HAVELOCK
LONDON

July 2022

LF HAVELOCK GLOBAL SELECT

Q2 2022 NEWSLETTER

FINANCIAL RATIOS OF EQUITY ALLOCATION

PRICE TO EARNINGS RATIO 11.4×

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 3.3%

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

PERFORMANCE SINCE LAUNCH (%)

QUARTER 2 2022	YEAR TO DATE
-4.7%	-2.9%
3 YEARS	**SINCE LAUNCH**
+21.0%	+24.6%
2021	**2020**
+15.2%	+2.4%
2019	
+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 second quarter of 2022 was -4.7%, resulting in an increase of 25% since inception in August 2018.

The fear of losing money has returned to markets, with, arguably, the most speculative assets having suffered the largest price falls. The price of bitcoin has fallen 57% since the start of the year and the poster child for investing in unprofitable companies, Cathie Wood, has seen her ARKK fund fall by 53%. A Fortune article, published in April, claimed that only 11% of SPACs launched in 2021 are now above their offer price, with many having seen brutal price falls. Time will tell the extent to which these "disruptive" businesses are innovative, rather than speculative.

Price inflation has continued to dominate financial headlines, with central banks clearly having shifted their stance to tighten money supplies. The prospect of a swift conclusion to the Ukraine war appears increasingly unlikely, with sanctions on Russian oil and gas exports continuing to impact global energy prices. The general concern amongst investors is that this sets the scene for an economic recession in the world's major economies.

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The next chapter of the inflation story appears focused on wage negotiations. On the one hand it seems right that workers are compensated for the rising cost of living, especially given the lack of real wage growth for society's lowest earners. Set against this is the fear that large wage rises will push economies into an inflationary spiral, that will ultimately be bad for everyone. I do not know how this will play out, but it seems unlikely to reach a swift conclusion.

In a recent discussion with the management team of one of our portfolio companies, they explained that they had locked in fixed electricity prices for their manufacturing operations for the next three years. For now, they get the benefit, but they are all too aware of the delayed cost pressure that it will likely bring. I am sharing this story, as I think it illustrates how inflationary pressures will take time to work their way through the financial eco-system.

Fund Performance

The largest positive contribution to the change in unit price for the quarter came from Prosus, the Dutch investment company that is dominated by owning almost one third of the Chinese tech giant, Tencent. The holding stemmed from research that we undertook at the start of the year into Tencent and the other large Chinese tech companies.

Prosus has always been priced at a discount to the value of its underlying investments, but this discount moved to an extreme level earlier this year. We did not believe its price fall relative to Tencent was rational, and so it allowed us to gain exposure to Tencent at a much lower level of valuation risk.

At the end of the quarter Prosus announced that management would reduce the size of their Tencent ownership stake and use the proceeds to buy back shares, to narrow the discount. The Prosus share price reacted strongly to this news, delivering a quarterly gain for the fund of circa 1.5%. I see this as an example of how current market conditions are creating opportunities for calm and analytical investors. Despite the discount having narrowed, we continue to see value based on our assessment of the Tencent business.

The second largest contributor in the quarter was Johnson Matthey, the British speciality chemicals business. The business is under the command of a new CEO, Liam Condon, whose new strategy is based on a view that the company is overflowing with technical expertise but has lacked commercial judgement. This fits with our own view of the company. The share price was positively impacted in the quarter, following the US firm, Standard Industries, acquiring a 5% stake. The large fall in the British Pound against the US Dollar obviously make such acquisitions more appealing for American firms.

If taken collectively, the second largest contribution would have been from our four holdings in diversified oil and gas companies. Our thesis is that the volatile nature of commodity prices means that natural resource companies tend to see their own prices anchored to the short-term more than a reasonable analysis of long-term prospects. This view appears validated in the last two years, with sentiment towards oil companies having undergone a major U-turn as headlines of a negative crude oil price were replaced by stories of energy shortages in Europe.

The largest negative contributor in the quarter was the US media company, Warner Bros Discovery. The company is the product of a merger in which Discovery effectively took over Warner Bros, which was previously owned by the telecoms company AT&T. The fall in price appears to be in part due to a halt in subscriber growth at Netflix souring many investors view of the entire industry. The fall has also been blamed on many AT&T shareholders selling down the shares they received in the new combined company, because it is unfamiliar and does not pay the large dividends that they had come to expect from AT&T.

Warner Bros Discovery CEO, David Zaslav, has a strong track record and is backed by some notable shareholders from the media industry. He is pursuing a strategy that will avoid the company getting drawn into the "content spending wars" and has lost no time in trying to rationalise the business. Although it has a higher level of debt than we typically look for, it has both strong cashflows to service this debt and a balance sheet underpinned by an impressive back-catalogue of media content.

The second and third largest negative contributors were Berkshire Hathaway and the gold miner, Newmont, both of which were giving back gains made in the first quarter.

Inflows into the fund during the quarter gave us the ability to move portfolio weights without the need to sell down existing holdings. We will look to make use of this "optionality" that flows provide us with, where it makes sense. This allowed us to up-weight several holdings that saw large price falls, as well as introduce three new holdings. The general theme of this has been to "shift" some weight from companies involved in oil, gold, and food production and into industrial and consumer businesses. The direction of travel here being counter to general stock market sentiment and dictated by our long-term valuations.

We completely sold down our long standing holding in Subaru in the quarter, as a rally in its share price left us of the view that there were better opportunities to be had elsewhere. Many of the companies that we follow have seen price falls that we judge to be beyond a reasonable interpretation of any change to their long-term prospects, and it follows that we are optimistic about the investment opportunities that this is providing.

Will there be a recession?

The question that many investors appear to be asking themselves right now is if we will see a recession – prompted by concerns that higher interest rates will undermine economic growth.

I do not know if there will be a recession in the world's major economies this year or next, and our approach to investing is not based on trying to second guess this. What I do know is that there have always been periods of economic contraction in history. I think of it like waiting at a bus stop with no timetable – you may have absolutely no idea when the next bus will arrive, but you shouldn't be surprised when one does appear.

For the companies that we follow I take a casual interest in broker research and, of late, I have seen many "target prices" revised down by amounts as large as 25% or more. One way, or another, these revisions are blamed on the fear of a recession causing lower earnings. I struggle to see the justification for such large changes, as surely any reasonable judgement of valuation would look far enough into the future to anticipate one or two bad years.

Moving on from bus-stop analogies, the noise of financial punditry reminds me of the sirens from Greek mythology, who lured sailors to their death with their alluring songs. The mythical Greek hero Odysseus avoided this fate by strapping himself to the mast of his boat and plugging his sailors' ears with beeswax. I wouldn't advocate going this far to ignore the financial news, but I do think that it requires determination not to get drawn into the short-term narrative of markets. We certainly want to be alert to changes in our environment, but do not believe that success will come from trying to make timing calls about a recession.

What were we thinking?

So far this year the performance of the fund has been helped by two distinct views that I have previously written about. I thought it was worth recapping them.

In my first quarter 2021 investor letter I wrote about our growing concern that the amount of money that central banks and governments were injecting into their economies would cause higher inflation.

While we do not make investment decisions based on macro-economic forecasts, we do want to own a portfolio that will be robust to perceived threats. In this case we made efforts to consider the impact of higher levels of inflation on our holdings, and those companies engaged in the primary production of energy, food and gold have "held up" as we had hoped, as the threat became a reality.

In my year end 2020 letter I set out the case for financial markets being in a bubble, having shared our analysis in my Q3 2020 letter on the evidence for much of the outperformance of "growth" over "value" being driven by price earnings multiple expansion.

There have been two distinct types of "growth" company that investors have been pursuing. The first are companies, with no profits, where the value placed on them is based on a belief about the distant future. The second being companies that are highly profitable, but where investors have paid ever higher premiums to own them. In broad terms both types of growth company have seen price falls this year, with the former being impacted more than the latter. Our valuation driven approach has helped us avoid the worst of this excess.

Before I start to sound too clever, we know full well that our abilities as investors can only reasonably be judged based on our long-term track record. Nonetheless it is gratifying to feel that our analytical investment views have been shown to have merit.

Air Lease

As part of how we communicate I periodically put one of our companies under the spotlight, and on this occasion, it is Air Lease. Please consider this as bonus material for the motivated reader!

Air Lease is a US listed airplane leasing business. We first invested in it during September 2018, following two separate research projects on its entire industry. They operate a simple business model, purchasing planes to lease to airlines. They finance these purchases using both their shareholder's capital and borrowed money. The company was founded in 2010 by industry veterans Steve Udvar-Hazy and John Plueger, who previously worked together for more than two decades at AIG's airplane leasing business.

The management's strategy is to own modern and fuel-efficient planes and rent them to a diverse group of reputable airlines. This follows from a belief that during downturns, it is older flight equipment that falls the most in value and the weaker airlines that are least able to pay their dues. This approach was severely put to the test during the COVID pandemic, in the face of an almost unimaginable halt to global air travel. Despite this the business generated positive cashflows from its operations in every quarter during the crisis, albeit that they were reduced by the decision to defer the timing of lease payments for some customers.

As part of their strategy, they seek to maintain an investment grade credit rating, meaning that they can borrow money more cheaply than most of their airline customers and competitors. They also have deep longstanding relationships with Boeing and Air Bus, helped by being very large customers. Both provide a competitive advantage.

In our research we spent time understanding the industry accounting conventions. The balance sheets of the leasing companies are dominated by the value of the planes they own, and their earnings are stated after charges for the depreciation of these assets. This introduces a major accounting risk, as both earnings and book values are dominated by valuations that are untethered to actual aircraft resale values. Our investment was made on the conservative assumption that the planes were worth less than their accounting value, despite the company's track record of reselling them above these values.

In the time that we have owned Air Lease the business has been severely put to the test, not only by the shutdown of the entire aviation industry, but also with the confiscation of planes leased in Russia. I believe the most recent price falls are the result of a further drop in sentiment because of the economic climate and potential impact of higher interest rates. Despite this it has delivered a positive return since we initially invested, and we have used the current price falls as an opportunity to increase our holding.

Our investment analysis made use of data from the business that the management team previously ran and informed our thesis that their strategy would help weather economic downturns. In terms of the risk of higher interest rates, they attempt to manage it in the short term by using mainly fixed rate debt. In the long-term lease rates have historically tended to rise to reflect higher interest rates.

We think this is a high-quality business backed by a clear strategy and management team with a successful track-record of creating shareholder value. As at the end of June 2022, its price-to-book ratio was 0.67×, stated after the impact of writing off the value of stranded aircraft in Russia. This is not how we value the business, but it illustrates how the current share price already contains a lot of pessimism. Furthermore, high levels of inflation should mean that the accounting value of the planes is an increasingly conservative estimate of the price they could be sold at.

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 30.06.22 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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CONTACTS

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

Havelock London
19 Eastbourne Terrace
London, W2 6LG
Tel: +44 (0)20 3637 7300
www.havelocklondon.com

Link Fund Solutions
PO Box 389
Darlington, DL1 9UF
Tel: +44 (0)345 9220044
www.linkfundsolutions.co.uk

www.havelocklondon.com

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