QUARTERLY REPORT
Q1 2019

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.

INTRODUCTION

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FUND MANAGERS

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Our Team

Daniel Lockyer *Senior Fund Manager*
Financial Express aggregated track record of 14+ years running retail funds – outperformed peer group by 44%, returning 124% versus 80% (13/01/2005 to 31/03/2019)

Ben Conway *Senior Fund Manager*
Financial Express aggregated track record of 5+ years running retail funds – outperformed peer group by 9%, returning 38% versus 29% (01/01/2014 to 31/03/2019)

Ben Mackie *Fund Manager*

Dan Cartridge *Assistant Fund Manager*

Richard Scott *Advisor*

Hannah Isaac *Head of Fund Operations*

David Chapman *Business Development Manager*

Michelle Johnston *Team Assistant*

Left to right: David Chapman, Dan Cartridge, Ben Mackie, Ben Conway, Daniel Lockyer, Hannah Isaac

 Source: Financial Express Analytics GBP total return

MARKET PERFORMANCE

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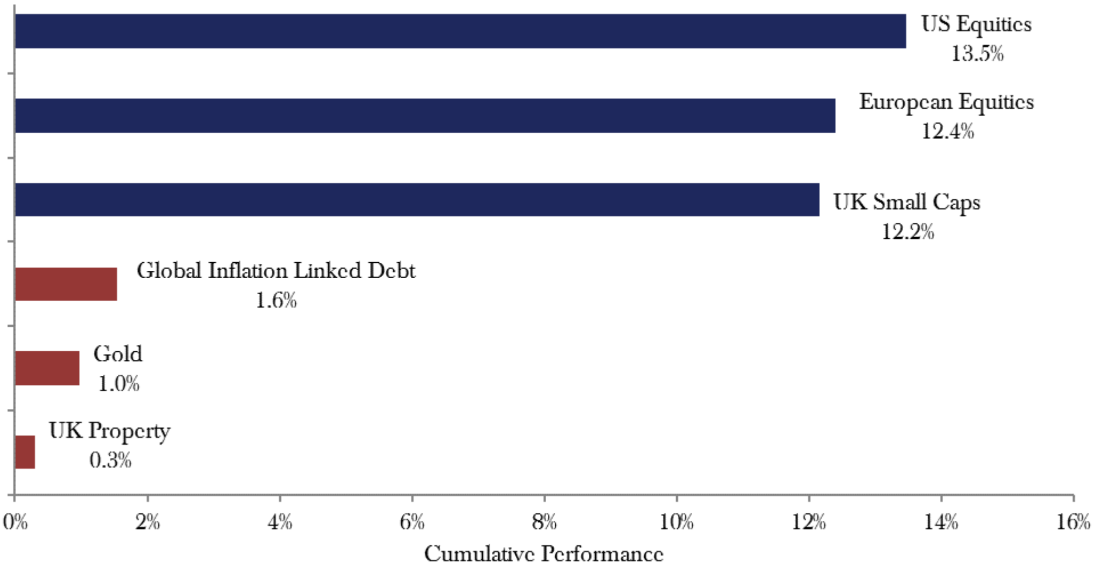
FUND MANAGERS

Top and bottom three performing asset classes



US Equities - S&P 500, European Equities - MSCI Europe, UK Small Caps - MSCI United Kingdom Small Cap, Global Inflation Linked Debt - Bloomberg Barclays Global Inflation-Linked, Gold - ETFS Physical Gold, UK Property - MSCI UK Monthly Property

Commentary

Following a difficult end to 2018, global financial markets have bounced back this year, with several equity indices posting their best quarterly returns since 1998. Concerns regarding the maturity of the business cycle and moderating economic growth persist, whilst US-China trade negotiations and Brexit uncertainty rumbled on without clear signs of resolution. Risk assets have rallied however, supported by dovish comments from the US Federal Reserve which have encouraged investors to reappraise their expectations of tighter monetary policy. This 'lower for longer' interest rate narrative has helped sustain lofty equity valuations and appease worries regarding the economic outlook and corporate balance sheets alike.

US equities have led the way, helped by the dominant technology sector, although UK smaller companies, which started the year looking particularly cheap, have also performed admirably in spite of the ongoing shambles at Westminster. The 29th of March has come and gone but failed to provide clarity over the Brexit endgame, yet sterling has been strong relative to both the dollar and euro, detracting from the returns UK investors have achieved on overseas assets. The move higher in equities has occurred against a backdrop of softening economic data and falling corporate earnings growth forecasts, which have helped fuel a rally in developed government debt where 10-year German Bund yields fell into negative territory for the first time since October 2016. In the US, the yield curve briefly inverted with equity and bond markets sending unusually mixed messages regarding the outlook for global economic growth.

 Chart Source: Financial Express Analytics local currency total return 31/12/2018 - 31/03/2019

DISTRIBUTION FUND PERFORMANCE

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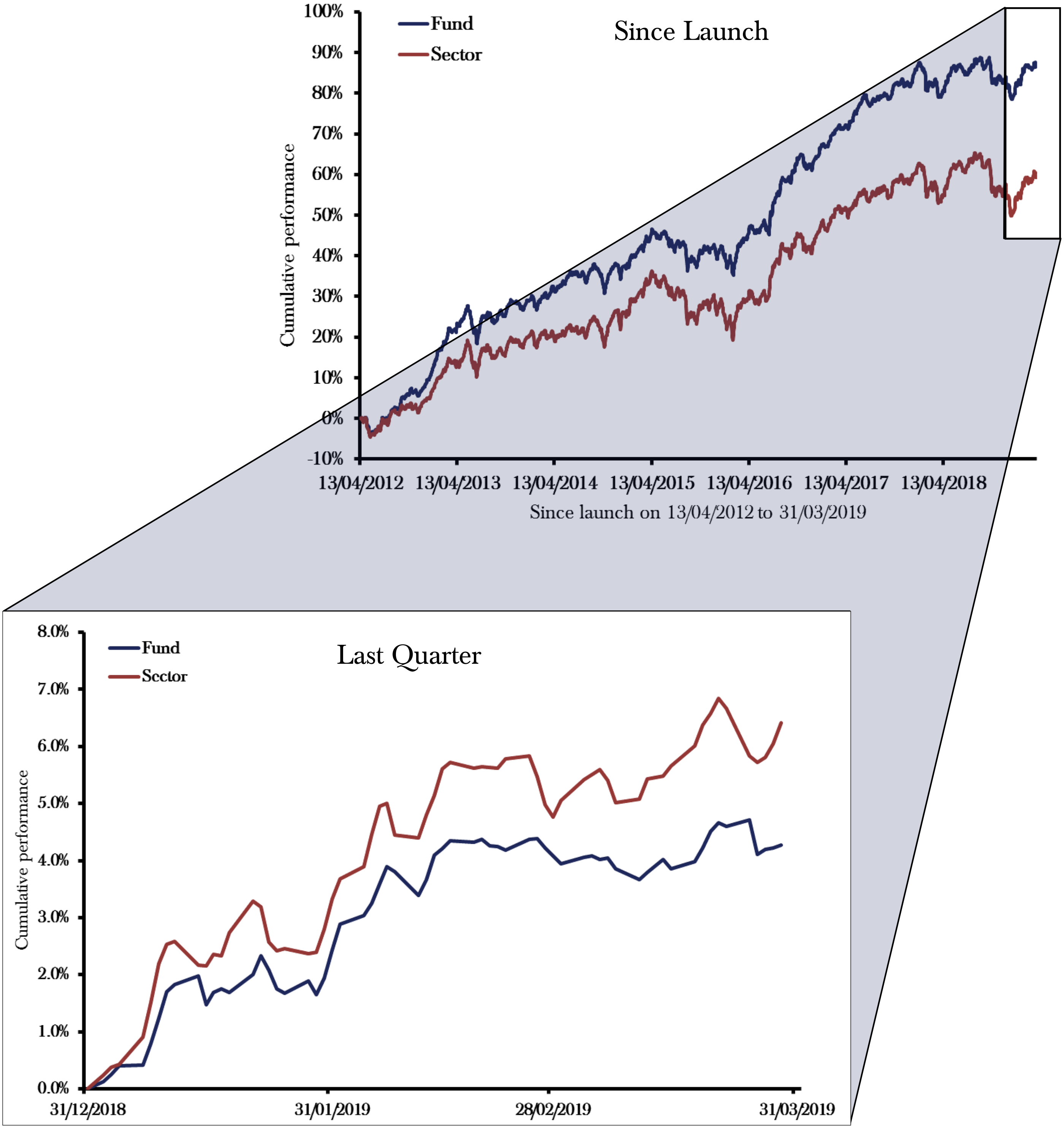
FUND MANAGERS

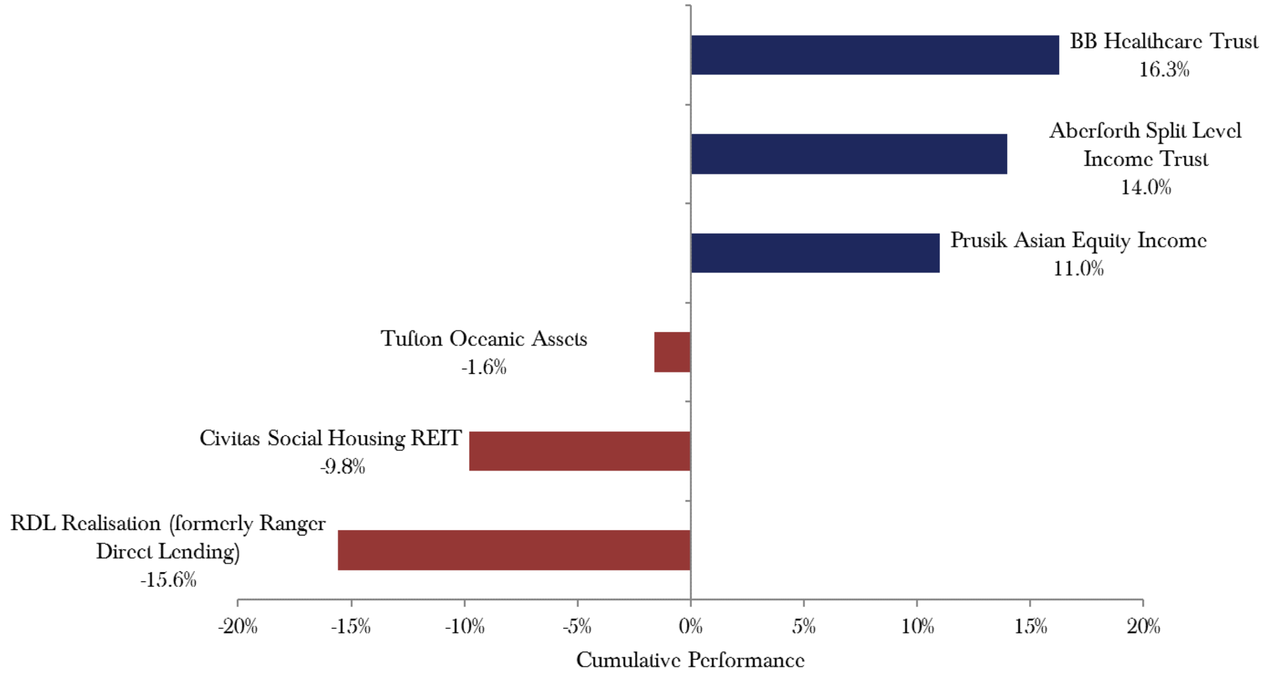


 Source: Financial Express Analytics GBP total return 31/03/2019. C Acc units. Sector: IA Mixed Investment 40-85% Shares.

DISTRIBUTION FUND PERFORMANCE

HAWKSMOOR FUND MANAGERS

Top and bottom three performing funds



Best performers:

- **BB Healthcare Trust** (thematic equities) - after a difficult Q4 for the trust, during which it raised additional equity to take advantage of opportunities in the market, the net asset value rallied as investor sentiment towards the sector and growth stocks improved after the Federal Reserve Bank in the US provided more accommodative forward guidance.

- **Aberforth Split Level Income Trust** (UK equities) - benefitted from the strong equity market rally, with smaller value focussed UK equities performing particularly strongly.

- **Prusik Asian Equity Income** (Asian equities) - benefitted from the strong equity market rally, with Chinese and Indian equities exposure in particular, contributing strongly to performance as the Chinese equity market was among the best performing in the world for the quarter.

Worst performers:

- **Tufton Oceanic Assets** (ship lending) - a relatively quiet quarter as the C shares converted into the Ordinary shares. The share price drifted slightly lower.

- **Civitas Social Housing** (UK property) - increased Regulatory attention into the social housing sector, whilst positive long term for the sector, when combined with ongoing Brexit uncertainty, sentiment remained poor and the share price suffered.

- **RDL Realisation (formerly Ranger Direct Lending)** (direct lending) - the trust is now in realisation mode and is gradually returning cash to shareholders. As such, liquidity is now tight and there was a material widening of the discount over the period.

Source: Financial Express Analytics GBP total return 31/12/2018 - 31/03/2019

DISTRIBUTION FUND ACTIVITY

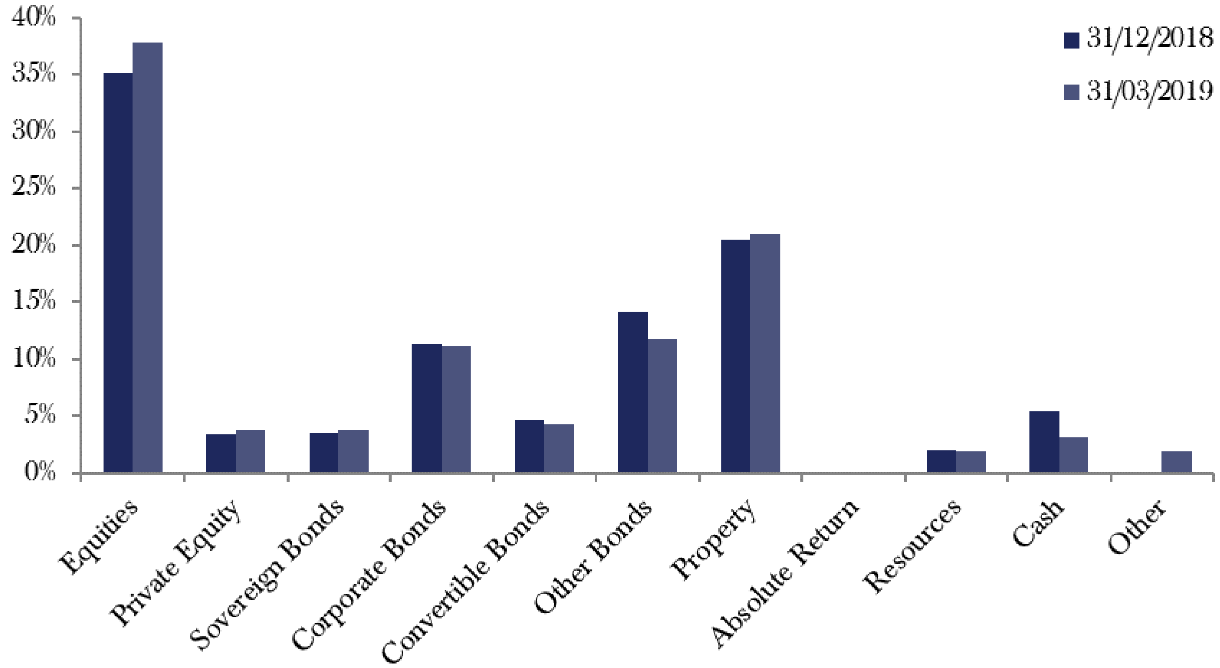
By holding

Purchases/Increases:
- Civitas Social Housing REIT
- GAM UK Equity Income
- Man GLG UK Income
- Schroder Income Maximiser
- Supermarket Income REIT
- Tufton Oceanic Assets

Disposals/Reductions:
- BlackRock UK Income
- Chelverton UK Dividend
- LXi REIT
- Polar Capital UK Value Opportunities

During the quarter we introduced GAM UK Equity Income. We know manager Adrian Gosden well from his Artemis days and think he will be well motivated to deliver performance at his new home. The highly active, value driven investment process and availability of a cheap share class are further attractions. Blackrock UK Income and Polar Capital UK Value Opportunities were exited to fund the position and we also continued to manage down our small holding in Chelverton UK Dividend. With the UK market looking reasonably valued we increased overall exposure via additions to Man GLG UK Income and Schroder Income Maximiser. LXi REIT was sold in the quarter with the shares trading on a significant premium to net asset value. Proceeds were recycled into other property trusts offering attractive yields including Civitas Social Hosing REIT, which sold off following a regulatory review of one of their Housing Association tenants and as investors weighed the risks of an alternative funding model for the supported living sector. We think these risks have been overplayed and used weakness to add. A placing of shares enabled us to add to Tufton Oceanic Assets at a discount to the prevailing share price. Supermarket Income REIT has been on our radar for some time and was introduced following an excellent meeting with management.

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 as at 31/12/2018 and 31/03/2019

DISTRIBUTION FUND HOLDINGS

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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.

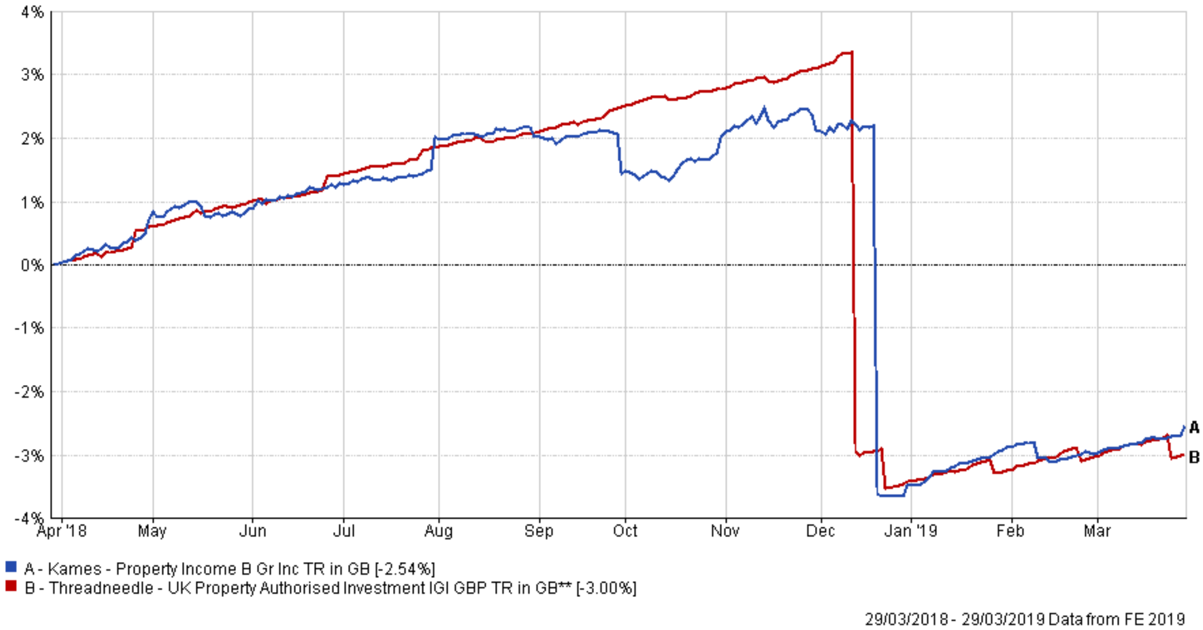
 Source: Internal as at 31/03/2019

AN OPEN AND SHUT CASE

Direct property has an important role to play in multi-asset portfolios offering yield, diversification and inflation-hedging benefits. Investors unable, or not inclined to purchase individual commercial warehouses, shopping centres or office blocks directly, can achieve exposure to the asset class via diversified open ended funds or listed Real Estate Investment Trusts (REITs). There are several reasons why we at Hawksmoor Fund Managers believe that the closed-ended REIT structure is by far the more appropriate vehicle.

We have made this argument before but revisiting is apposite, given the Financial Conduct Authority's recent consultation on potential new rules that seek to reduce the risk to investors in open-ended funds that hold illiquid assets such as physical property. The regulator has also increased its scrutiny of the sector and is in daily contact with managers regarding the health of their underlying portfolios. The fourth quarter of 2018 saw **UK property funds suffer net outflows of £336m,** sparking concerns that a re-run of 2016, when a number of open-ended property funds suspended trading in the face of heavy redemptions, might be on the cards. In response to the latest bout of selling, Columbia Threadneedle and Kames shifted from offer to bid pricing, resulting in net asset value (NAV) declines of around 6%. This swing pricing mechanism is employed by open-ended managers to help protect long- term investors from the dilutive impact of trading in the fund's underlying assets. When net inflows are strong, the NAV swings upwards to offer basis but when redemptions are high, the opposite occurs with the NAV moving to bid basis. The high transaction costs associated with buying and selling property means that the spread between the bid and offer price is wide, which in turn can result in the large NAV movements illustrated below.

Fig.1 – Kames Property Income and Columbia Threadneedle UK Property 1 year total return



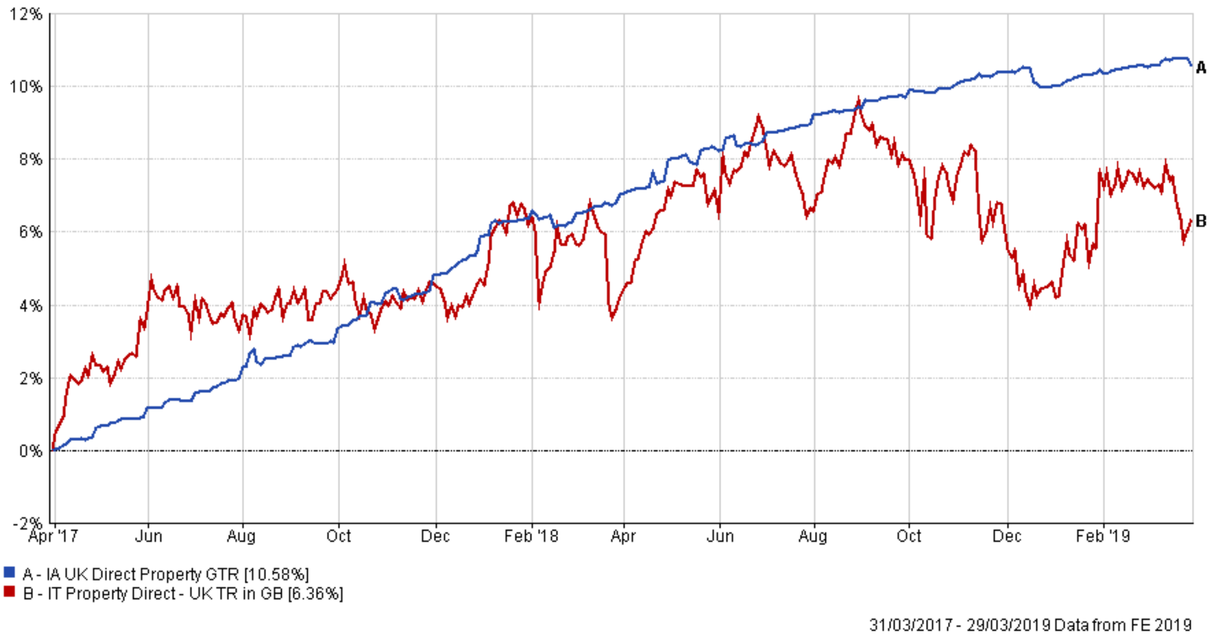
In February 2019, rating agency Fitch warned that **open-ended funds are poorly equipped to deal with an expected spike in outflows** in the coming months and, whilst many funds hold higher cash balances than they did in June 2016, the ratings agency still believes that there is insufficient liquidity to prevent suspensions and other withdrawal restrictions. Ultimately, risks around gating and volatility associated with swing pricing, which always lurk in the background due to the fundamental liquidity mismatch inherent in open-ended property funds, are particularly prevalent in the current environment.

 Source: Financial Express Analytics

In the interests of balance, there is of course a valid argument that **the gating mechanism helps protect existing investors** and that the swing-pricing inspired volatility in open-ended funds is more than mirrored in the closed-ended space, due to widening discounts (further magnified by gearing). Indeed, in the aftermath of the June 2016 referendum vote, the discounts on UK Commercial Property Trust and F&C Commercial Property Trust, two of the larger listed generalist REITs, blew out to around 20%, having traded at or above par as recently as April of that year. On the issue of gating, the FCA's consultation recognises that the suspensions of 2016 were temporary in nature and generally worked, protecting investors from the negative consequences of forced selling. The regulators' views aside, the point remains that open-ended funds are meant to be daily dealing but in certain circumstances are unable to meet that obligation. Furthermore, it seems likely that withdrawal restrictions will become more commonplace in the future, with the regulator suggesting trading should be suspended if independent valuers express uncertainty around the value of 20% or more of the portfolio. Given low transactions and problematic price discovery in the retail sector, it is not hard to imagine suspensions happening more often, whilst the regulators drive to improve disclosure regarding liquidity risks has the potential to exacerbate the problem around net flows.

Over the past 2 years, the IA UK Direct Property Sector, in aggregate, has delivered positive returns with limited volatility, which seems anomalous considering the anecdotal evidence from the retail sector and when compared with the negative returns of equivalent REITs and listed property companies. We have argued before that the serene pricing of open-ended funds may prove to be overly optimistic and that their relative price outperformance is vulnerable to unwind as NAV's begin to reflect more accurate valuations. REITs, on the other hand, have already taken a hit in the form of widening discounts as investors move to price, in perceptions of true value. On a total return basis, the quantum of REIT underperformance is significantly lower, due to the higher average income yields available. It is also worth pointing out that the chart below compares open ended fund performance with the generalist property investment trust sector which, as discussed later, does not constitute a fair reflection of our more targeted REIT exposure.

Fig.2 – IA UK Direct Property Sector and IT Property Direct Sector 2 year total return



 Source: Financial Express Analytics

One way for open-ended property funds to mitigate liquidity and suspension risk, is to hold high levels of cash which has an inevitably dilutive impact on returns. According to research from Canaccord, for every £1 invested in large open-ended property funds, investors on average get only 78p of property exposure. The fact that funds charge an annual management fee on the cash element of the portfolio, rubs salt in the wound. In contrast, **due to their fixed capital nature, REITs can remain fully invested** and furthermore can enhance exposure through their ability to use gearing. Implications for potential relative returns should be stark for long-term investors that wish to capture the asset class's attractive income streams or who expect capital values to rise.

Evidence suggests that open-ended property funds have been adding to their cash buffers recently, which seems entirely natural given the regulator's greater scrutiny and the increase in net withdrawals. We are hearing, however, that in the absence of buyers in the troubled retail sector, managers have been forced to sell more attractive properties in the industrial and alternatives space, leaving portfolios with undesirable skews. Most open-ended funds are generalist in nature and will have exposure to offices, industrials and retail, with the latter accounting for over a third of portfolio totals on average. **We favour a more targeted approach to property, with the existence of specialist REITs** enabling us to gain specific exposure to warehouses, nursing homes, supermarkets and residential property, where we have greater confidence in the underlying lease structures and sustainability of income streams.

The use of REITs in our funds, help us deliver diversified exposure to property sub-sectors that we believe offer the best risk-return profiles in the most efficient manner possible, whilst protecting investors from the cash drag and suspension risks associated with open-ended property funds. With the regulator circling and outflows accelerating, the health warnings associated with these vehicles should be more pronounced than ever.

Ben Mackie
Fund Manager

 Source: Financial Express Analytics

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RISK WARNINGS AND OTHER INFORMATION

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