HAVELOCK LONDON

31 March 2023

LF HAVELOCK GLOBAL SELECT

FUND PERFORMANCE

Cumulative Returns

1 Month	YTD	1 Year	3 Years	Since Launch
-3.4%	3.4%	7.6%	63.6%	40.7%

Calendar Returns

Year	Q1	Q2	Q3	Q4	Annual Return
2019	6.2%	2.9%	1.9%	3.5%	15.3%
2020	-20.9%	13.9%	1.7%	11.8%	2.4%
2021	11.0%	2.8%	2.4%	-1.4%	15.2%
2022	1.9%	-4.7%	-4.6%	14.3%	5.9%
2023	3.4%				

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.

FUND DETAILS

Fund Size	£156M
Fund Manager	Matthew Beddall
Fund Structure	OEIC (UK UCITS)
Fund Domicile	UK
Launch Date	21st August 2018
Base Currency	GBP
ISIN	GB00BFM7DN78
SEDOL	BFM7DN7

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

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COMMENTARY

The first three months of the year provided investors with a certain amount of psychological comfort, as equity markets recouped some of last year's falls. The prevailing narrative behind this was that central banks have "tamed" inflation, they will stop raising interest rates, and hence corporate profits will resume their upward growth. The comfort was punctuated by the failure of two US banks, but this seemed to cause only a temporary dampening of the optimistic mood.

Against this backdrop the fund's unit price increased by 3.4% in the quarter.

After a decade of zero interest rates, and levels of debt in most large countries that are at seventy five year highs (as a percentage of GDP), I continue to be cautious about what the future might hold. I certainly did not predict the two US bank failures, but the fact that someone, somewhere, got caught short by the rapid increase in rates seemed predictable. I expect there will be further consequences, even though I don't claim to know what they might be.

Our focus, as ever, is on owning sound businesses, purchased at prices that do not rely on undue optimism about the future. At the same time we try not to get drawn into the noise of short term market narratives.

There is only one thing that causes a market to go up, and that is there are more buyers than sellers. This doesn't make for a very satisfactory explanation, and so pundits create retrospective narratives as to why the buyers are buying (or vice-versa). I believe it is important to see these explanations of market moves as narratives, not facts, as it is not possible to know why each and every market participant did what they did. Indeed, some probably don't even know themselves!

Whilst the dominant narrative in markets is currently one of calm, I think there are still reasons for caution. Profit margins still look high relative to history, stock prices are not particularly low relative to earnings and the full consequences of zero interest rates are not fully known. Despite these concerns I think there will be no shortage of opportunity ahead for careful level-headed investors. Rather than leave you with just this platitude, I provide an explanation at the end of this letter as to why I think the US banking crisis is already creating such opportunity.

Portfolio Update

Almost all of our portfolio companies either reported their annual or semi-annual results in the last quarter, and so much of my time was spent reviewing these reports. The main reoccurring theme was that of "increased revenue decreased margins", as a result of companies working to recoup the impacts of cost inflation via price increases. An extreme example of this is the Danish industrial conglomerate, Schouw and Co, where revenue increased by 35% whilst profits fell by 4%. The extent to which our portfolio companies overall were able to raise prices appeared satisfactory.

Another clear theme in reviewing company results was that of higher interest rates. I think it possible that the businesses we own will collectively be net beneficiaries of higher rates. This is because the industrial and consumer businesses tend to have little debt, and the financial businesses have historically experienced higher margins when interest rates rise. My discussion of our bank investments elaborates on this point.

Three holdings were sold in the quarter and two new ones established.

We sold our holding in MillerKnoll, the high end furniture manufacturer. We bought the holding when the company was known as Herman Miller, subsequent to which it undertook a leveraged buyout of its competitor, Knoll. Since the buyout it has faced a high level of supply chain disruption and cost inflation. We like the business, but the amount of debt now on the balance sheet is much higher than when we first invested, and above where I am comfortable for such a cyclical business.

We sold our holdings in Hargreaves Lansdown and Taylor Wimpey. Both were relatively small and, after a general rally in the share prices of domestically focused UK businesses, had converged on our intrinsic value estimates. Hargreaves' strategy to move towards running investment funds is a deviation from its core business that makes it harder to assess what the future might hold. Likewise, Taylor Wimpey's business is very dependent on the UK housing market, and materially higher interest rates increase the risk of a large downturn. This left us being more cautious on the intrinsic value of both companies.

We established a new holding in a shipping company. The industry has been flush with cash after receiving "windfall" profits from the extreme shipping rates seen during the COVID pandemic. Historically, companies have tended to build new ships at the exact moment when weakening economies see demand falling, leading to cyclicality and sub-par profits. Concerns of this repeating pushed down the share prices of the entire industry, despite balance sheets being awash with cash. We purchased shares in one of the more disciplined operators at a price that, when corrected for cash on the balance sheet, was close to a historic low versus the value of their hard assets.

Our second new holding is in a specialist chemicals business. Somewhat counterintuitively it is in a similar position to MillerKnoll, whereby it has taken on a large debt to acquire a competitor. The difference we see is that it has a more diversified and less cyclical business, making us more confident about it paying down its debt from operating cashflows. Furthermore, the discount to intrinsic value gave us a greater "margin of safety". Like a number of our holdings, we gained some extra comfort from seeing that a well known value investor also owns shares in the business.

Performance

The largest contributor to the increase in unit price was Warner Brothers Discovery, at 2.2%. This meant the fund regained most of last year's losses from the holding. The turnaround in the business continues, with the increase in share price being more due to investor sentiment than any material change of course. The company made an accounting loss due to writing down the value of certain assets, but its operating cashflows were positive and in line with management's pre-merger "game plan".

The second largest contributor, at 1.2%, was Associated British Foods. This meant the holding recouped all of last year's losses, and has moved to overall profitability for the fund. The increase in price followed both from their Primark business performing ahead of management's original cautious outlook and a general uplift in domestically focused UK businesses .

The third largest contributor was the US semiconductor business, Micron, that was added to the portfolio in the final quarter of last year. The movement in its share price appears mainly due to a less pessimistic outlook within the stock market on the prospects for the memory-chip industry. Our thesis is that Micron, and its two large competitors, are now more focused on margins than sales volumes. We are seeing some evidence of this playing out based on recent announcements about planned production volumes.

The worst contributor in the quarter was the regional US Bank, Prosperity Bank, at -0.9%. The words "regional US Bank" are particularly spine-tingling to investors at the moment following the failure of Silicon Valley Bank. I believe we have a good understanding of Prosperity's business, its balance sheet and the impact higher rates will have on it. There is more on this at the end of the letter.

The second largest negative contribution of -0.5% came from the Hong Kong listed paper and cardboard manufacturing business, Nine Dragons Paper, which was impacted by lower demand during the COVID lockdowns in China. The share price of the business has historically moved with the industry's volatile earnings, with the last year being no exception. We think the company looks cheap versus our view of its intrinsic value and that it is underpinned by a certain amount of support from the Chinese state. Nonetheless, the rapid growth in production capacity funded by increased debt is of some concern and a reason why we have kept it as one of our smaller holdings.

The third largest negative contributor was Fresenius SE, at -0.4%. We have been invested in the business since 2019, and I have written before about how it has moved to become something of a "turnaround" situation. Whilst the business has faced headwinds, it appears to be its complex corporate structure that made it particularly disliked by investors. The new CEO, Michael Sen, has managed to secure the backing of the company's controlling shareholder to change the structure, paving the way for potentially divesting its holding in the separately listed US dialysis business. I believe the share price fall this year was, in a large part, because of disappointment that these changes are not happening more quickly.

US Banks

The rapid demise of Silicon Valley Bank has been well documented elsewhere and so needs little introduction. The combination of a concentrated depositor base and large losses from bond investments, led to a run on the bank that ended in its failure.

A traditional banking operation charges a higher rate to lend money, than the one it pays to borrow. If profits from doing this exceed losses from loans gone bad, then it makes money. The difference, or spread, between the lending and borrowing rate is small, and so this model requires leverage to turn a reasonable profit.

Loan losses are never neatly spread out through time, but cluster around periods of economic stress. Furthermore, these losses are the catalyst for "bank runs" where customers lose faith and withdraw their deposits. This means the true profitability of a bank has to be judged over a multi-year period. The most profitable banks during " good times", risk being the ones that made the riskiest loans, had the weakest source of funding, and or used the most leverage.

The central feature of the SVB crisis is that the bank did not have to recognise the losses from the decline in value of their bond portfolio in either their accounts or their regulatory capital calculations. We divested one of our, then, two holdings in regional US banks last year, because of specific concerns on their bond portfolio. We saw the company reclassify some holdings from "available for sale" to "held to maturity", which meant they had recognised gains when interest rates fell, but could now ignore losses when they rose. This was a cause for concern.

These observations lead to the three central tenets, or rules, behind our bank investments;

1) Judge banks based on risk of loss, not profitability.
2) Understand the balance sheet, including what is not on it.
3) Only invest with people you trust.

Our holding in regional US bank, Prosperity Bank, is judged to meet these criteria. It has a track record of low lending losses, low leverage and a diversified depositor base. We believe we have a good understanding of its balance sheet, as well as the actual value of its "held to maturity" portfolio. Finally, its CEO has been working in the business for 38 years and speaks with a level of candor that is all too often lacking in public company management. He is someone that I trust.

Relative to other industries, banks have in recent history seen their shares trade on low valuations. This "discount" does not just show in the weakest banks, but the entire sector. We think this means we are able to purchase shares in the higher quality operators, at prices that do not fully reflect their likely earnings power. Put differently, we see a trade off between the risk of loss from balance sheet leverage in banks, versus the risk of loss from paying too high a valuation that can come with many non-financial companies.

Many non-financial companies have seen record profit margins, whereas the banking industry has had profits pushed down by low interest rates. I believe the strongest firms within the financial sector have the capability to benefit from higher interest rates. This has the potential to provide genuine diversification to our portfolio. Buying a business with the potential to increase earnings, for a low valuation, is obviously appealing. All the more so if it is in the opposite direction of travel to many other companies.

Like all good crises, the recent share price falls of many financial companies contain potential opportunity. Where we know a business, have an informed view of its intrinsic value, and it is of good quality, we are happy to travel in the opposite direction to those investors that are panicking.

I will end by saying that clearly, no matter how much homework you do, all investments have a risk of delivering bad outcomes. Banks are no different in this sense. Our stance is not so different from those investors who "wouldn't invest in banks", the particular focus we have on quality in this sector means we "wouldn't invest in most banks".

Matthew Beddall
CEO, Havelock London

IMPORTANT INFORMATION

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.

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.

Performance Data

All performance information is for the A-Accumulation share class, which is the longest running share class for the fund. 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.

The data in this document is sourced from the fund accountants unless otherwise specified. The data used to calculate the price to earnings ratio is sourced from Bloomberg.

Other Information

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