QUARTERLY REPORT
Q1 2019

HAWKSMOOR
FUND MANAGERS

THE MI HAWKSMOOR GLOBAL OPPORTUNITIES FUND

The one-stop investment solution to maximise long-term real returns.

INVESTMENT OUTCOME

The Global Opportunities Fund's primary aim is to deliver returns, after charges, in excess of general markets over the long term (defined as rolling periods of 5+ years). In order to achieve this, the managers will invest in a variety of financial assets, using collectives to invest in long term structural growth themes, together with exploiting inefficiencies in the closed-ended sector - i.e. investment trusts trading at a discount. The portfolio will be fully invested and, whilst diversified, it will have a minimum exposure to equities of 60% . It is therefore likely that investors will see fluctuation in the value of their investment over the short term, so they need to share the managers' long term perspective in order to increase the likelihood of superior long term total returns.

INTRODUCTION

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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*

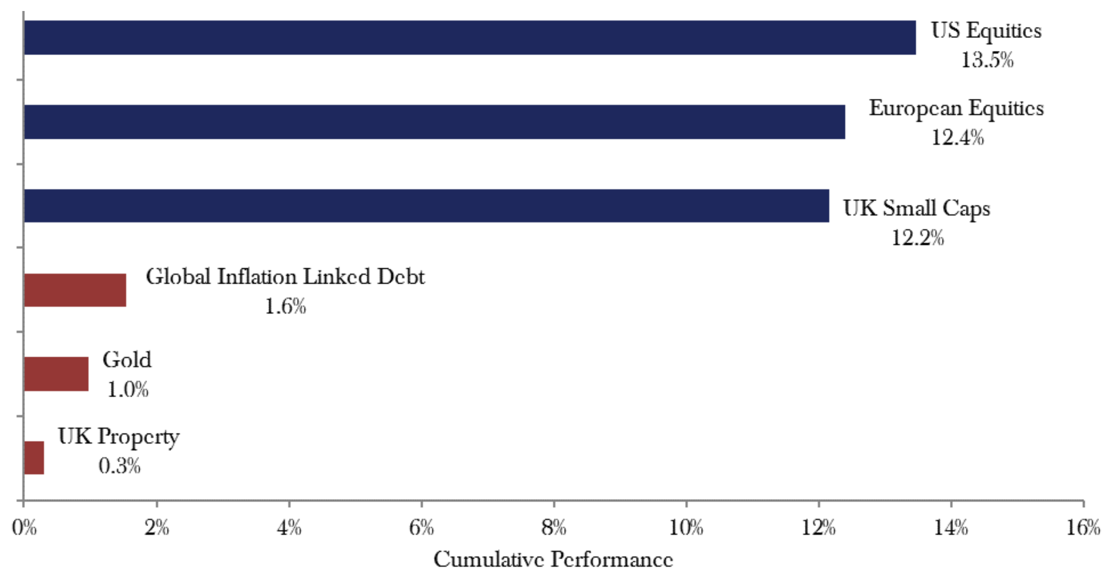
Michelle Johnston *Team Assistant*

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

 Source: Financial Express Analytics GBP total return

MARKET PERFORMANCE

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

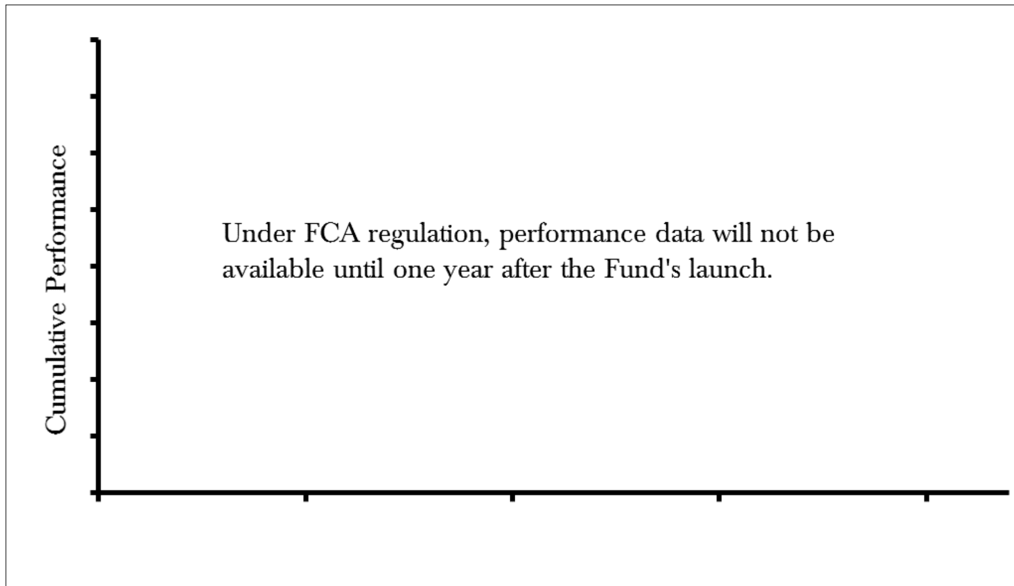
Commentary

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.

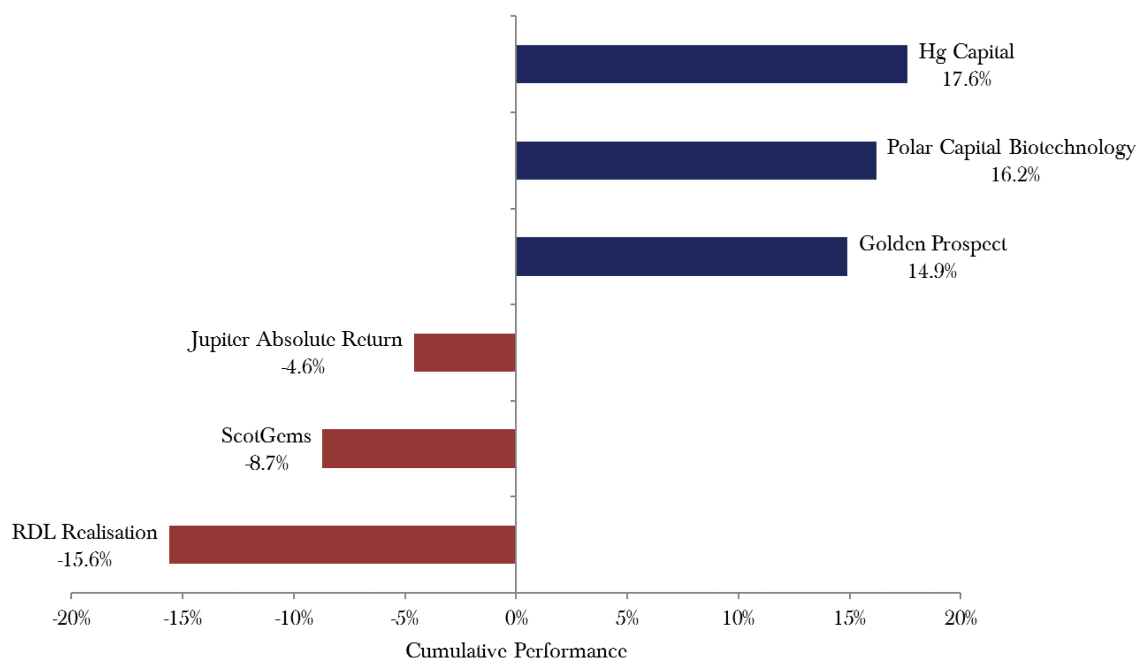
 Chart Source: Financial Express Analytics local currency total return 31/12/2018 - 31/03/2019

GLOBAL OPPORTUNITIES FUND PERFORMANCE



GLOBAL OPPORTUNITIES FUND PERFORMANCE

Top and bottom three performing holdings



Best performers:

- **Hg Capital** (private equities) - the release of another excellent set of full-year results from this best in class, private equity trust resulted in the net asset value (NAV) rising and the discount to NAV narrowing by nearly 10%.

- **Polar Capital Biotechnology** (thematic equities) - improved sentiment towards the sector and towards growth stocks in general, following more accommodative guidance by the Federal Reserve Bank in the US, saw a sharp rally in the companies owned in the fund.

- **Golden Prospect** (gold equities) - after a challenging final quarter of 2018 for the smaller mining companies that the trust holds, despite the rally in the gold price, NAV performance was strong in the quarter, catching up the better performing large cap miners.

Worst performers:

- **Jupiter Absolute Return** (absolute return) - the sharp rally in the share prices of many growth oriented companies that the fund is short hampered performance during the quarter.

- **ScotGems** (emerging market equities) - poor performance was a function of the discount widening out, as the NAV actually rose during the quarter.

- **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

GLOBAL OPPORTUNITIES FUND ACTIVITY

By holding

Purchases/Increases:

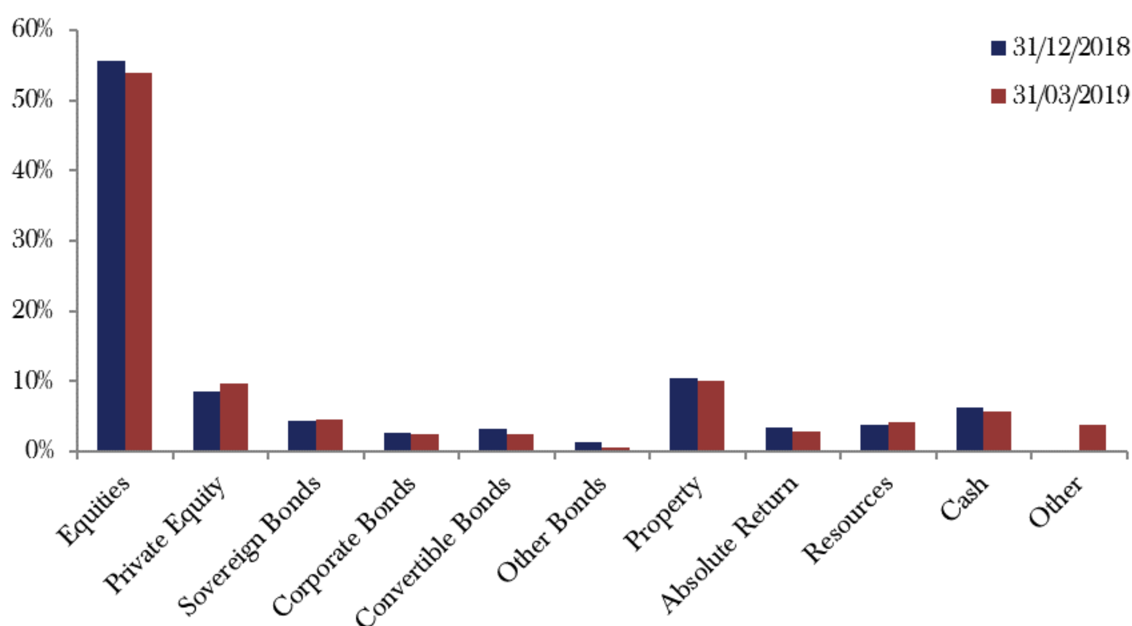
- Ashoka India Equity
- Fidelity Asia Pacific Opportunities
- Oakley Capital
- Odey Swan
- Polar Capital UK Value Opportunities
- Tufton Oceanic

Disposals/Reductions:

- Baillie Gifford Global Discovery
- Cape Wrath Focus
- Guinness Asian Equity Income

Baillie Gifford Global Discovery was exited in the period as we rotated out of global equities in favour of the more attractively valued UK equity market, where we added to our core holding in Polar Capital UK Value Opportunities. Cape Wrath Focus was sold following a protracted period of disappointing performance. Guinness Asian Equity Income was sold to fund a new position in Fidelity Asia Pacific Opportunities, where we like manager Anthony Srom's high conviction, stock picking approach. Oakley Capital, the listed private equity trust, released a strong net asset value (NAV) update in the period, demonstrating excellent operational performance from their underlying companies. With the shares languishing on a deep discount, we took the opportunity to meaningfully increase our holding. A placing of shares enabled us to add to Tufton Oceanic Assets at a discount to the prevailing share price and we also took advantage of a placing in Ashoka India Equity to build our position here. Whilst the growth prospects for India look attractive in the long term, the key attraction for us at this stage is the quality of the team and our conviction in their ability to generate alpha. We also introduced a position in Odey Swan, a hedge fund that we believe is capable of producing uncorrelated returns, particularly during times of market stress.

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

GLOBAL OPPORTUNITIES FUND HOLDINGS

Absolute Return 4%
Jupiter Absolute Return
Odey Swan

Multi-Asset 1%
Henderson Alternative Strategies

Bonds 8%
Ashmore Emerging Markets Short Duration
Ashmore Emerging Markets Total Return
RDL Realisation

Property 12%
AEW UK REIT
Phoenix Spree Deutschland
Tufton Oceanic Assets
Urban Logistics REIT
Warehouse REIT

Cash 5%

Equities 70%
Artemis Alpha Trust
Artemis Global Select
Ashoka India Equity
Aubrey Global Emerging Markets Opportunities
Augmentum Fintech
Baillie Gifford Japanese Income Growth
Blue Whale Growth
Downing UK Micro-Cap Growth
Fidelity Asia Pacific Opportunities
Gabelli Value Plus Trust
Genesis Emerging Markets
Golden Prospect
HG Capital Trust
ICG Enterprise Trust
Jupiter Emerging & Frontier Income Trust
Jupiter Global Emerging Markets
Jupiter Japan Income
Man GLG Undervalued Assets
Merian Gold & Silver
Mobius Investment Trust
Oakley Capital Investments
Pantheon International
Polar Capital Biotechnology
Polar Capital Global Convertibles
Polar Capital UK Value Opportunities
Prusik Asia
Schroder Global Recovery
ScotGems
Woodford Patient Capital

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.

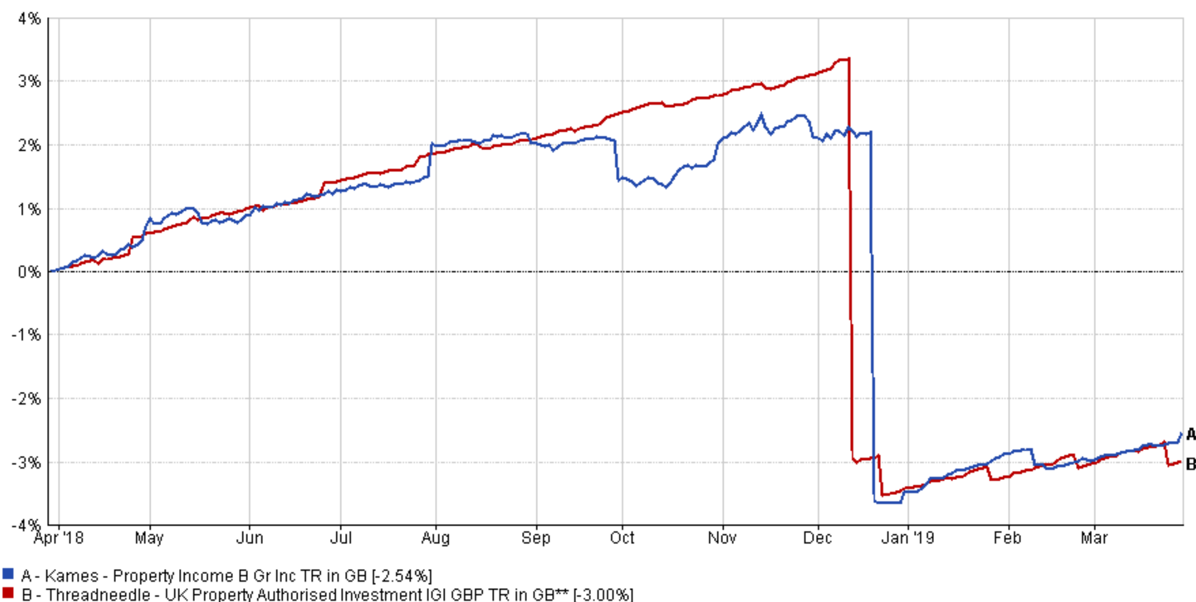
 Source: Internal as at 31/03/2019

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

HAWKSMOOR
FUND MANAGERS

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RISK WARNINGS AND OTHER INFORMATION

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