30 September 2023

HAVELOCK LONDON

HAVELOCK GLOBAL SELECT

FUND PERFORMANCE

Cumulative Returns

1 Month	YTD	1 Year	3 Years	5 Years	Since Launch
-0.4%	0.2%	14.5%	36.2%	35.9%	36.2%

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%	-0.1%		

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	£148M
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 -0.1% in the quarter, taking the total increase in unit price for the year to +0.2%.

The third quarter felt, in many respects, like a continuation of the second, with both the US and global stock indices being nudged higher by share price gains in a narrow group of large technology companies. This is demonstrated by the S&P 500 being up 12% for the first three quarters of the year, versus the equal weighted variant being flat over the same period. This continues to create a dichotomy between the valuations of a few large companies and much of the rest of the stock market. The most credible explanation that I have seen for this is a concern that small and mid-sized companies are the most indebted and will be facing starkly high interest costs as their debts mature.

On a "bottom-up" basis we have seen the valuations of many companies that we follow fall, despite no obvious material change in business outlook. Given our focus on companies with little or no debts, it is not obvious that higher interest rates present much of a direct threat, and hence the price falls appear somewhat indiscriminate. I believe that this is creating opportunity, and we have been selectively increasing certain holdings accordingly.

I think of share price movements as partly due to changes in the underlying earnings power of a company, and partly due to changes in the price market participants are willing to pay to own a share of these earnings (characterised by the price to earnings ratio[1]). The reason I think in this way is that I believe it is corporate earnings that matter for long-term investors, rather than valuations, which can be driven in the short-term by the emotions of the crowd. .

Our portfolio level price earnings ratio has moved somewhat higher to 14.1x, from 12.5x three months ago, which contradicts my observation above that we are seeing lower valuations. This statistic is calculated using the previous years' earnings, and the increase is partly due to the introduction of new holdings, and partly due to changes in earnings at a small number of existing holdings.

The forward price earnings ratio of our portfolio, calculated using earnings forecasts from a large number of stock market analysts, is circa 11x. This is lower than the figures I mention above, due mainly to a handful of companies that experienced one-off accounting items that are not expected to reoccur. By way of comparison the MSCI World index has a forward price earnings ratio of circa 17x, the MSCI World Value Index 13x, and the MSCI World Growth Index 26x.

The combination of the quality of the companies that we own, and their valuation relative to the broad stock market, leaves me of the view that our current opportunity set looks attractive. We have been deploying our dry powder accordingly. With this said I cannot know what the future holds, but I believe the low valuations in our portfolio make us more resilient to whatever challenges lie ahead.

Portfolio Update

The salmon farming business, Bakkafrost, is an example of one of the companies that has experienced lower earnings, and hence caused the portfolio level price earnings ratio to increase. The cause of this was higher than normal fish mortality in their Scottish operations, which I think makes for a good example of a "one off" rather than "permanent" fall in earnings. Furthermore, the company is making substantial investments in their Scottish operations that specifically target improving the health of their fish, which they expect will in turn improve their earnings.

Within our core holdings one distinct area of the portfolio where we have seen price falls, is across a variety of European mid-sized industrial companies that includes Krones, Schouw & Co, Hexpol, Aalberts, Johnson Matthey, and Bucher. They offer products that are integral to the modern world, such as specialist plumbing valves, modern farm machinery, bespoke electronic circuit boards and specialist rubber compounds. For all but the last of these businesses current analyst forecasts are for earnings this year to be higher than last year, with price to forward earnings ratios of between 8.5x and 12.5x appearing to already contain a good degree of pessimism.

Neither of our two bank investments, Handelsbanken and Prosperity Bancshares, are yet showing any signs of material increases in borrower delinquency rates. Despite this I believe that it is somewhat inevitable that higher interest rates will cause problems for the weakest borrowers. Both have very strong track records of making good lending decisions, and have valuations that appear to already factor in a certain amount of "bad news". Handelsbanken has the highest credit rating of any non Government backed bank in the world, and both companies have loan-to-value ratios in their property lending activities that average around 50%. Both companies are holdings in the asset-heavy part of our portfolio, which is a genre of investment that I think is out of favour in the stock market and hence offers attractive valuations.

More broadly the updates that we are seeing from the companies that we invest in are not yet showing any material signs of economic slowdown, but there is certainly an expectation that consumers are coming under pressure. I would note that the valuations of most of the companies we own already appear to be pricing in more challenging times ahead.

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[1] There are, of course, many ways to value a company, and a multitude of ways to calculate a price earnings ratio. I avoid plunging into the depths of this topic for the sake of brevity!

Six new holdings were established during the quarter, and three existing ones were disposed of.

We finished selling our holding in the Dutch investment vehicle, Prosus, which owns around one third of the Chinese technology company Tencent. Part of the rationale for owning it was that it had moved to an extreme discount to the value of its stake in Tencent. The fund benefited from this gap having narrowed, such that it was no longer at such a compelling discount to our valuation.

Our holding in Whitbread, which is predominantly known for its Premier Inn hotel business, was also sold. Their business has seen a strong recovery coming out of the pandemic, and is undertaking an ambitious expansion into Germany. It is a strong and well-run business, but we decided to sell it as the share price had converged on our valuation, and we have several new UK based ideas that appear to offer more favourable opportunities.

We also sold our remaining tiny holding in a UK listed cash shell that we had originally bought because of its discount to the value of its net cash holdings. This discount had not closed by as much as we would have hoped for, but with better opportunity elsewhere, it was time to move on.

We established holdings in two UK listed, and well established, "digital" companies. The first operates a diverse collection of consultancy businesses, and has an impressive list of blue-chip clients based predominantly outside of the UK. Its origins are in public relations, but it has grown to offer a number of related technology-based services. The second is an online media business, that has successfully reinvented itself from a traditional print-based operation, and again has significant non-UK exposure. We believe that both will benefit from structural growth tailwinds, are highly cash generative, and are very attractively priced relative to their earnings power.

The third new UK-based holding was a smaller company that runs a chain of pawn broking shops. Despite the stereotypes of this industry, it offers small value loans to many individuals who are excluded from mainstream financial services. As the loans are secured by an item of jewellery, customers do not need a credit history and will have no recourse if they are unable to repay. Furthermore, the company does not allow customers to add interest charges to the balance of the loan, unlike more unscrupulous forms of lending. The company will only ever have a small weight in our portfolio, but is diversifying, attractively priced, and has a well proven track record.

We added a Canadian gold mining business into the portfolio, again with a small weight. We believe that it complements our existing holding in Newmont, and is attractively priced relative to their substantial gold reserves. The rationale for owning both gold mining companies, is that they are cash generative, attractively priced, and will benefit in the scenario that the high level of debt in Western economies calls into question the dominance of the US dollar as the world's reserve currency.

I mentioned last quarter that we have been focusing some of our research bandwidth on Japan. We established one new holding there during the quarter, which is to a manufacturer of instant noodles. The company has a very high level of cash on its balance sheet, which we think could be returned to shareholders and helps underpin the value of the company. Our research in Japan continues, but we have been treading quite carefully given how many Japanese companies have seen a surge in their share prices this year.

The Japanese companies that we are adding to the portfolio generally have higher price earnings ratios than our typical investments, because the "value" that we see in them is more dictated by the contents of their balance sheets. The typical Japanese company that we are investing in has a healthy core business, but an overly conservative balance sheet whereby cash and investment holdings appear to far exceed any likely need. Were these resources to be paid out to shareholders, their price earnings ratios would appear more modest.

Just as the quarter came to a close we started to establish a holding in a Korean company, which is one of the "chaebol" conglomerates. The parent company is at a significant discount to the value of its publicly listed subsidiary holdings, and has meaningful exposure to the high-growth electric vehicle battery market. We are well aware that there is no guarantee that this discount will close, but the valuation is underpinned by the earnings power of the various businesses with a very modest forward price earnings ratio of circa 6x.

Performance

Given that the fund's unit price was practically unchanged over the course of the quarter, it was the case that the positive contributors almost exactly offset the negative ones. I have already described how we have generally seen lower valuations, and hence price falls, across our European industrial holdings. Outside of this the only other distinct theme, was that our US holdings benefited from the upwards movement in the value of the US dollar.

The largest positive contributor to the change in the fund's unit price was the German medical business, Fresenius. The company is in the midst of a turnaround effort by its recently appointed CEO, that not only appears sensible, but also welcomed by shareholders. The second largest contributor was Handelsbanken, where concerns about the threats that it faces appear to have softened. The third largest contributor was Berkshire Hathaway, which is more a reflection of the strengthening value of the US dollar against the pound, than movements in the company's own share price.

At the opposite end, the largest negative contributor was the Danish industrial conglomerate Schouw & Co. The company has a strong track record of buying and improving niche businesses, but has been contending with cost inflation, and higher working capital demands. The combination of the management's track record and a modest valuation, means that we continue to see it as an attractive investment. The second largest negative contributor was the media business Warner Bros Discovery. The company is expected to deliver cashflows ahead of the original management plan, but negative sentiment around the writer's strike appears to have overshadowed this. The third largest negative contributor was Bakkafrost, which as described above has seen its earnings fall due to expectations that this year's fish harvest will be lower than originally expected.

Patience Is A Virtue

When we select an investment, we typically look for companies that have balance sheets with relatively low levels of debt. When interest rates were at near zero levels this felt like a needlessly cautious approach, but we wished to own a portfolio that would be robust in the face of a rapid rate rise.

Given the increase in rates in the last year, our concerns seem valid, but the transmission mechanism whereby they feed into the broad economy is neither instantaneous nor transparent. I have been surprised by how much of the punditry on the impact of higher rates is singularly focused on short-term changes in economic data, without any regard for the longer-term transmission mechanisms.

What do I mean by the transmission mechanisms?

A very real example is the experience of British homeowners, where convention dictates that mortgage rates are typically fixed for between 2 and 5 years. This means that the impact of higher rates is gradually fed through to borrowers as they need to refinance. This mechanism is somewhat arbitrary, as it is those households who have their existing mortgage deal expiring who initially feel the impact. By contrast, mortgages in the US tend to be fixed for the entire duration of the loan, and so consumers are seeing the benefit of higher rates in their savings accounts, without their existing mortgage payments going up. This makes it clear how very different transmission mechanisms are at play.

The transmission of higher rates onto household finances is pertinent to most companies, as if consumers have less money to spend, sales will be harder to come by. Whilst I do not pretend to be able to know the exact mechanism, it is clear to me that sooner or later higher rates will have to reduce disposable incomes. That is, after all, what the central bankers are trying to achieve.

In much the same way as households, the impact on corporate finances will be most directly felt when companies need to "roll over" their debts and see their interest bill increase. Like households, the information that I have seen suggests that this is happening with a lag that is not the same in all regions. Goldman Sachs estimates that half of all debt will expire in the next four years for companies in the European Stoxx600 index, versus only a quarter for the S&P 500 index. They also estimate that around one third of all debt for US smaller companies in the Russell 2000 index has a floating rate, and hence has been feeling the immediate impact of higher interest rates.

I believe that we live in a world of increasing short-termism, where many market participants are too impatient to wait for the impact of higher rates to become apparent. Instead, I think there is too high an expectation of seeing an immediate impact in the economic statistics, despite the clear rationale for there being a "lag" effect. I would like to think that in a world of short attention spans, investors who are able to be genuinely long-term will be advantaged.

Matthew Beddall
CEO, Havelock London

Unless otherwise stated all numerical data was courtesy of Bloomberg.