QUARTERLY REPORT
Q4 2019

THE MI HAWKSMOOR VANBRUGH FUND

The one-stop investment solution for real returns.

INVESTMENT OUTCOME

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

Daniel Lockyer *Senior Fund Manager*
Financial Express aggregated track record of 14+ years running retail funds – outperformed peer group by 47%, returning 141% versus 94% (13/01/2005 to 31/12/2019)

Ben Conway *Senior Fund Manager*
Financial Express aggregated track record of 5+ years running retail funds – outperformed peer group by 9%, returning 48% versus 39% (01/01/2014 to 31/12/2019)

Ben Mackie *Fund Manager*

Dan Cartridge *Assistant Fund Manager*

Richard Scott *Advisor*

Hannah Isaac *Head of Fund Operations*

David Chapman *Business Development Manager*

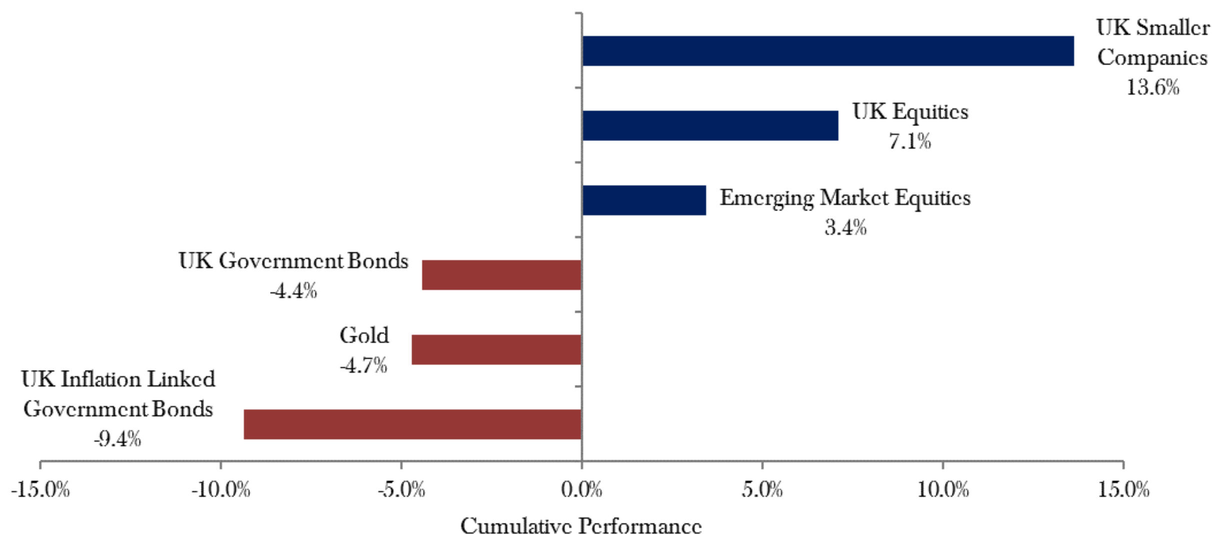
Charlotte Sternberg *Team Assistant*

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

 Source: FE Analytics GBP total return

MARKET PERFORMANCE

Top and bottom three performing asset classes



UK Smaller Companies - IA UK Smaller Companies, UK Equities - IA UK All Companies, Emerging Market Equities - IA Global Emerging Markets, UK Government Bonds - IA Gilts, Gold - WisdomTree Physical Gold, UK Inflation Linked Government Bonds - IA UK Index Linked Gilts

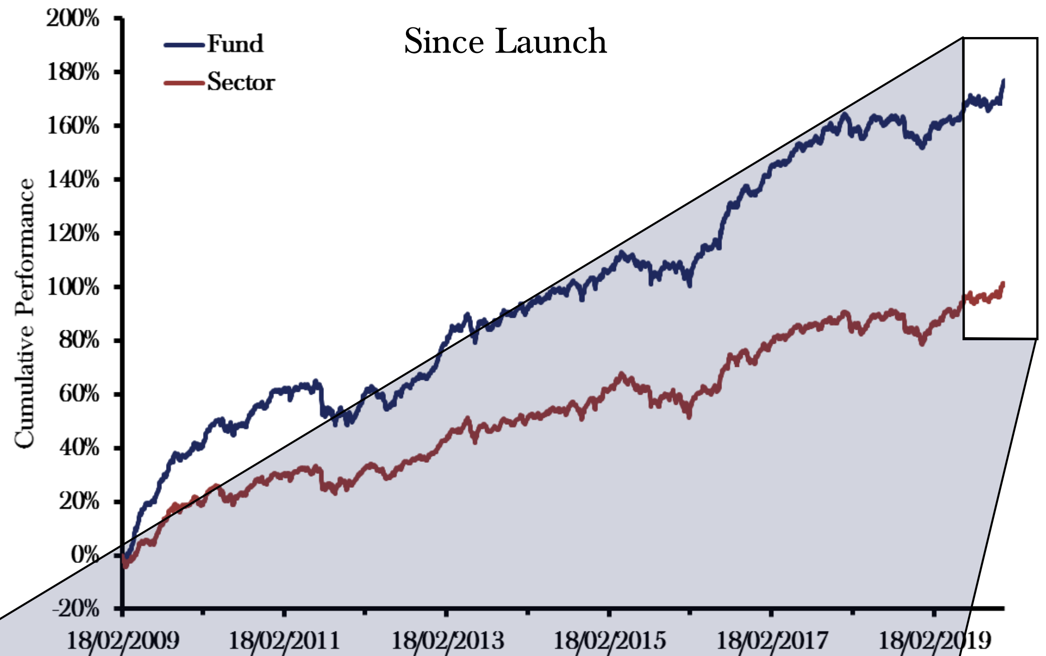
Commentary

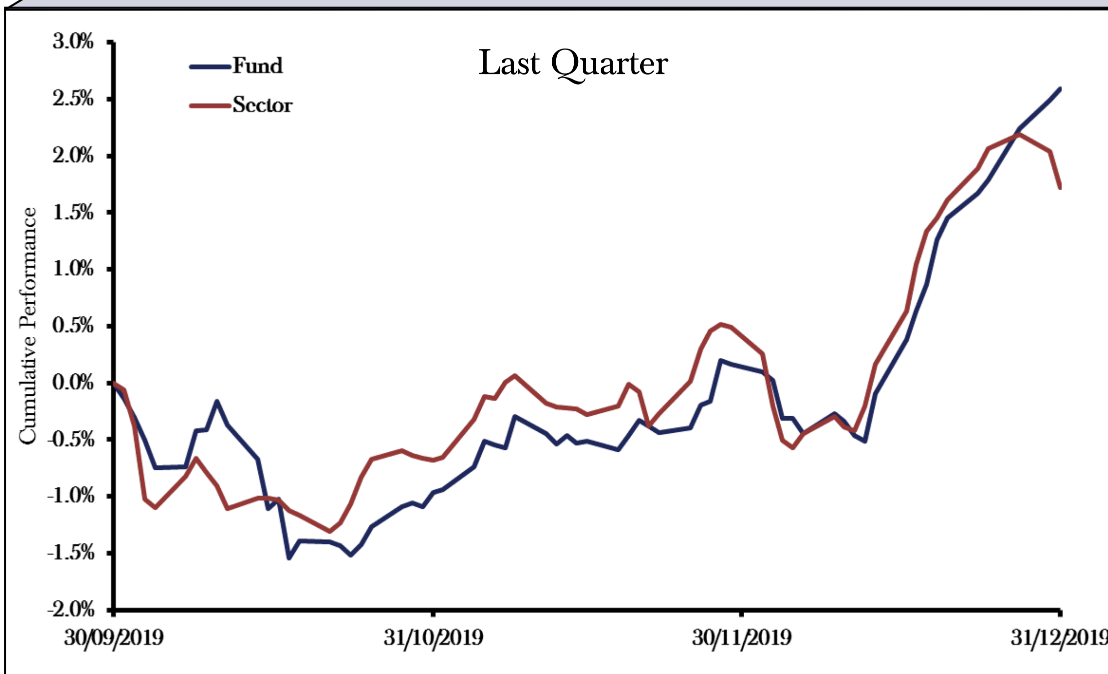
The final quarter of 2019 proved to be a strong one for equity investors as two long-standing geopolitical risks took steps toward positive resolutions during the period. The biggest of these steps was experienced in the UK. Boris Johnson comprehensively won the first UK general election held in December since 1923, securing an 80 seat majority in the House of Commons that allows him to carry out his election promise of 'getting Brexit done'. Sterling rallied and UK equities soared on the back of the result, in part enjoying a Jeremy Corbyn relief rally as Labour's headline grabbing confiscatory manifesto was quashed with Corbyn declaring that he would not be leading the Labour government into any future general elections. Smaller domestically oriented UK stocks enjoyed a very strong bounce, rapidly closing the valuation gap that had opened between domestic revenue earning companies and international revenue earners since the referendum vote to leave the EU in 2016. Despite the valuation gap closing within the UK equity market, UK equities continue to offer compelling value relative to international stocks. UK real estate investment trusts also rallied, seeing discounts narrow and in some cases premiums open up. Anecdotal evidence since the election result suggests property transaction volumes are picking up, which should provide investors with enhanced confidence in the net asset value of property trusts.

Markets were also buoyed by Donald Trump's declaration that there would be a 'phase one' trade agreement signed on the 15th January between the US and China, and that negotiations on 'phase two' would begin in earnest. Meanwhile, the US Federal Reserve (Fed) was forced to inject hundreds of billions of dollars into the overnight repurchase (repo) market after the short term repo rate spiked to 10% amid a shortage of liquidity in the financial system. The injection has been dubbed 'not QE4', but has seen the Fed's balance sheet rapidly expand. Government bond yields backed up as UK election promises to boost infrastructure spending suggest that the new government will need to borrow large sums, whilst Trump is also likely to push a populist spending agenda in the run up to the US presidential election in November 2020. Perceived safe havens generally struggled as the risk-on mood took hold, one example being the fall in the gold price over the quarter. Though the fortunes of gold began to improve again into the year end with the precious metal and related mining equities rallying strongly into the new year.

 Chart Source: FE Analytics GBP total return 30/09/2019 to 31/12/2019.

VANBRUGH FUND PERFORMANCE





 Source: FE Analytics GBP total return 31/12/2019. C Acc units. Sector: IA Mixed Investment 20-60% Shares

VANBRUGH FUND PERFORMANCE

Performance history

Cumulative performance % growth to last month end

	Annualised since launch	*Since launch*	*10 years*	*5 years*	*3 years*	*1 year*	*3 months*	*Annualised volatility since launch*
Fund	**9.8**	**176.9**	**97.8**	**36.4**	**16.9**	**9.8**	**2.6**	**5.4**
Sector	6.6	100.6	67.3	27.0	13.7	11.8	1.7	5.5
Quartile in Sector	1	1	1	1	1	4	2	1

Commentary

Unsurprisingly, given the strong rally in UK stocks on the back of the Conservative's victory in the general election, several of the biggest contributors to performance during the quarter were UK equity funds which we had added to in the quarter ahead of the general election with valuations looking compelling. The 4.3%* position in **Polar Capital UK Value Opportunities (+14.2%)**, the 1% position in **Odyssean Investment Trust (+11.9%)** and the 4% position in **Man GLG Undervalued Assets (+9.2%)** all rose strongly. The best performing fund in the portfolio was the 1.4% position in **Artemis Alpha Trust (+24.5%)**, which predominantly invests in UK equities. In addition to the strong underlying performance of the portfolio, shareholders benefitted from a narrowing in the discount from -20% to -15%. The uptick in fund performance combined with a continuation vote scheduled for 2021 provides the foundation for further discount narrowing, and with many UK focussed investment trusts moving to a premium in the aftermath of the election result the trust continues to offer attractive value.

Private equity trusts contributed strongly to performance. Vanbrugh's 1.8% position in **Oakley Capital (OCI, +18.6%)** performed well, with the NAV boosted over 8% during the period following the disposal of one of the underlying investments. The trust continues to trade on an anomalously wide 20% discount when compared with peers such as **HG Capital (HGT, +12.0%, 1% position)**, which trades on a 3% premium. Vanbrugh has owned a position in HGT since February 2009, a period during which the trust has risen 450%. We have managed the position sizing throughout that period, reducing when the trust has looked expensive, and adding when it becomes more attractive. In November, we reduced the holding on a premium and with the underlying portfolio valuation having re-rated this year, in favour of increasing OCI on a c.25% discount. This switch worked well, with OCI subsequently up 21% and HGT up 7%.

Vanbrugh currently has a basket approach to property, with exposure to the most attractive areas of the property market that benefit from strong long term structural tailwinds such as warehouses/logistics and healthcare, as well as taking advantage of special situations and valuation anomalies that arise. Property trusts proved to be another good source of returns in the quarter, boosted both by enhanced certainty following the general election result and from positive individual news flow with all of our property trusts up in excess of 5%, led by **LXi REIT (+8.5%)**, **Warehouse REIT (+8.4%)**, and **Civitas Social Housing REIT (+6.7%)**.

Performance detractors were driven by currency moves with sterling rallying in the lead up to and on the back of the UK general election. Over the quarter, sterling strengthened 7.3% against the US dollar, 7.7% against the Japanese yen and 4.6% against the euro. This impacted the return of **CG Dollar**, which invests in US TIPS. The fund fell –6.6% during the quarter, with most of this loss attributable to sterling's rally against the US dollar.

Source: FE Analytics GBP total return 30/09/2019 to 31/12/2019. *Holding sizes throughout reflects average of month end weights at end October, November and December unless otherwise specified.

VANBRUGH FUND ACTIVITY

By holding

Purchases/Increases:

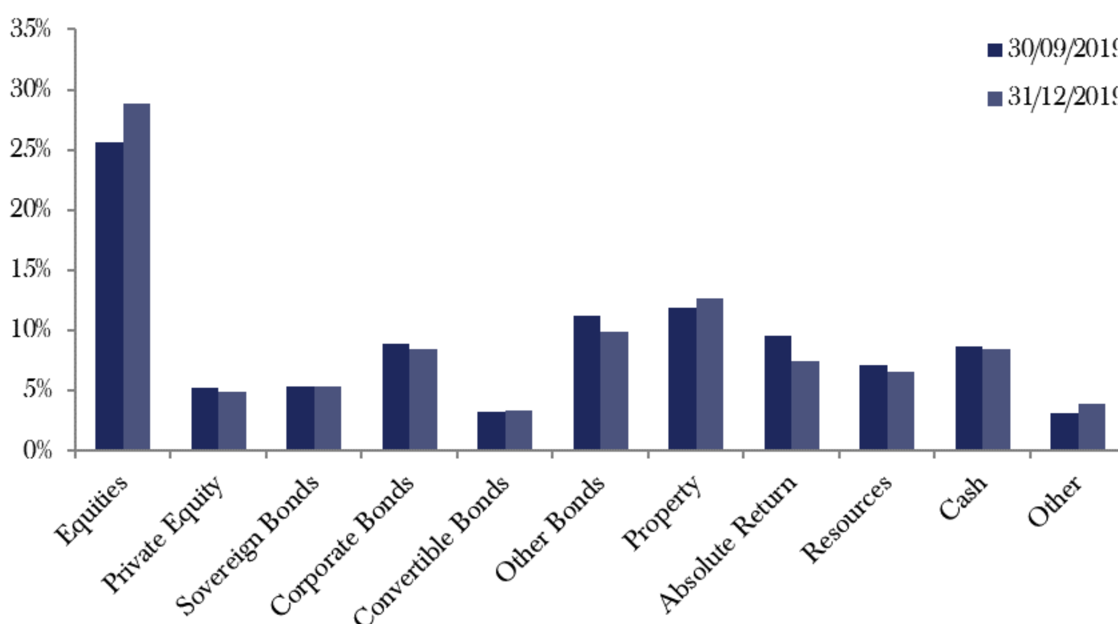
- Crux UK Special Situations
- Hipgnosis Songs
- Investec Global Gold
- Polar Capital Japan Value
- Urban Logistics REIT

Disposals/Reductions:

- Baillie Gifford Japanese Income Growth
- Merian Global Equity Absolute Return (GEAR)
- Ruffer Gold
- Warehouse REIT

As highlighted last quarter, Merian GEAR was reduced in Q3 and subsequently sold early in the quarter. We sold our position in Ruffer Gold. The fund size increased rapidly over our c.5 year holding period from £100m to in excess of £1bn, making it more difficult for the manager to have high conviction weightings in his favoured smaller company stocks. Historically, the smaller company focus and manager skill has compensated for frustration that the fund is weekly dealing, but with the prior angle diminished we decided to move on and recycled the proceeds into a new position in Investec Global Gold. We recalibrated our Japanese equity exposure, selling our position in Baillie Gifford Japanese Income Growth and introducing a position in Polar Capital Japan Value. The value style has suffered in Japan much like the rest of the world in the past decade, but despite this style headwind the fund has kept pace with the Japanese market and is well positioned to benefit in the event of a rotation towards value. We reduced our holding in Warehouse REIT in order to facilitate the introduction of Urban Logistics REIT. The net asset value appears materially undervalued and the trust will continue to benefit from the long term structural shift in consumer habits with a portfolio of single let logistics buildings located close to urban centres. We increased our UK equity exposure ahead of the general election, with UK equities offer compelling absolute and relative value both compared with their own history and international peers. We introduced a position in Crux UK Special Situations, a multi cap fund with a smaller company skew alongside an increase in existing UK funds. We introduced Hipgnosis Songs, which pays an attractive level of income from the royalty streams from thousands of songs, whose revenues are benefitting from the growth in streaming services.

By asset class

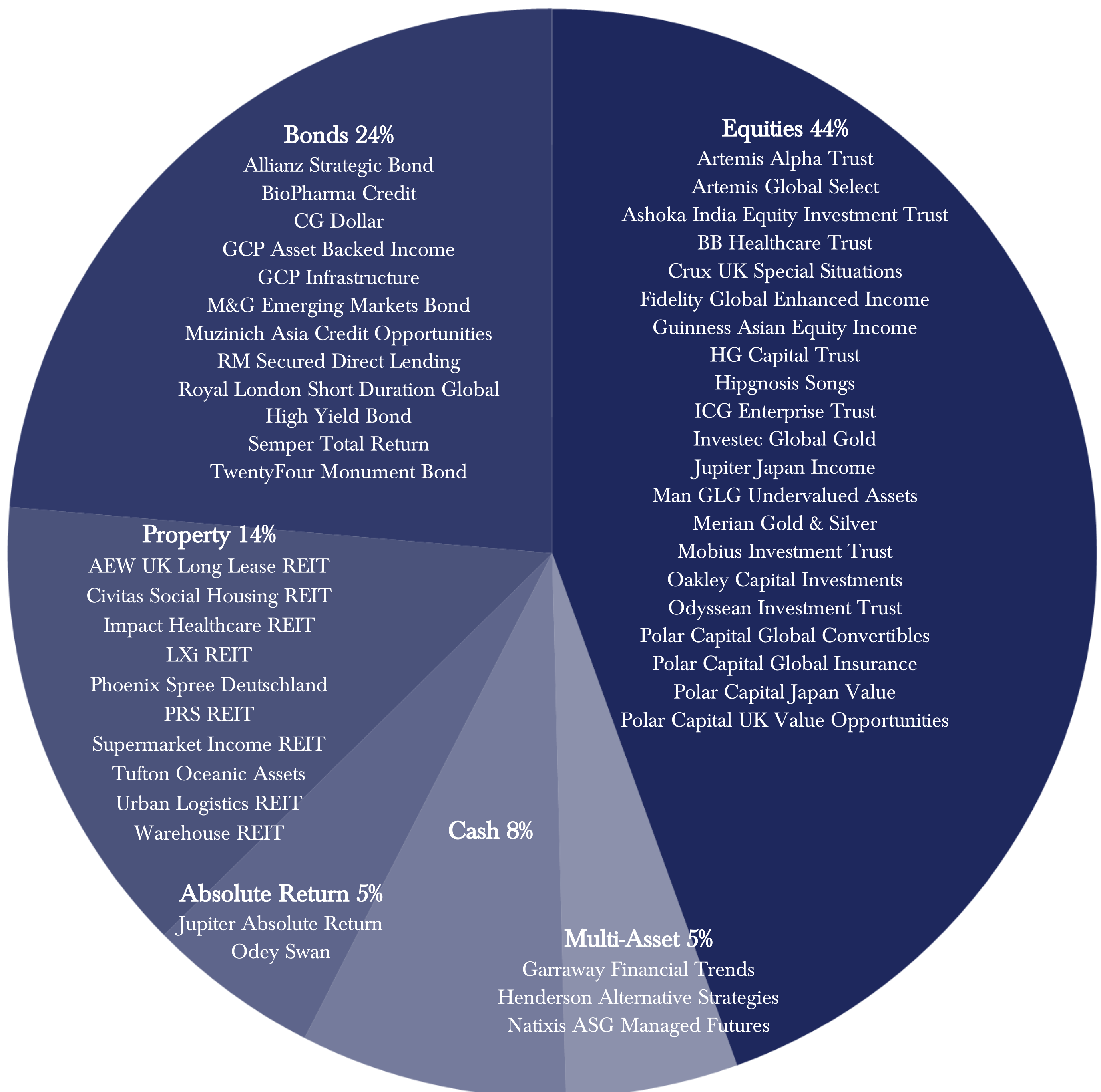


This chart calculates the asset breakdown on a look through basis of the underlying holdings, therefore there may be differences in the breakdown shown here and on the pie chart on page 7.

 Source: Internal as at 30/09/2019 and 31/12/2019

VANBRUGH FUND HOLDINGS

HAWKSMOOR
FUND MANAGERS



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 31/12/2019

2019: WHY BOTHER WITH FUNDAMENTALS?

In managing the three Hawksmoor Funds we are guided by the simple and overriding objective of growing the value of our client's wealth over time, once adjusted for inflation and all costs. In this regard 2019 has been a good year with our more cautious Vanbrugh Fund delivering a nominal net return of 9.8%, which is broadly in line with its annualised return since launch. The Distribution and Global Opportunities Funds returned 11.0% and 16.4% respectively.

In constructing portfolios we are entirely benchmark agnostic and are not influenced by how peers are positioned as we don't believe either would help in achieving the core goal described above. We are aware however, that some of our investors will compare our Fund's performance with that of other multi-asset funds and recognise that 2019 in relative terms was difficult, with both Vanbrugh and Distribution finishing the year in the bottom quartile of their respective IA sectors. The turning of a New Year often inspires a little retrospection and as such this article seeks to explain some of the factors behind the underperformance and why we retain conviction in our current portfolio positioning.

2019 was a remarkable year for global financial markets with practically all major asset classes delivering positive returns. The Morningstar US Market index of US equities, for example, was up 26% in sterling terms, an outsized return in any year but all the more incredible given the maturity of the market cycle and elevated starting valuations. US equities look expensive on a host of metrics with one of our favoured measures (the sector neutral cyclically adjusted price earnings ratio) trading well above its long run average. In the face of deteriorating expectations for corporate earnings growth, the anatomy of the US equity rally is troubling with 2019 returns almost exclusively driven by multiple expansion.

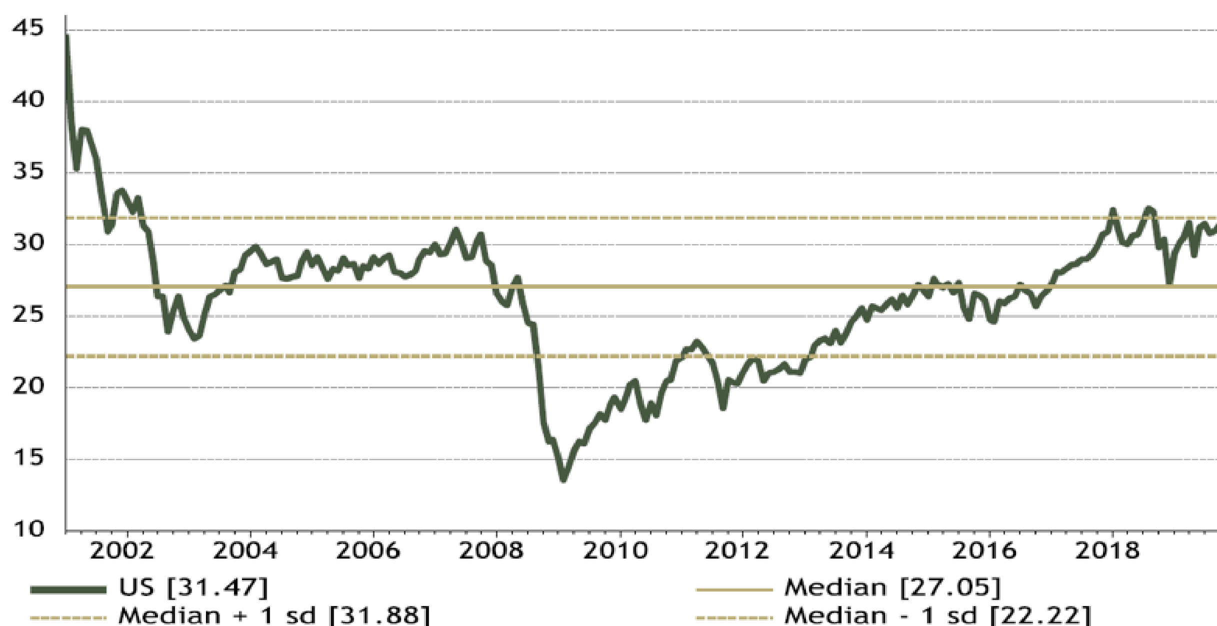


Fig1: ASR sector neutral cyclically adjusted price earnings ratio (current market price divided by the average of the past ten years of earnings, adjusted for inflation)
Source: Absolute Return Strategy, 04/11/2019

Source: Fund and Index performance from FE Analytics. 31/12/2018 to 31/12/2019

Elsewhere, investors in lower risk 10 year UK government debt netted a healthy total return of 7.5% despite the bond offering a paltry yield of just 1.2% at the start of 2019. Even more incredible were the huge swathes of the global bond market which ended the year trading with negative nominal yields, a development symptomatic of the distorting effects of unconventional and highly accommodative monetary policy from the world's central banks.

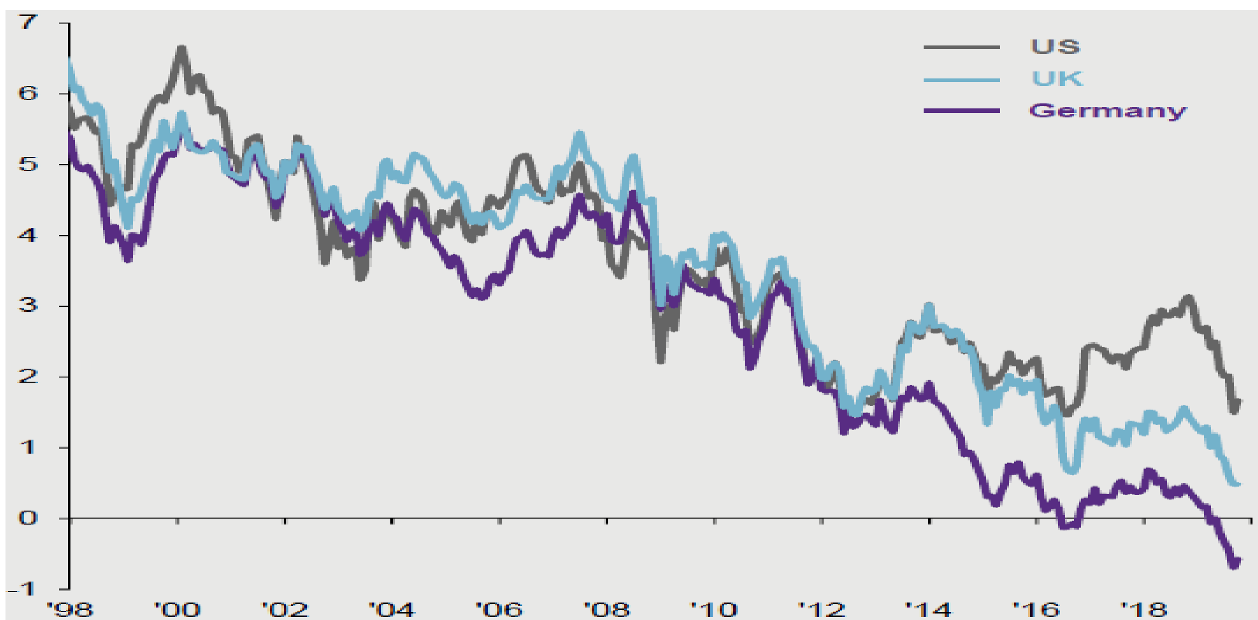


Fig2: US, German & UK nominal 10 year government bond yields grinding lower and close to historic lows
Source: JPM Guide to the Markets, 30/09/2019

2019 it seems then, was a year when fundamentals did not matter. The valuations of already expensive US growth stocks became even more demanding and the already painfully low gross redemption yields offered by high quality bonds headed further south. In the context of our valuation driven process, this proved to be a difficult environment for us. Whilst not complacent about underperforming the peer group we have, however, been vehement in ensuring that we stick to our investment principles and that we adhere to our disciplined approach of constructing well diversified portfolios of cheap assets that possess a margin of safety. We accept that valuation is a poor market timing tool but also retain conviction that it is the most important determinant of future long term returns and similarly believe that the best way of reducing the probability of a permanent loss of capital is to avoid overpaying for an asset. These core beliefs combined with our unconstrained approach to asset allocation mean we have refused to chase unequivocally expensive assets, resulting in minimal exposure to US equities and long duration bonds which in 2019 led markets higher. Avoiding these types of assets contributed to short term underperformance but owning them would, to our mind, expose our investors to unacceptable risks.

As a result of our process, our portfolios will often look very different to the peer group and this is especially true at mature stages of the cycle when valuations tend to become extended. We are happy to leave some parties early,

9 Source: 10 year UK Government return from Alpha Terminal, 31/12/2018 to 31/12/2019

especially when there are more interesting, less crowded places to go. Within major markets we have been able to identify some pockets of value and have targeted allocations to UK, Japanese and emerging market equities as well as emerging market debt. Overall however, exposure to traditional equities and bond markets is almost as low as it has ever been in the Funds' history. The corollary of this is a higher allocation to more idiosyncratic risk and investments that exhibit limited correlation to mainstream financial markets. These include investment trusts investing in private equity, direct loans, ships, song royalties and niche areas of the property market. Most of these investments have performed admirably but on the whole have inevitably failed to keep up with exuberant equity markets.

Both Vanbrugh and Distribution exhibit significantly lower volatility than their sector averages and historically have tended to outperform peers on the downside, owing in large part to our margin of safety focused process and the highly diversified nature of the portfolios we construct. 2019 was no different with Vanbrugh in particular, delivering positive relative returns (versus its IA sector) during the rapid equity market sell-off of the late summer. Pleasingly the funds also did well in the final quarter of the year, a period in which general markets delivered positive returns, with the allocation to cheap UK equities and Real Estate Investment Trusts, which re-rated in the aftermath of the general election, driving outperformance.

Should the 'melt-up' in markets persist we will stick to our principles and it is likely that we will endure another period of relative underperformance. Equally we would expect to deliver good risk adjusted absolute returns in such an environment. Exactly what happens over the course of the coming year is impossible to say, but we do observe that the cycle is mature and that heightened economic and political risks do not appear to be reflected in the prices of many assets. Against this backdrop our more cautious positioning seems prudent and we are sure that one day valuations will matter again. In the meantime we remain enthused by the opportunity offered by many of our more idiosyncratic investments and continue to adopt a highly selective approach to mainstream equity and bond markets.

Ben Mackie
Fund Manager

HAWKSMOOR
FUND MANAGERS

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IMPORTANT INFORMATION

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