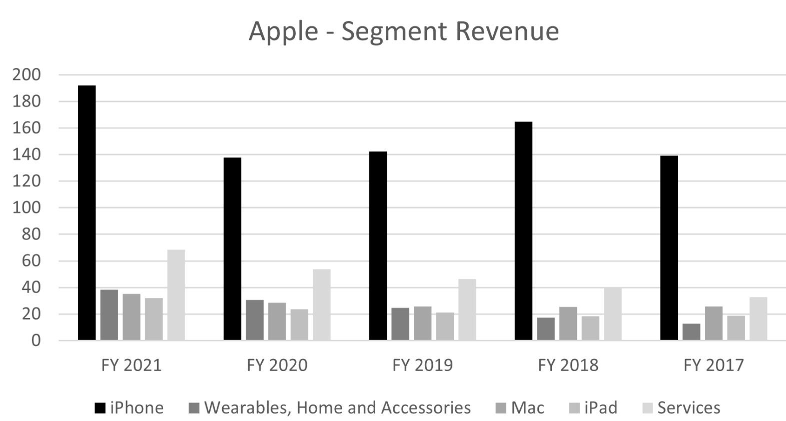
The extent to which a small number of large companies supported the major stock index returns in 2021 has been well written about in the financial press. For example, a recent Bloomberg article told how the "number of Nasdaq stocks down 50% of more is almost at a record" with "40% of index's firms having fallen by half from one-year highs".

As of writing the 10 largest Nasdaq stocks account for more than 50% of the index, with the largest company, Apple, having recently hit a $3 trillion valuation. Apple is an impressive company, and one that, via Berkshire Hathaway's holding, we have some exposure to. It has been a clear beneficiary of the lock down economy and has seen a year of "bumper" profits. The chart below shows a history of the company's net income or earnings, together with the average analyst forecast of the next two years.



Source: Bloomberg

The next chart shows the company's revenue by line of business for each of the last five years. Although the "services" revenue has been growing as we all watch more movies and download more apps from Apple, sales of their iPhone are still the dominant source of revenue, and one that had a big lift in the last year.



Source: Bloomberg

Apple's share price is currently around 30× the value of its earnings. Prior to 2020 the company had spent ten years during which this ratio was almost always less than 20×. Furthermore, its most recent earnings are substantially higher than it has ever seen before, arguably helped by lots of lock-down induced iPhone purchases.

In my experience, it is a fundamental human tendency to like to extrapolate recent history into the future. This makes good sense as it is a good heuristic for many aspects of life. I believe that stock analysts are particularly susceptible to this, with company forecasts for the near future typically being "like last year plus a bit".

The risk I see in owning a company, like Apple, at its current price is that not only are you susceptible to its price earnings multiple reverting back to historic levels (which would equate to a circa 30% price fall), but to the company struggling to deliver results that match last year's "blow out" success. This is the type of situation that I am happy to leave to other investors with a more optimistic disposition than my own.

The Year Ahead

I do not know what 2022 has in store. Will we see another COVID wave? Will central banks taper or not? What I do know is that markets will be hanging off every word that the central bankers utter. When you look at the history of financial markets, euphoric bouts of retail speculation have never had happy endings. I have no idea what could cause this euphoria to end, but I would not be surprised if the markets deliver a bumpier ride in 2022 than they did in 2021. In other words, expect the unexpected.

We continue to see many quality businesses available to buy for attractive prices, with many companies that we follow having seen price declines of more than 20% in the second half of the 2021. The current market environment feels very fickle, with a small piece of bad news often appearing to cause a disproportionate price fall. We remain humble about our ability to foretell the future and move forward wanting, as always, to own a portfolio that will be robust in a range of future economic scenarios.

Matthew Beddall
CEO, Havelock London

Unless otherwise stated all numerical data was courtesy of Bloomberg.

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The data in this document is sourced from the fund accountants as at 31.12.21 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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