

# QUARTERLY REPORT Q1 2019



## THE MI HAWKSMOOR VANBRUGH FUND

The one-stop investment solution  
for real returns.



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### INVESTMENT OUTCOME

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The Vanbrugh Fund's primary aim is to deliver returns, after charges, in excess of the Consumer Price Index (CPI) over the medium term (defined as rolling periods of 3-5 years). In striving to achieve this target, the managers seek to strike the right balance between the need to generate positive real returns and preserve capital by investing in a variety of financial assets which can be volatile. The managers will seek to mitigate against this volatility by ensuring a diversified portfolio of assets, each of which share the common characteristics of a margin of safety and low intra-asset correlations. However, investors may 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. Whilst there is no yield target, the Fund will always contain an allocation to bonds and other income producing assets, so some income generation is likely.

# INTRODUCTION



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## Our Team

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**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*

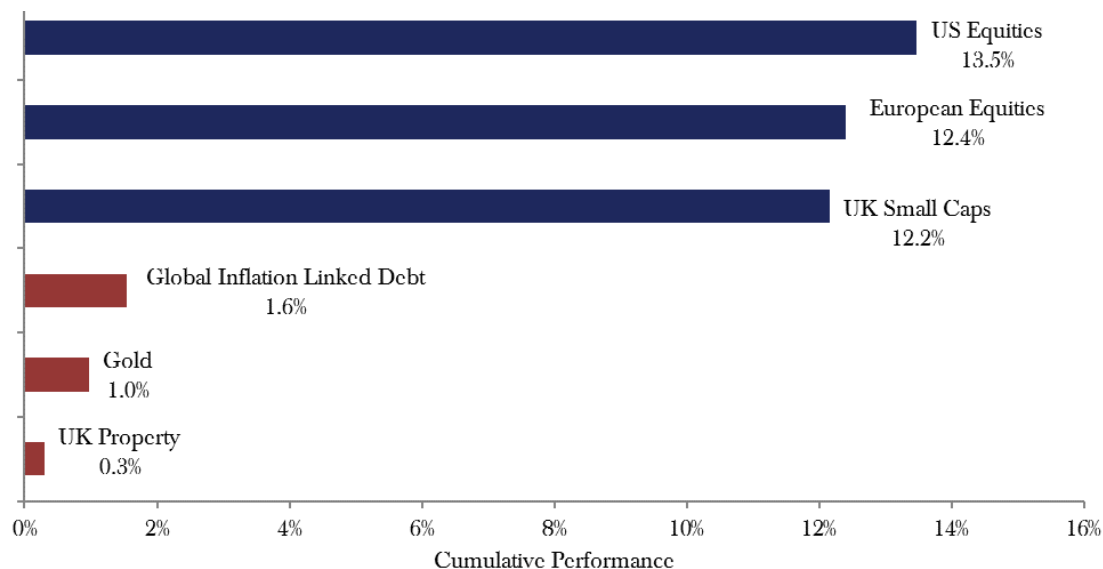


Left to right: David Chapman, Dan Cartridge, Ben Mackie, Ben Conway, Daniel Lockyer, Hannah Isaac

# MARKET PERFORMANCE



## Top and bottom three performing asset classes



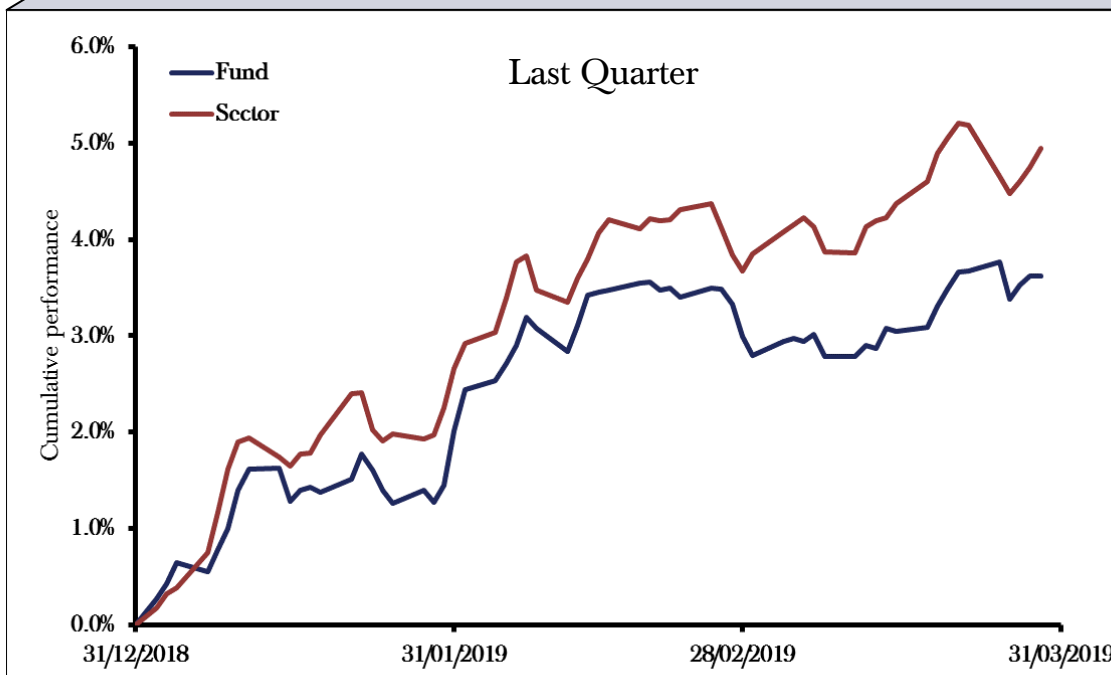
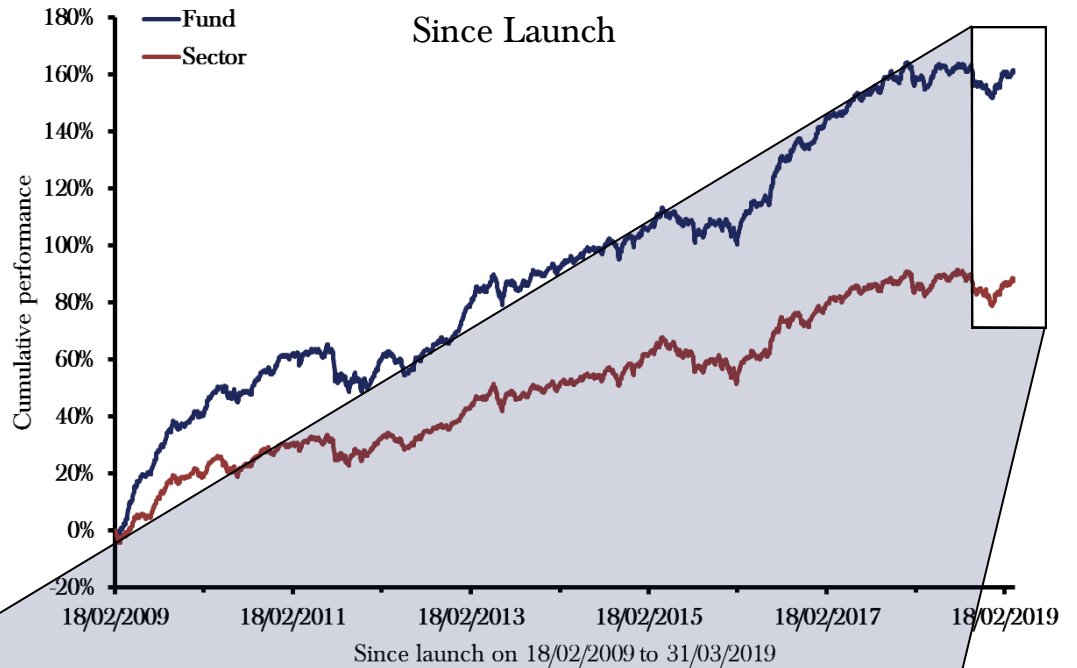
US Equities - S&P 500, European Equities - MSCI Europe, UK Small Caps - MSCI United Kingdom Small Cap, Global Inflation Linked Debt - Bloomberg Barclays Global Inflation-Linked, Gold - ETFS Physical Gold, UK Property - MSCI UK Monthly Property

## 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.

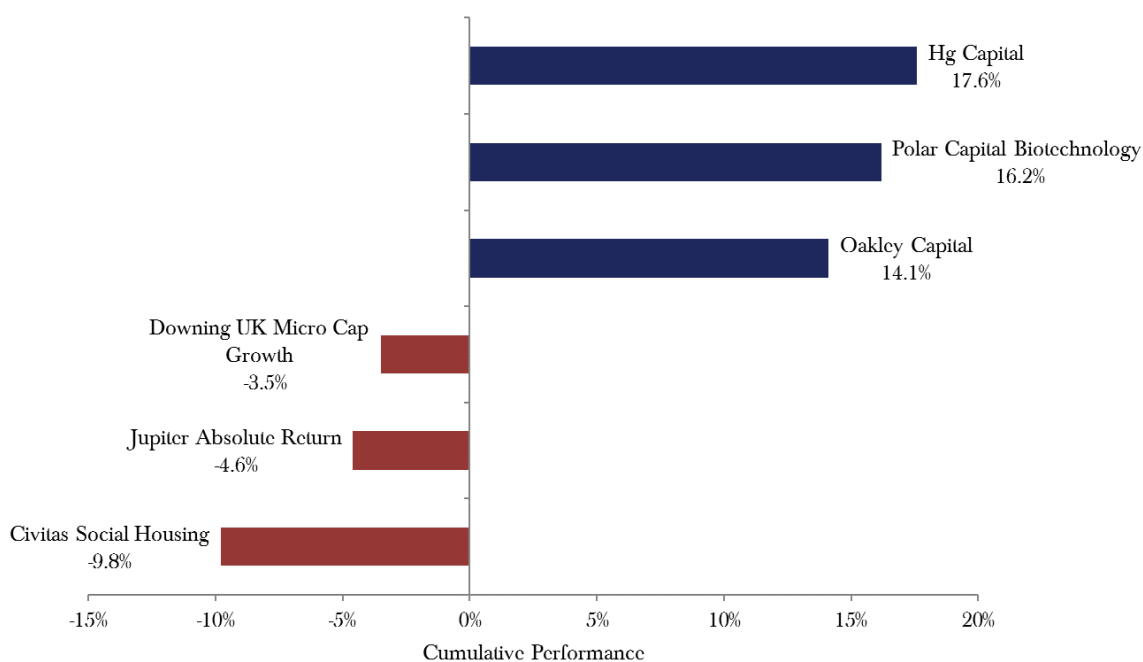
# VANBRUGH FUND PERFORMANCE



# VANBRUGH FUND PERFORMANCE



## Top and bottom three performing holdings



### Best performers:

- **Hg Capital** (private equity) - 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.
- **Oakley Capital** (private equity) - the release of a strong set of annual results in March saw strong NAV and share price returns, though the wide discount the trust trades at persists for now.

### Worst performers:

- **Downing UK Micro Cap Growth** (UK smaller company equities) - this idiosyncratic portfolio bucked the trend of strong equity market returns as the managers continue to battle with some difficult turnaround situations.
- **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.
- **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.

# VANBRUGH FUND ACTIVITY



## By holding

### Purchases/Increases:

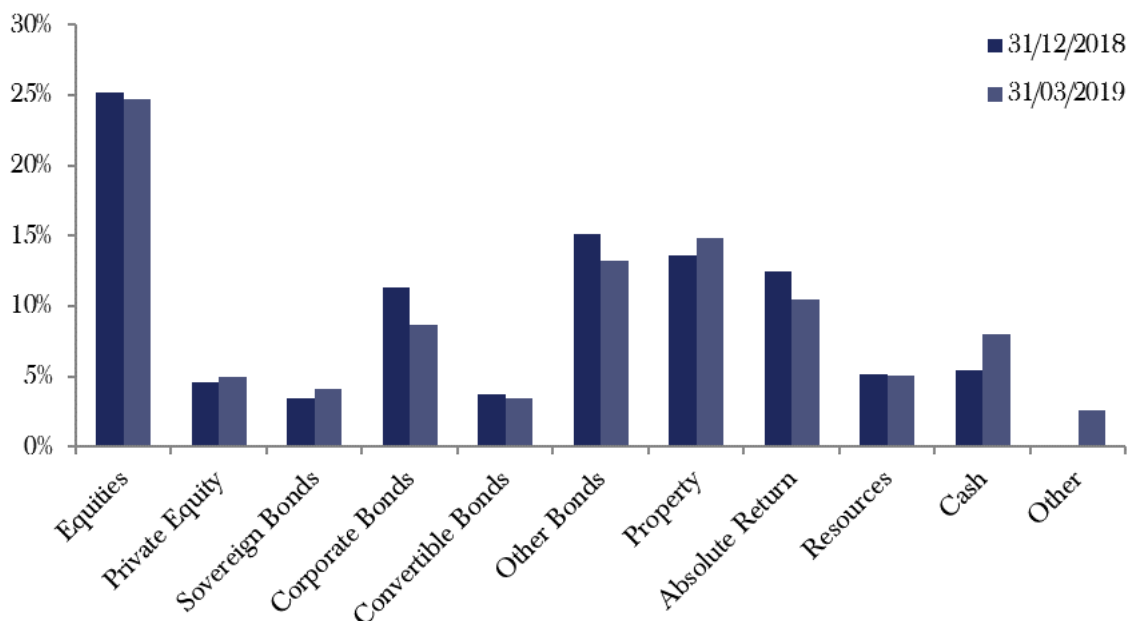
- BH Macro
- CG Dollar
- Civitas Social Housing REIT
- Man GLG Undervalued Assets
- Odey Swan
- Polar Capital UK Value Opportunities
- Supermarket Income REIT
- Tufton Oceanic Assets

### Disposals/Reductions:

- Artemis Pan European Absolute Return
- Hermes Asia ex Japan
- M&G UK Inflation Linked Corporate Bond
- M&G Global Macro Bond

Reconfiguration of our absolute return exposure saw us exit the equity net-long Artemis Pan-European Absolute Return fund in favour of Odey Swan, a hedge fund that we anticipate will protect capital better in times of equity market stress. Our exposure to investments with lower correlation to traditional asset classes was bolstered later in the quarter with the introduction of BH Macro, an interest rate and currency focussed hedge fund managed by Brevan Howard at an attractive discount. M&G UK Inflation Linked Corporate Bond and M&G Global Macro Bond were both sold to finance a purchase in CG Dollar which, via its holdings in US Treasury Inflation Protected Securities, provides attractive diversification benefits. Hermes Asia ex-Japan was sold as part of a rotation into cheap UK equities where we topped up Polar Capital UK Value Opportunities and Man GLG Undervalued Assets. A placing of shares enabled us to add to Tufton Oceanic Assets at a discount to the prevailing share price. Civitas Social Housing REIT sold off in the period 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 issues have been overplayed and used weakness to add. Supermarket Income REIT has been on our radar for some time and was introduced via a placing of new shares.

## 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.



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.

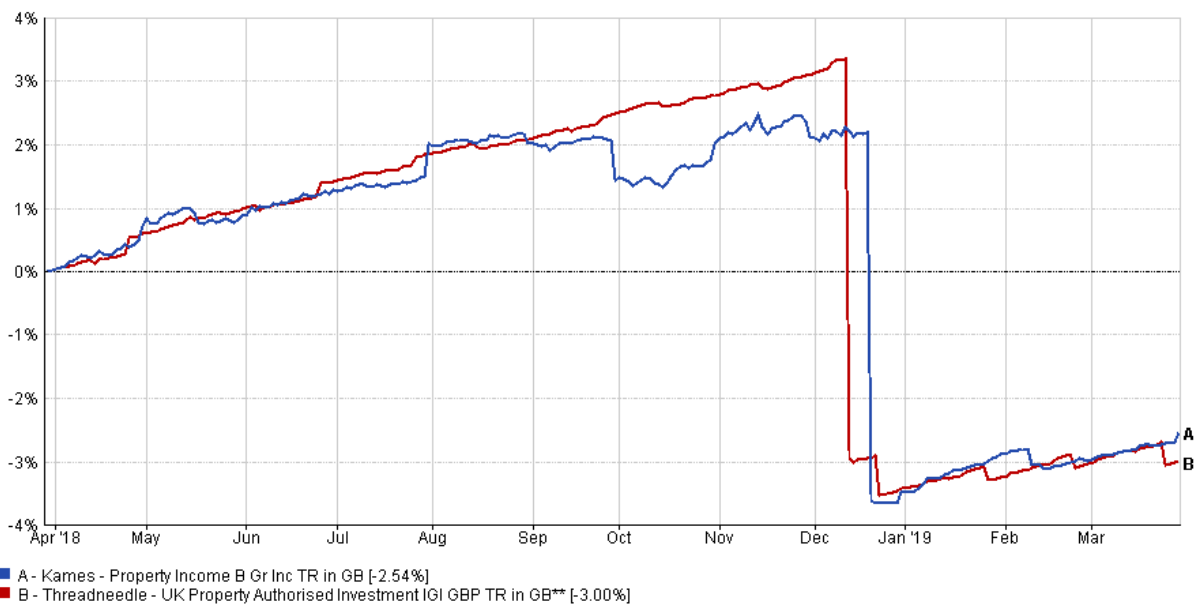
# AN OPEN AND SHUT CASE



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



29/03/2018 - 29/03/2019 Data from FE 2019

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.



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



31/03/2017 - 29/03/2019 Data from FE 2019

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*

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## CONTACT INFORMATION

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## RISK WARNINGS AND OTHER INFORMATION

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