HAVELOCK
LONDON

30 June 2023

LF HAVELOCK GLOBAL SELECT

FUND PERFORMANCE

Cumulative Returns

1 Month	YTD	1 Year	3 Years	Since Launch
0.3%	0.3%	9.4%	39.1%	36.3%

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%	-3.0%			

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	£153M
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 fund's unit price fell by 3.0% in the quarter, taking the total change in unit price for the year to 0.3%.

Sentiment within financial markets ebbed and flowed, as market participants attempted to second guess what each economic announcement meant for the future path of interest rates. On top of this there was renewed investor excitement at the prospects for investing in artificial intelligence, which helped lift the share prices of the large technology companies. These companies have large weights in global stock indices, making for a "two tier" stock market, with indices rising based just on the share price action of a handful of companies.

Speculation about the future path of interest rates also led to movements in the currency markets. The pound rose by 5% against the US dollar in the first half of the year, which created a meaningful headwind for British investors abroad. It has since risen by a further 2.8% in the two weeks after the end of the second quarter.

At the same time that the share prices of many large technology, or "growth", companies have staged strong recoveries, many other public companies are being priced as if there will be challenging economic times ahead. This dichotomy is frustrating, as it is hard to see the scenario in which these large businesses are booming, whilst the broad economy is struggling. This discrepancy of opinion, and price volatility, is however what creates the seeds of opportunity for us.

As the final section of my letter demonstrates, I believe that there is still evidence of "froth" in markets. This was further spelt out in my mid-quarter thought piece[1] "Back off to the races?". It continues to be the case that many large funds have similar holdings, concentrated in a small group of large companies. Whilst we cannot make any promises about the returns we generate for investors, we do own a very different cohort of companies to these funds. If it is diversification you are looking for, then you have come to the right place. Furthermore, with a portfolio level price earnings ratio of circa 12.5x, our portfolio appears cheaper than the more crowded corners of the market.

Portfolio Update

For those companies that release quarterly updates, the general theme was "more of the same", with revenues increasing but margins coming under inflationary pressure.

These pressures are forcing many of our portfolio companies into tough decisions. By way of example, Associated British Foods intentionally limited price increases at their Primark clothing stores, and benefited from increased sales volumes as a result. Meanwhile, the consumer goods business, Henkel, had organic revenue growth of 7% in their first quarter, but with price increases driving a 5% fall in unit volumes. In the face of disposable incomes remaining under pressure, we look on with interest as to how these challenges are being tackled.

The salmon farming business, Bakkafrost, is a pleasing example of a portfolio company actually benefiting from inflation in their first quarter. High salmon prices meant that despite harvest volumes being 10% lower, earnings were only just shy of their all time high.

Elsewhere, we were happy to see the media company Warner Brothers Discovery have their first quarter of positive earnings from their direct to consumer streaming service. The business is undergoing a major restructure, with a focus on cashflows over subscriber numbers. Whilst the company is under pressure from reduced advertising spend, we believe that concerns on this front are already reflected in the low share price.

I wrote about our bank holdings in my last letter, following the attention that the banking industry received after the collapse of Silicon Valley Bank.

Handelsbanken reported an increase in deposits in the first quarter together with record high quarterly earnings. Prosperity Bank saw a 5% fall in deposits, but two thirds of this had already left prior to the events of SVB. Prosperity have been cautious about growing their loan book in the face of rising deposits, and in their quarterly call spoke about other banks pulling back from lending, such that there is less competition to lend to "really good" customers.

Handelsbanken's commercial loan book has 98.6% of loans with a loan to value of less than 60%, and Prosperity's has an average loan to value ratio of 50%. Hence, I believe both are well placed to weather a downturn in the property markets. I continue to believe that the highest quality banks have seen their shares discounted, alongside their entire peer group, such that they offer an attractive risk / reward trade off.

We sold our holdings in the Japanese real estate company, Daito Trust Construction, the Canadian media technology business, Evertz Technologies, and the Chinese manufacturer, Haitian International, in the quarter. It has become increasingly clear that there is a "cold war"

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[1] https://www.havelocklondon.com/commentary/back-off-to-the-races/

underway between China and the West, which has made me incrementally more cautious in investing in Hong Kong, despite many decent companies having attractive valuations.

We established a holding in a northern European industrial mid-cap business in the quarter. It is exactly the type of company that we like to see at the heart of our portfolio, operating in a number of specialist niches, having a low level of research coverage, and with a large founder shareholder. Although it operates in many cyclical industries, we believe that concerns on this front were already reflected in its modest valuation.

The second new holding in the quarter was in a Japanese retail business, albeit with an immaterial portfolio weight.

I spent some time this quarter trying to better understand the “lay of the land” in Japanese equity markets, where it is clear companies face pressure to reform their “governance” and become more shareholder friendly. By way of example, I have been researching another company where the proxy shareholder services are recommending to not re-elect the Chairman and CEO, because they are refusing to sell a large “strategic” shareholding. This sort of thing has been virtually unheard of in Japan hitherto. The Nikkei has seen a large rally this year, much of which focused on the largest companies, but we still see evidence of opportunity remaining.

Performance

The largest positive contributors to the change in unit price in the quarter was, Berkshire Hathaway. The company has a broad exposure to the US economy, and so it is hard to point to any one single catalyst for the rise in its share price. What we have seen from their first quarter’s earnings, is that materially higher interest rates are having an immediate positive impact on their profits, given the sizeable amount of cash held by their insurance business.

The British hotels business, Whitbread, was the second largest contributor. Despite the pressure on consumers’ wallets, the company has seen brisk trading. They have done a good job of weathering inflationary pressures, with their results helped by their data-driven algorithmic approach to pricing their hotel rooms. They have also been expanding the business into Germany, which will continue under the watch of a new CEO who rejoins the company after a stint as CEO of Dominos Pizza UK.

The third largest positive contributor was the Canadian Energy business, PrairieSky Royalty. The company owns the energy extraction rights for large swathes of land in Canada, and so do not actually engage directly in the operational aspects of the energy business. Our investment thesis is that this will make them robust to higher levels of inflation, as they are less subject to cost pressures (as well as having a progressive ESG track-record).

The largest negative contributor was Warner Brothers Discovery, but this represented “giving back” less than half the positive contribution made in the first quarter. The company continues to experience a very volatile share price, but this appears to be a direct consequence of the business being restructured, as many market participants hate uncertainty. In contrast, we can live with such short-term uncertainty, if it means that we get to invest at a more attractive price.

The gold miner, Newmont, was the next largest negative contributor. We own the company, in part, because we think it would benefit in the scenario of persistent levels of high inflation. Furthermore, gold mining companies look cheap relative to the gold price itself. Newmont has seen its share price come under more pressure than others this year owing to its takeover of Newcrest. Despite this we believe that we understand the logic behind the takeover, and that it continues to play a role in our portfolio.

The next largest negative contributor was Prosperity Bancshares. As described above I have a clear reason to think that it makes sense to own very high quality banks, even in the face of price falls. They will soon announce results for the second quarter, and I will be keenly watching to see how much of the increase in interest rates they are having to pass on to their depositors.

We move into the second half of the year, as ever, not pretending to know what will happen in markets in the short term. We remain resolute that owning decent companies purchased at reasonable prices remains the best form of defence against this uncertainty.

AI, ChatGPT, and Nvidia

ChatGPT has been grabbing headlines, becoming totemic for a new generation of artificial intelligence algorithm that can produce informed human like responses to questions. Excitement about the potential for this technology has seen the share prices of AI related companies go up, with many investors anticipating that it will turbo charge their growth. The most prominent of these companies is Nvidia, which makes computing solutions for AI, derived from its historic core business of computer graphics cards.

The value of Nvidia has risen to be 40x the value of its previous year's sales which, for a value investor like me, makes it appear expensive. I thought I'd ask ChatGPT what it thought, and here is its response:

Should I invest in Nvidia at a price to sales ratio of 40x?

I'm sorry, but as an AI language model, I cannot provide personalized investment advice or make specific recommendations on individual stocks. Investing in any particular stock involves various factors, including your financial goals, risk tolerance, investment horizon, and individual research.

When evaluating a potential investment, it's important to consider multiple aspects beyond just the price-to-sales ratio. Some factors to assess might include the company's financial health, competitive positioning, growth prospects, management team, industry trends, and overall market conditions.

The price-to-sales ratio is one metric that can provide insights into a company's valuation. A high ratio like 40x suggests that investors are willing to pay a significant premium for each dollar of the company's sales. However, it should not be considered in isolation. It is important to compare the valuation to historical levels, industry peers, and the company's growth potential.

Before making any investment decisions, it's advisable to do thorough research, potentially consult with a financial advisor, and consider diversifying your investments to manage risk effectively.

ChatGPT and I appear to share similar investment philosophies. Who would have thought it!

I have not undertaken "thorough" research on Nvidia, but I have made a few back of the envelope calculations about what would be required for it to grow into the current "significant premium" valuation.

Nvidia's current share price is around 248x the previous year's actual earnings, or 214x adjusted earnings. I suspect buyers aren't anticipating a two and half century wait to earn back their initial stake (we pride ourselves on being long-term thinkers, but this would take it to another level). They are buying on the basis that they expect a high level of profit growth, which has to come from a combination of revenue and profit margins being higher in the future than they are now.

Nvidia's net profit margin in the last year was 16% of sales, which was below the average for the last ten years of 23%. Its average revenue growth in the last ten years was an impressive 22%. In the decade prior to 2020, when its explosive growth in sales and share price really took off, it had an average price earnings ratio of 28x.

The table below shows the previous financial year's results for Nvidia (FY23), Bloomberg's average analyst forecast for 2025 (FY25E), and three scenarios for how the company might grow in the decade ahead. In each of the three scenarios I make an assumption about how sales will grow and what average net profit margins will be. All three scenarios assume that the P/E ratio multiple in ten years time will be 28x (its historic level prior to it's recent rapid growth).

	FY23	FY25E		Scenario A	Scenario B	Scenario C
10Y Annual Sales Growth	20%	28%		15%	20%	20%
Net Income Margin	16%	39%		25%	25%	35%
Revenue	26,974	55,271		109,125	167,016	167,016
Market Cap	1,084,379	1,084,379		763,874	1,169,111	1,636,756
Net Income	4,368	21,642		27,281	41,754	58,456
Price / Sales	40	20		7	7	10
Price / Earnings	248	50		28	28	28
Prospective Return				**-3.4%**	**0.8%**	**4.2%**

In my most optimistic scenario, where revenues grow at 20% per year for the next decade and margins average 35% (which is about the highest they have been in history), I forecast that an investor would earn 4.2% per annum. This is a little below the 4.4% rate that you could lock in by buying a 10 year UK Gilt! Alternatively, if sales growth averages just 15% a year for the next decade and margins are in line with history, then I forecast an average annual loss of 3.4%.

I think there are two possible conclusions from this analysis:

- Investors in Nvidia have followed ChatGPT's advice, conducted "thorough" research, and are confident that the company will increase sales and margins at much higher rates than I assume above.
- Investors in Nvidia haven't conducted "thorough" research, and are buying in anticipation of the share price going up and then being able to sell their shares to a "greater fool".

In the last 12 months the Director's of Nvidia have sold[2] $294M worth of shares and bought none. Perhaps the people buying at the current share price know something that the folk actually running the company don't? I'll leave you to draw your own conclusions.

Matthew Beddall
CEO, Havelock London

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[2] https://www.secform4.com/insider-trading/1045810.htm

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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