QUARTERLY REPORT
Q4 2018

HAWKSMOOR
FUND MANAGERS

THE MI HAWKSMOOR DISTRIBUTION FUND

The one-stop investment solution for income and growth.

INVESTMENT OUTCOME

The Distribution Fund's primary aim is to deliver an attractive level of income. In doing this the managers will aim to ensure the Fund's yield will always be at a premium to a composite index of financial asset classes (equities, bonds, property and cash). The intention is to increase the distribution alongside an increase in capital growth in order to maintain an attractive distribution yield for new and existing investors. Therefore investors should expect to receive a total return on their investment that will be somewhat correlated to financial markets given the Fund's fully invested, albeit diversified, portfolio.

1 The Defaqto 5 Diamond Multi-Manager Return Focused Rating reflects the C Share Class. Defaqto Multi-Asset Income and Risk Ratings apply to all available share classes.

INTRODUCTION

"Saru mo ki kara ochiru"
Japanese proverb meaning literally: "Even monkeys fall from trees."

Contents

Our Team

Daniel Lockyer *Senior Fund Manager*
Financial Express aggregated track record of 13+ years running retail funds – outperformed peer group by 45%, returning 115% versus 70% (13/01/2005 to 31/12/2018)

Richard Scott *Senior Fund Manager*
Financial Express aggregated track record of 18+ years running retail funds – outperformed peer group by 211%, returning 460% versus 249% (31/12/1999 to 31/12/2018)

Ben Conway *Senior Fund Manager*
Financial Express aggregated track record of 4+ years running retail funds – outperformed peer group by 10%, returning 32% versus 22% (01/01/2014 to 31/12/2018)

Ben Mackie *Fund Manager (joined 02/01/2019)*

Hannah Isaac *Head of Fund Operations*

David Chapman *Business Development Manager*

Dan Cartridge *Assistant Fund Manager*

Matilda Cretney *Team Assistant*

Left to right: Richard Scott, Hannah Isaac, Daniel Lockyer, Dan Cartridge, Ben Conway

 Source: Financial Express Analytics GBP total return

MARKET PERFORMANCE

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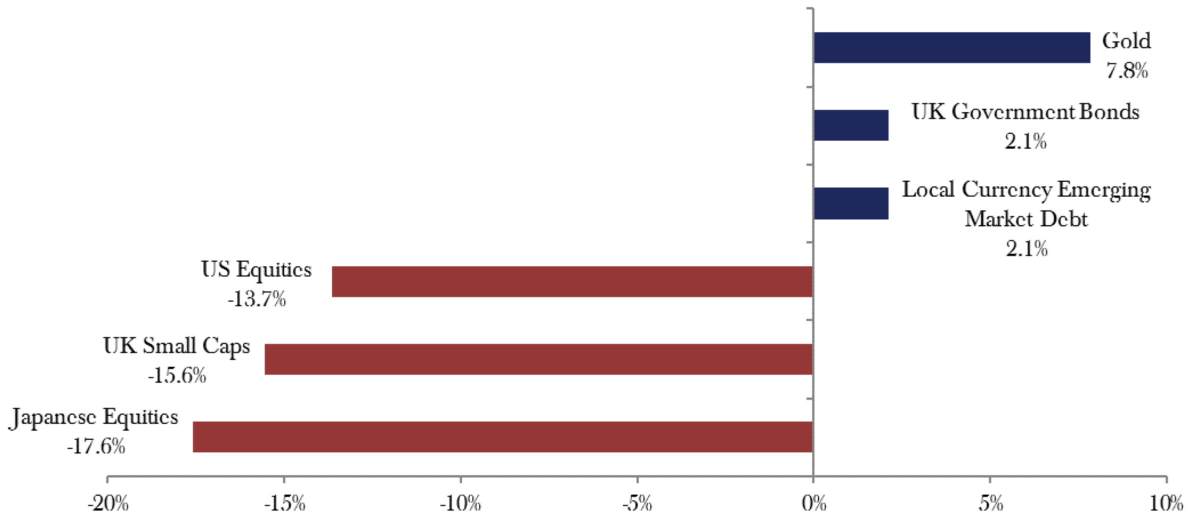
FUND MANAGERS

Top and bottom three performing asset classes



Commentary

The final quarter of 2018 was a challenging one for investors in global financial markets, with the negative returns generated by many global equity indices being the worst for a single quarter since the Great Financial Crisis a decade ago. It should not come as a big surprise that such a difficult quarter occurred on the back of the world's central banks in aggregate moving from a period of quantitative easing to quantitative tightening. Tighter monetary conditions, combined with ongoing friction in US-China trade negotiations, ongoing Brexit uncertainty and signs (albeit muted) of slowdowns in the growth of some major economies sparked indiscriminate selling across many financial markets. The performance of the S&P 500 in the US had decoupled from the majority of global equity market indices for much of the year as it rose when most other equity markets were down. This decoupling ended sharply during the quarter with the index down 13.7% in local currency terms.

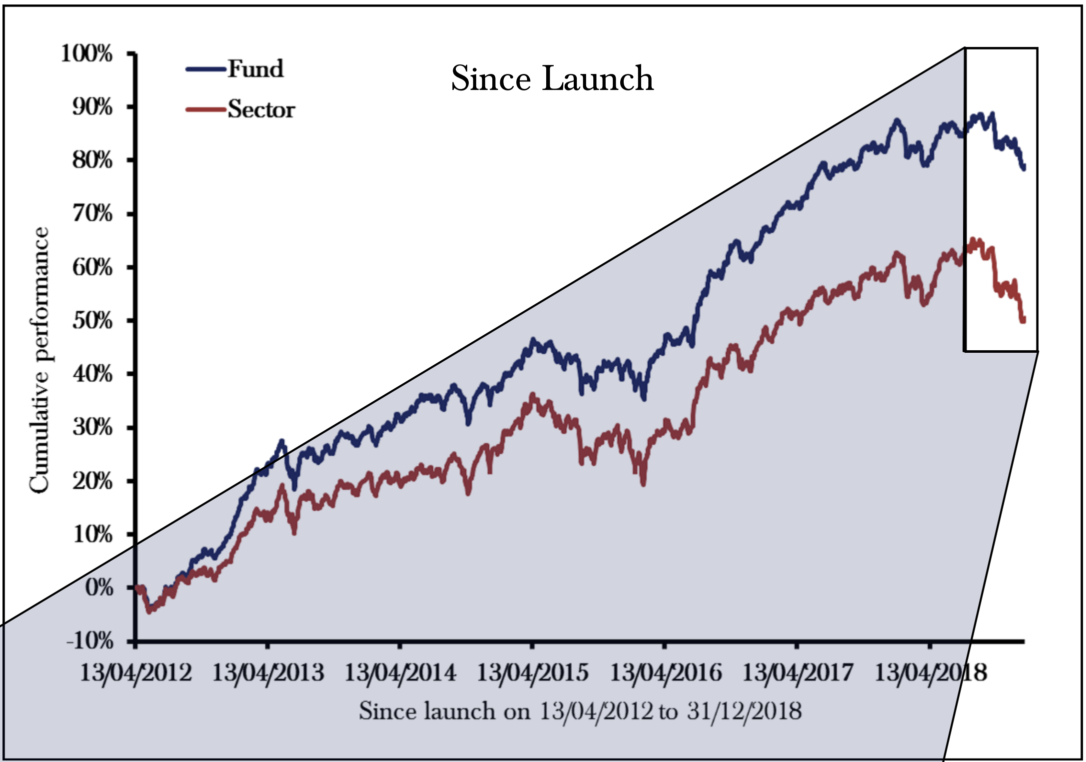
UK equity markets suffered further pain during the quarter, with the share prices of smaller, domestically focussed companies amongst the worst performing asset classes globally. Brexit negotiations continued to dominate UK headlines, culminating with Prime Minister Theresa May delaying a vote by Parliament on her Brexit deal the day before the vote was due to occur, exacerbating investor concerns. The price of sterling relative to other currencies has been a good proxy for the current state of Brexit negotiations and has had a material impact on the returns UK based investors have achieved from any unhedged overseas exposure.

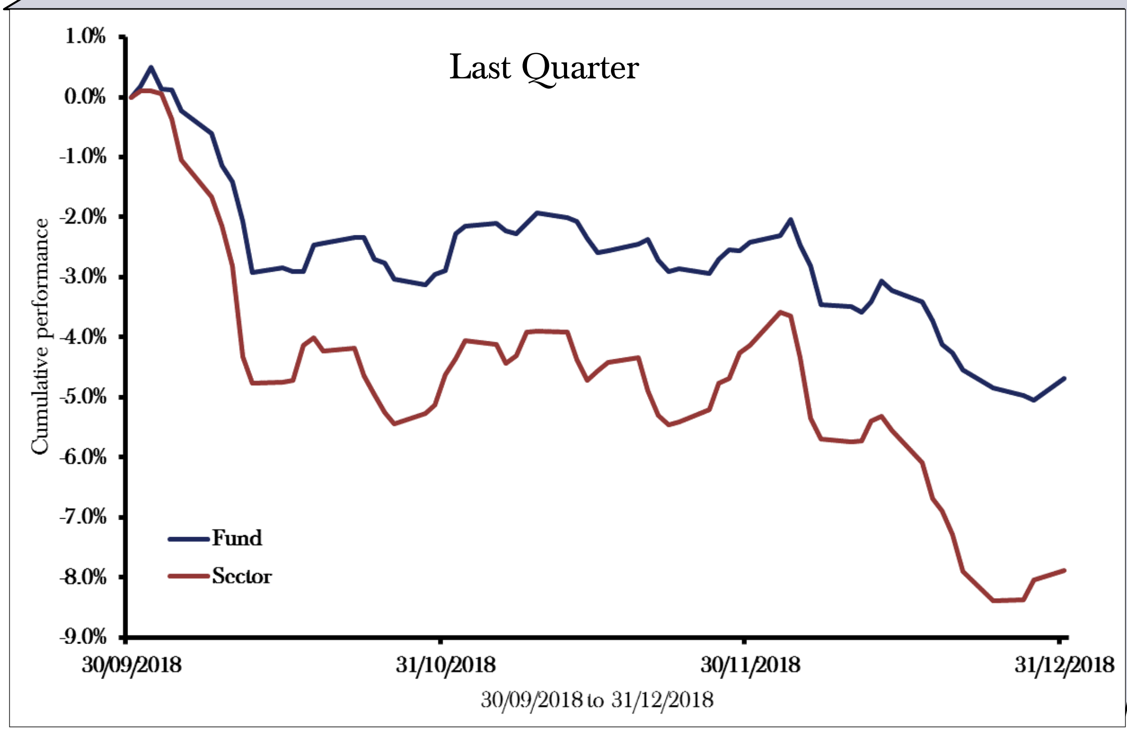
Whilst global equity markets experienced turmoil, investors sought safer havens, resulting in a rally in the gold price and in government bonds. The gold price rally had a knock on effect on the share prices of gold mining companies, which were amongst the top performers over the quarter.

Indices: Gold - ETFS Physical Gold, UK Government Bonds - Bloomberg Barclays Sterling Gilts, Local Currency Emerging Market Debt - JPM GBI-EM Global Div Composite, US Equities - S&P 500, UK Small Caps - MSCI United Kingdom Small Cap, Japanese Equities - TSE TOPIX.

 Source: Financial Express Analytics local currency total return 30/09/2018 - 31/12/2018

DISTRIBUTION FUND PERFORMANCE



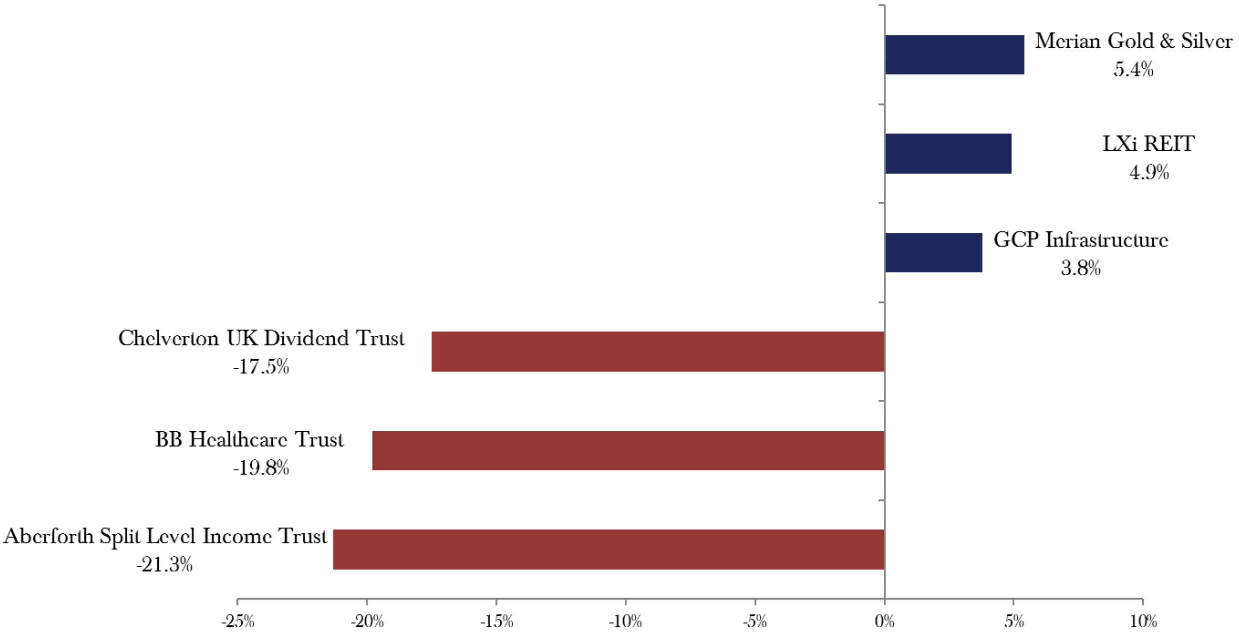


 Source: Financial Express Analytics GBP total return 31/12/2018. C Acc units. Sector: IA Mixed Investment 40-85% Shares.

DISTRIBUTION FUND PERFORMANCE

HAWKSMOOR FUND MANAGERS

Performance by holding (top three and bottom three)



Best performers:

- **Merian Gold & Silver** (gold & silver equities) - as investors sought safer havens with sharp falls across global equity markets the gold price experienced a material rally, resulting in a strong quarter for the performance of gold mining shares. Silver also began to rally towards the end of the quarter, which proved beneficial for silver miners.

- **LXi REIT** (commercial property) - the release of a strong set of results saw the trust re-rate to a significant premium during the quarter.

- **GCP Infrastructure** (infrastructure debt) - the premium on the trust increased following the release of a good set of results towards the end of the quarter.

Worst performers:

- **Chelverton UK Dividend Trust** (UK equities) - the net asset value (NAV) suffered falls alongside the broader UK equity market, whilst the discount on the trust widened further hampering total returns to investors.

- **BB Healthcare Trust** (thematic equities) - a particularly difficult quarter for the trust as growth style equities sold off aggressively. The trust raised more money to invest in resulting attractive opportunities.

- **Aberforth Split Level Income Trust** (UK equities) - a challenging quarter particularly for domestically focused UK companies as Brexit concerns took centre stage resulted in a sharp fall in the share price of the trust.

 Source: Financial Express Analytics GBP total return 30/09/2018 - 31/12/2018.

DISTRIBUTION FUND ACTIVITY

By holding

Purchases/Increases:

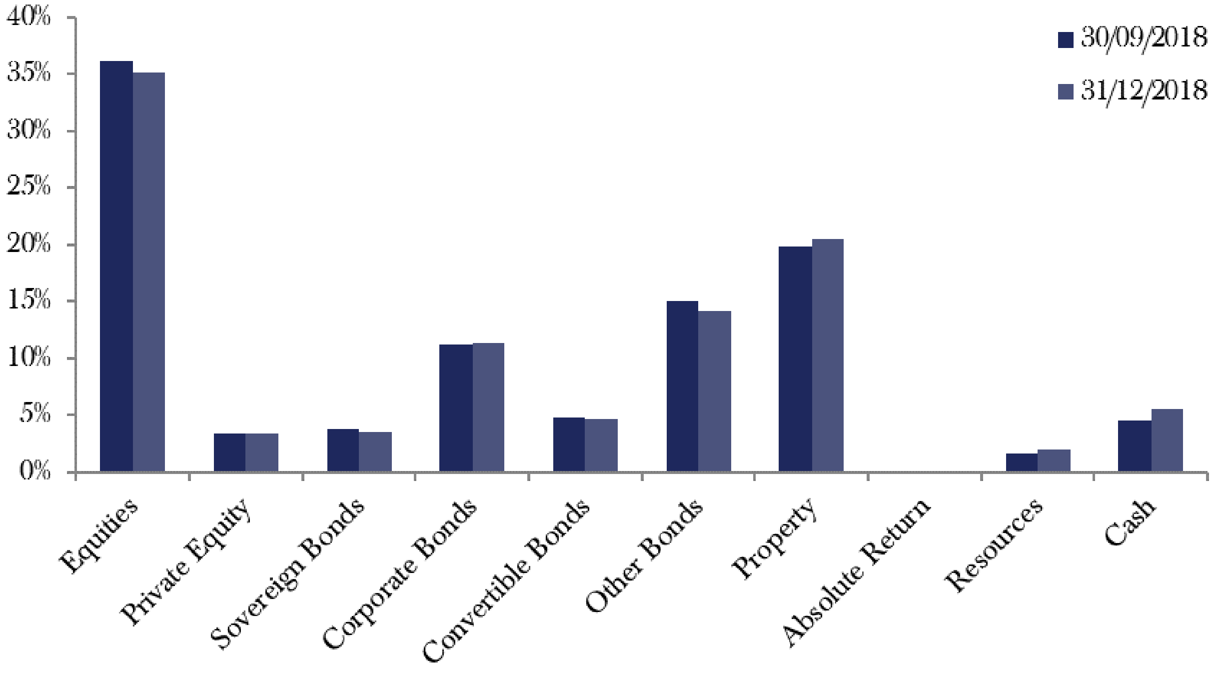
- BioPharma Credit
- Civitas Social Housing REIT
- Jupiter Japan Income
- LXi REIT
- Schroder Income Maximiser
- Tufton Oceanic Assets

Disposals/Reductions:

- Alcentra European Floating Rate Income Fund
- BlackRock UK Income
- ICG Longbow Senior Secured UK Property Debt
- LXi REIT
- Polar Capital Income Opportunities

We introduced two new positions during the quarter, in BioPharma Credit, a bespoke lender to biopharmaceutical companies, and Tufton Oceanic Assets, which owns and leases out ships. During the period we both added to, then reduced the holding in LXi REIT, participating in a share raise, then taking profits after strong performance in the share price, coupled with more attractively valued opportunities emerging elsewhere in the REIT space. Thus we took advantage of weakness in the share price to add to Civitas Social Housing REIT. We added to our holdings in Japanese equities via a top up of Jupiter Japan Income. We both tweaked and added to our exposure to UK equities via trimming the holding of BlackRock UK Income and adding to Schroder Income Maximiser. We completely sold out of the position in Alcentra European Floating Rate Income to raise cash and fund higher conviction ideas. For a similar reason, we trimmed both ICG Longbow Senior Secured UK Property Debt and Polar Capital Income Opportunities.

By asset class



This chart calculates the asset breakdown on a look through basis of the underlying holdings, therefore there may be differences in the breakdown shown here and on the pie chart on page 7.

 Source: Internal

DISTRIBUTION FUND HOLDINGS

Each fund has been allocated to an asset class for this pie chart, therefore there may be differences in the breakdown shown here and on the asset allocation chart on page 6.

 Source: Internal as at 31/12/2018

JAPAN: ONCE BITTEN, TWICE SHY?

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Throughout history, financial markets have gone through bull (rising) and bear (falling) phases but in most cases tend to recover eventually so that any correction is a mere blip many years later. For example, the 35% crash in UK equities back in 1987 is barely noticeable in the long-term chart below (Figure 1)

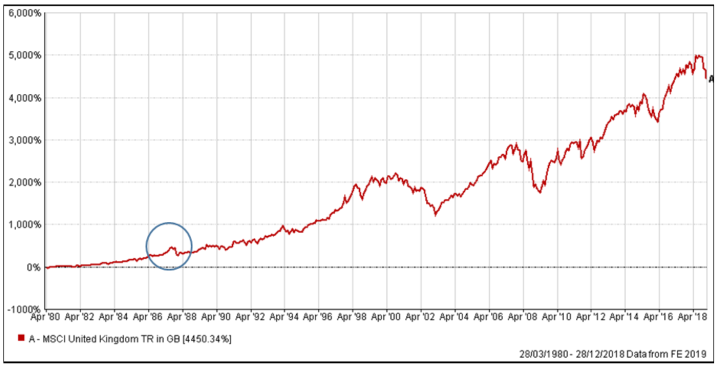

Figure 1

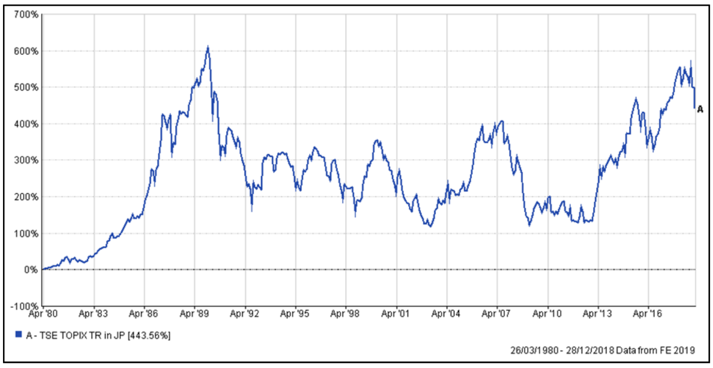

Figure 2

But spare a thought for Japanese investors who have perhaps witnessed the deepest and most prolonged bear market in history in both equity and property markets. See Figure 2 of the Topix Index over the same period.

The 1980s was a booming time for Japanese assets with the stock market increasing 600% during that decade and that exuberance extended to the property market. It has gone down in folklore that the value of the Imperial Palace in Tokyo was worth more than the whole of California. Japanese property values remain a long way below the values reached in the 1980s while the stock market is close to regaining the lost ground 30 years on, during which time most other stock markets are a long way ahead of previous peaks. It is therefore understandable why many investors, both domestic and foreign, choose to ignore Japanese equities having been scarred by past experiences.

Looking back on these episodes one can only wonder how such extreme valuations ever came to exist. But history is littered with examples of investors getting sucked into the latest 'get rich quick' craze, whether it be the Tulip mania in the 17th century, the dot com bubble in the late 1990s or the very recent bitcoin craze. So how can one be confident of not making a similar mistake in the future?

Among the key tenets of our investment philosophy at Hawksmoor is to ensure every investment has a sound valuation support with a margin of safety. We hope and expect this anchor will lessen the chance of us overpaying for anything and therefore reduce the risk of a permanent loss of capital. We believe that the starting valuation of any asset relative to its prospects is the key determinant of future returns and this is what is attracting us to ensure a meaningful proportion of our investors' capital is allocated to Japanese equities at a time when many other mainstream equity markets appear expensive relative to their history and to prospective returns. But valuations alone are not sufficient to make an investment case. There are a number of other reasons why we believe Japan is on an improving trend.

Almost a third of companies in the Topix hold more than 30% of their total market capitalisation in cash, a function of management also being scarred by the bursting of the stock market bubble in 1989. They spent the following decades paying off debt and building up a cash store for a rainy day. This inevitably caused Japanese returns on equity to shrink to very low levels, which, combined with poor corporate governance giving low prominence to minority shareholders and long periods of deflation, led global investors to seek better returns elsewhere and caused domestic investors to allocate more to government bonds.

 Source: Financial Express Analytics total return 31/12/2018 both charts are in local currency showing the respective experiences of the domestic investors

The political climate is among the most stable in Japan's history. Prime Minister Abe, appointed in 2012, is set to be the longest serving leader since 1868 if he remains in power in 2019. His very progressive economic policy, often referred to as Abenomics, has drawn scepticism over recent years for lack of progress in achieving the stated targets of beating deflation, stimulating economic growth and implementing structural reforms. One of his first acts as Prime Minister was to appoint Governor Kuroda as head of the Bank of Japan, with the task of reflating the economy. Extraordinary loose monetary policy, including buying equities and bonds as part of its Quantitative Easing program, combined with a big fiscal stimulus seem at last to be having an effect.

According to Oldfield Partners (managers of the Overstone Global Equity Income Fund) GDP per capita has risen by 0.65% per annum over the last decade, equal to the rise in the US and ahead of the UK and France. This statistic can partly be explained by the different demographics as Japan have a much older and therefore wealthier population. Demographics in Japan has long been a negative dynamic but Abe is taking steps to turn this around. As well as providing support for women to return to the workplace, Abe is taking a controversial stance in relaxing the hitherto strict immigration rules to help ease the shortage of workers. Currently there are more than three job vacancies for every one applicant and this will only worsen as the population falls by approximately half a million a year. This dynamic is at least helping to combat deflation as wages are rising to attract quality staff as unemployment is at record lows.

Among the myriad reforms implemented, addressing the demands of shareholders for better governance and focus on returns on equity (ROE) has been high on the agenda. A relatively new equity index, the JPX Nikkei 400 Index only includes the highest ranked companies based on certain criteria including a 3-year average ROE and operating profit. This has created a catalyst for many companies to change their approach as they competed for inclusion. Dividends are now much more commonplace to the extent that the 1.5% yield available from Japanese equities is now comparable to that of American equities but crucially dividend growth should be greater from Japanese companies given their relatively low payout ratio. Share buybacks and corporate acquisitions are also more common today than before as cash is spent much more wisely. Another demonstration of corporate governance improvements has been the increased involvement of independent directors on Japanese company boards. In 2010, only 50% of listed companies had an independent director compared to 100% today.

Further, Japan is home to some of the world's leading innovative companies specialising in high-specification technology, such as robotics, that is relevant to the new world we live in. This creates a fertile environment for active global stock-pickers. Lastly, it is an unloved area, understandably because of the history of negative returns, with international equity funds reported to be the most underweight to the region than at any time since 2002.

We are encouraged by the positive economic backdrop for the first time in many years, stability in the political environment, sustained improvements in corporate governance and valuations that seem to reflect Japan's historic problems rather than the exciting future prospects. Consequently, we believe this progress will ultimately result in better total returns for shareholders than in many other stock markets around the world over the long-term. While every investment carries risk and in Japan's case, a growing reliance on trade with China and the unshakable short-term correlation of the stock market performance with the direction of the Yen and global stock markets (perfectly illustrated in the last few weeks of 2018!) on balance we believe Japanese equities are worthy of a decent allocation in our Funds.

Daniel Lockyer
Senior Fund Manager

HAWKSMOOR
FUND MANAGERS

CONTACT INFORMATION

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RISK WARNINGS AND OTHER INFORMATION

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