QUARTERLY REPORT
Q3 2020

HAWKSMOOR
FUND MANAGERS

THE MI HAWKSMOOR DISTRIBUTION FUND

The one-stop investment solution for
income and growth.

defaqto 2020 Multi-Manager Return Focused

defaqto 2020 Multi-Asset Income

DYNAMIC PLANNER PROFILED 6

INVESTMENT WEEK 2018 FUND MANAGER OF THE YEAR AWARDS WINNER MANAGED BALANCED

defaqto 5 RISK RATING BALANCED

FT ADVISER INVESTMENT 100 CLUB Member 2018

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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Our Team

Ben Conway *Head of Fund Management, Senior Fund Manager*
Financial Express aggregated track record of 6+ years running retail funds – returning 42% versus 37% for the peer group (01/01/2014 to 30/09/2020)

Daniel Lockyer *Senior Fund Manager*
Financial Express aggregated track record of 15+ years running retail funds – outperformed peer group by 40%, returning 131% versus 91% (13/01/2005 to 30/09/2020)

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

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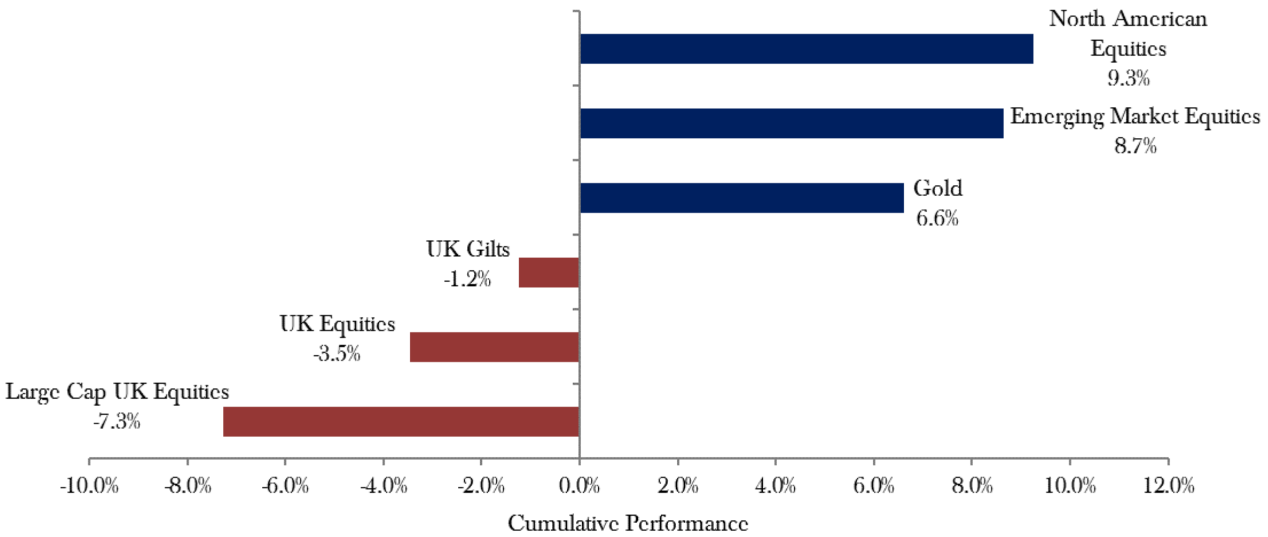
Top and bottom three performing asset classes



North American Equities: MSCI North America, Emerging Market Equities: MSCI Emerging Markets, Gold: WisdomTree Physical Gold, UK Gilts: ICE BofA UK Gilts All Stocks, UK Equities: MSCI United Kingdom All Cap, Large Cap UK Equities: MSCI United Kingdom Large Cap.

Commentary

For the most part, the third quarter of the year saw a continuation of the strong performance from global financial assets with the notable exception of those listed in the UK. US equities continued to lead global equities higher, with emerging market equities also registering strong performance, buoyed by a weakening in the US dollar. The Federal Reserve announced a subtle shift in their inflation target to an *average* of 2%, the implication being that following the recent protracted period of subdued prices, inflation will be allowed to run hot going forward. Market implied inflation expectations rose modestly and real yields fell helping gold and gold equities continue to shine. International investors continued to shun the UK market with Brexit uncertainty coming back to the fore with Prime Minister Boris Johnson's plan to break international law and override aspects of the withdrawal agreement with the European Union. Meanwhile, Chancellor of the Exchequer Rishi Sunak has outlined plans to move away from the expensive Furlough scheme, with the most likely outcome being a rise in unemployment in the coming months.

In our previous quarterly commentary, we explained that the high level index performance hides wide dispersion below the surface, with large technology companies in the US, which make up a significant proportion of US and global equity indices driving market returns. Indeed, in mid-August when the US market was hitting fresh all-time highs, the average stock in the index was 28% below its peak. Share price rises from Apple and Tesla, following stock splits that do nothing to alter the fundamental value of a company, were particularly eye-watering and serve to emphasise the irrational exuberance of the current environment, although September did see some rotation away from the leading technology companies with some of the summer froth being scraped off the top. It is highly likely that US markets will continue to be volatile as campaigning moves into full swing ahead of the November Presidential election, though the news that Trump and a number of his senior officials have contracted the virus in recent days means campaigning is likely to be truncated. Election polls have narrowed during the year, with Trump closing the gap on Democratic rival Joe Biden, and there is an outlying risk of the result being disputed. The last time an election result was disputed came in 2000, when markets acted in a risk off fashion as gold and US Treasuries rose and equity markets fell.

With a second wave of COVID-19 cases materialising at a rapid rate in the UK and globally, localised lockdowns have broadened and social distancing restrictions have increased. Meanwhile, the prospects of a widely available, proven vaccine are still some way off despite positive trial results. It is likely that the path to recovery will be slow and choppy as we move into the winter months for the Northern Hemisphere and have to contend with flu season alongside rising COVID cases.

 Chart Source: FE Analytics local currency, total return 30/06/2020 to 30/09/2020. See page 12 for MSCI disclaimer.

DISTRIBUTION FUND PERFORMANCE

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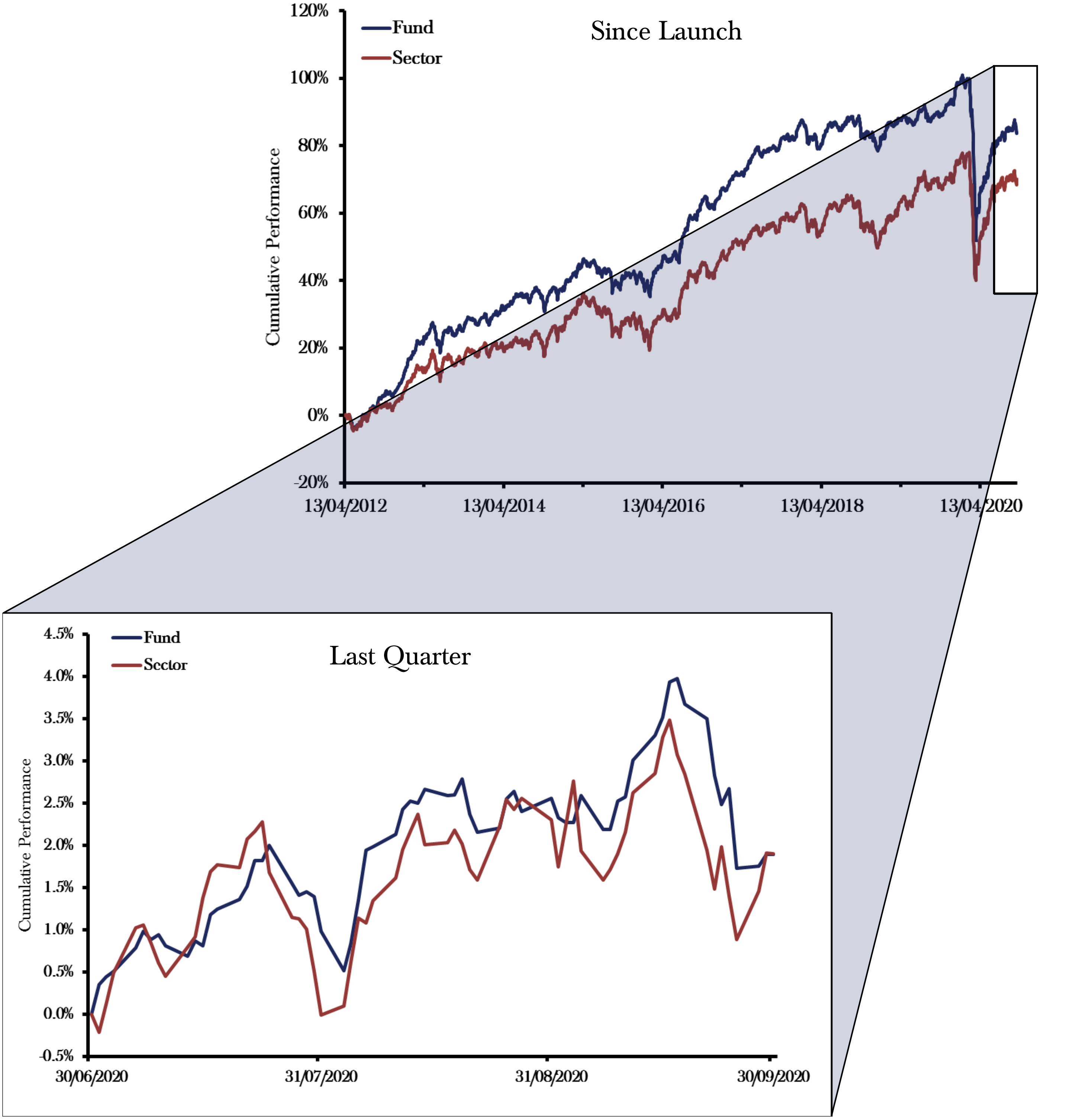
FUND MANAGERS



 Source: FE Analytics GBP total return 30/09/2020. C Acc units. Sector: IA Mixed Investment 40-85% Shares.

DISTRIBUTION FUND PERFORMANCE

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Performance history

Cumulative performance % growth to last month end

	Annualised since launch	*Since launch*	*5 years*	*3 years*	*1 year*	*3 months*	*Annualised volatility since launch*
Fund	**7.5**	**83.9**	**34.1**	**2.4**	**-3.2**	**1.9**	**8.0**
Sector	6.5	70.0	37.9	9.6	-0.2	1.9	8.8
Quartile in Sector	1	1	3	4	3	2	1

Commentary

After a strong Q2 where the Distribution Fund returned +11.9%, we are pleased that this has been backed up with another quarter of positive performance with the Fund up +1.9%. This was particularly satisfying given the Fund's low exposure to strongly performing, but already expensive US equities with the Fund's returns instead driven by alpha generation from a diverse range of investment trusts, with notably strong performance from Oakley Capital (+17.6%), AEW UK REIT (+15.3%), Phoenix Spree Deutschland (+11.4%), and Gore Street Energy Storage (+7.7%)

It was another strong period for gold, silver, and the respective mining equities. The best performing position in the Distribution Fund was Merian Gold & Silver (+19.8%). During the quarter we spoke with the managers of the three gold funds we invest in across our multi-asset range of funds to assess whether the sector had run too hot and had become too richly valued after the sharp recovery from the March lows. As explained in more detail in our feature article this quarter, on page 8, the precious metals mining complex remains extremely lowly valued relative to history, whilst the most important long term drivers of the gold price remain highly supportive. The next two results seasons are likely to see the miners deliver high levels of free cash flow and progressive dividends which should prove attractive to generalist investors confronted with the earnings contractions and dividend cuts expected from other sectors of the equity market.

Oakley Capital (+17.6%) performed notably well, benefiting from the sale of one of its underlying holdings, Casa.it, at a 50% uplift to the 30th June 2020 carrying value adding further evidence to the conservative valuation of the underlying portfolio. The balance sheet is awash with cash at a time when investment opportunities are rife and the board are buying back shares in size which is highly accretive to existing shareholders given the trust trades on a wide discount to net asset value (NAV). The shares continue to offer a significant margin of safety and upside potential, and we remain excited about future return prospects.

The worst performing position was Aberforth Split Level Income Trust (-11.7%), a relatively small holding in the Fund at c.0.8%. The trust has struggled as the value style and UK equities in general have continued to be shunned by investors, reflected in the discount widening from –10% to –17% over the period. Despite this, the portfolio valuation is close to the cheapest in history and offers significant upside, with the potential for returns to be further enhanced by a discount narrowing.

Despite the strong performance from the Distribution Fund over the past 6 months, we remain incredibly excited about the value in the portfolio today, and the new opportunities that we are unearthing across a diverse array of asset classes, accessed in both the open ended and closed ended investment universes, which we outline in more detail on page 6.

 Source: FE Analytics GBP total return 30/06/2020 to 30/09/2020.

DISTRIBUTION FUND ACTIVITY

HAWKSMOOR FUND MANAGERS

By holding

Purchases:

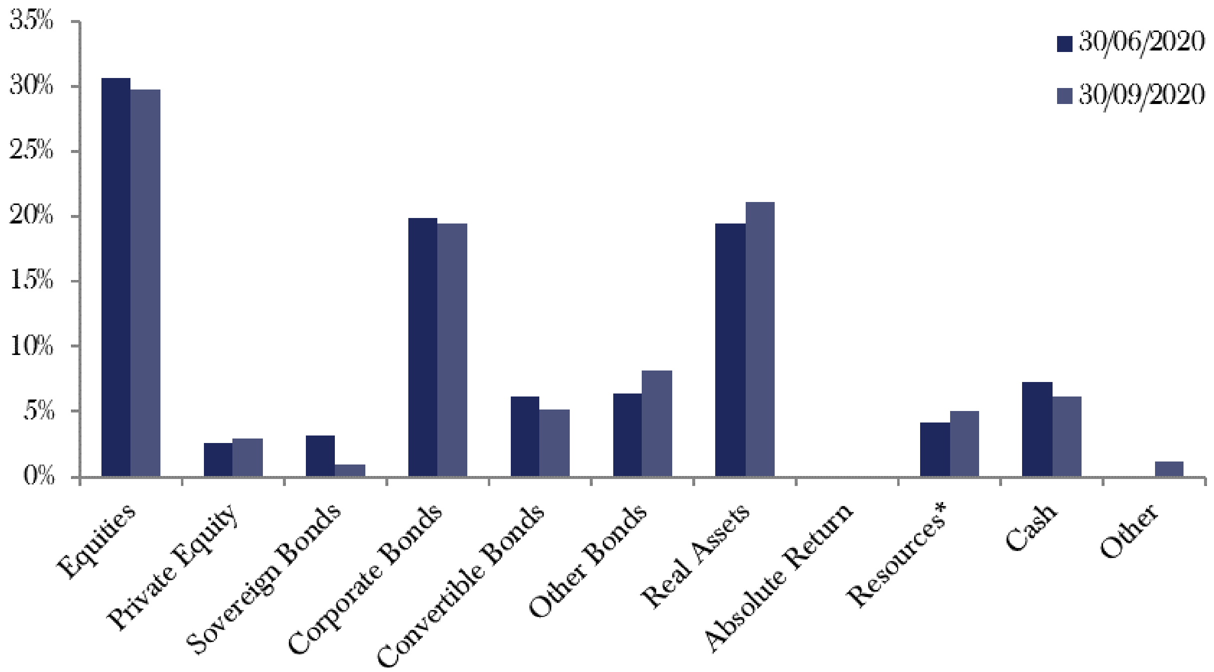
- AMP Capital Global Companies
- BlackRock Emerging Markets
- BMO Commercial Property Trust
- GCP Infrastructure
- Gore Street Energy Storage
- Secure Income REIT
- TwentyFour Income

Disposals:

- Allianz Strategic Bond
- Barings Global Dividend Champions
- Muzinich Asia High Yield

We introduced a new position in BlackRock Emerging Markets, taking advantage of emerging market equities offering the cheapest equity valuations globally on a sector neutralised, cyclically adjusted basis. Barings Global Dividend Champions was exited after it was announced the fund manager was leaving, we took the opportunity to recycle proceeds into a new position in AMP Capital Global Companies which has a similar style focused on high quality companies. We introduced two new positions in deeply discounted real estate investment trusts, BMO Commercial Property Trust (BCPT) and Secure Income REIT (SIRE). Both have suffered sharp share price falls this year, with BCPT trading on a c.50% discount, and SIRE at a c.40% discount to net asset value (NAV) at time of introduction and both offering dividend yields in excess of 5% despite both being conservatively cut (BCPT's by 50%!) and with scope to meaningfully grow/recover over the medium term. We took part in a secondary share placing to introduce Gore Street Energy Storage at an attractive price, with the trust giving us exposure to a nascent renewable energy asset class with strong long term growth drivers. Within fixed income, we sold Muzinich Asia High Yield, with the fund being wound up despite delivering strong performance over its four year life. We re-introduced a position in GCP Infrastructure, at a price offering a yield in excess of 6%, with government backed cash flows and some inflation linkage. We re-introduced TwentyFour Income, funded by the sale of Allianz Strategic Bond. The spread that ABS and CLOs offer versus equivalently rated plain vanilla credit overly compensates investors for the lower liquidity of the asset class, whilst completely ignoring the improving fundamentals underpinning the loan structures and the lower historical default rates versus equivalently rated vanilla bonds.

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 30/06/2020 and 30/09/2020. *Including Precious Metals.

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 30/09/2020.

THE CONTINUING IMPORTANCE OF GOLD IN OUR FUNDS

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Since our note on gold 3 years ago, the price of the metal in dollars has risen from $1,250 per ounce to over $2,000 and is currently trading around $1,900. Our exposure to the precious metals theme has been highly beneficial to our Funds' performance, despite for a short period being unhelpful when it accentuated the setback suffered in March when gold fell along with almost everything else in a kneejerk flight to liquidity.

As we will explain in this article, we continue to believe the reasons for holding gold remain valid such that our level of investment in the precious metals complex (holdings in physical gold and funds investing in silver and gold bullions and their related mining equities) has increased with roughly 10% in each of the Vanbrugh and Global Opportunities Funds and 5% in the Distribution Fund.

Here we address the case for continued high exposure to this area, but first, we believe it is important to illustrate the various arguments put forward to explain the long- and short-term drivers of the gold price.

What moves the gold price?

Real Yields

In our last note, we alluded to the attraction of gold being enhanced when the rate of interest available on cash is low, especially after adjusting for inflation. Thus the prevailing levels of "real yields" (the interest rate over a given time period adjusted for the deleterious impact of rising prices) is seen by many as an important determinant of the direction of gold prices.

In most of the developed world, thanks to the actions of central banks, bond yields have fallen precipitously, and meanwhile expectations for future inflation rates have risen. This dynamic has resulted in negative real yields across many economies. A negative real yield signifies that the act of holding money in the form of low risk securities like government bonds will result in the erosion of the purchasing power of that money. This makes gold, which offers no yield at all, comparatively more attractive. In jargon, the "opportunity cost" of holding gold falls with falling real yields.

Speculation

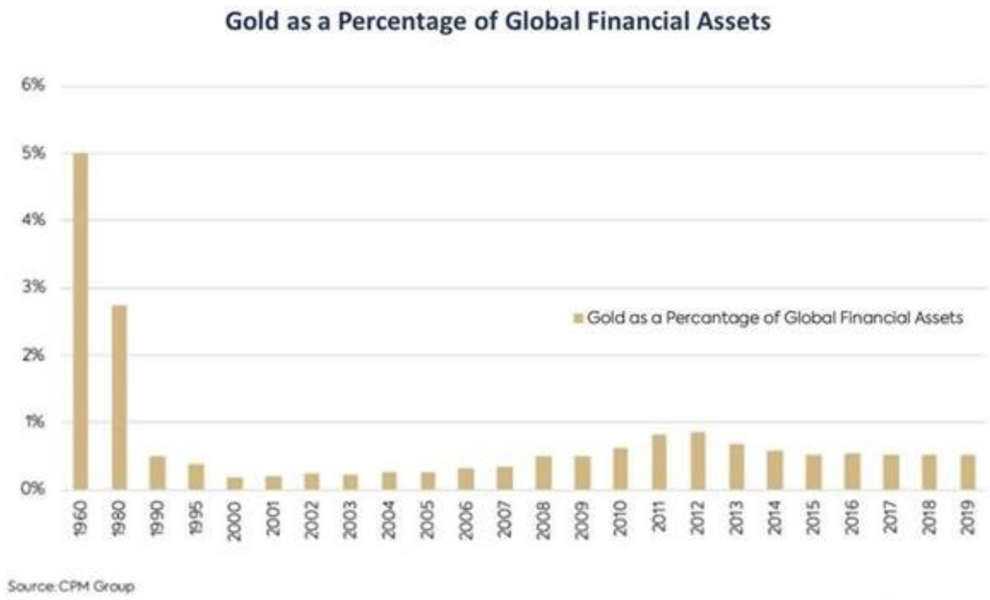
On the other hand, some commentators have pointed out that the gold price has risen far too quickly recently and that this cannot be explained by movements in real yields. In a paper by Claude Erb, Campbell Harvey and Tadas Viskanta[1], the authors argue that the price of gold in inflation adjusted terms is currently too high – i.e. it cannot be explained by merely appealing to the direction of real yields. They leave open the suggestion that the causation may run the other way, or that speculative demand for gold has recently increased, driven by the creation of Exchange Traded Funds (ETFs).

Currency debasement and increased liquidity

Meanwhile another framework looks at the price of gold in relation to the amount of money in circulation, or as a ratio against other financial assets (stocks, bonds etc). This argument runs that the more available liquidity (or money in circulation), the higher the gold price should be given new gold supply is highly constrained relative to the existing gold

[1]Source: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3667789

stock (you can't print more gold!). Further, gold could be seen as "cheap" if its total market value is low as a percentage of the market value of other financial assets.



The impact of the US dollar

Many investors cite the inverse correlation between the US dollar and the gold price, falsely believing that a weak dollar automatically leads to a strong gold price and vice versa. It is important not to forget that gold is a currency. If the dollar is weak, and the gold price in US dollars increases, it does not automatically follow that when priced in other currencies like sterling or yen that the gold price has increased. A gold bull market is characterised by gold rising in terms of all currencies.

Rising government deficits

Periods of rising government deficits tend to lead to increased interest in gold. If investors believe that persistent government deficits, especially in the world's larger economies, will lead to unsustainable levels of national debt then the only solutions available are either default (unpalatable for almost all governments) or the erosion of that debt in real terms - i.e. a government and its central bank may be forced into allowing (indeed even encouraging) a period of high inflation. If the interest it pays on its obligations is fixed, then rising inflation should allow it to manage its debt load more easily given tax revenues should rise with inflation. This should lead to falling real yields and is a good backdrop for gold to do well.

What is the case for gold in portfolios?

Similar to the case we outlined in our first piece, we believe the conditions for gold to do well have been in place for some time, and should continue for some time to come. Central banks globally have injected vast amounts of liquidity

9 Source: Baker Steel 1960 to 2019

into economies either by printing money and purchasing securities, such as government bonds and recently even corporate bonds and other types of security from private institutions, or by the direct financing of government deficits through printing money and purchasing the bonds that a government issues to finance a deficit. The necessity to keep interest rates and longer-term yields low (to avoid the servicing costs of this debt increasing) has never been greater given the extent and persistence of government deficits which have only been exacerbated this year by measures to support economies in the wake of the COVID-19 pandemic.

Inflation has been persistently low for the past decade but recently expectations of future inflation have been rising, partly due to a massive increase in the available amount of money in circulation and partly due to central banks deviating from their historic mandates to keep inflation low, in favour of allowing it to run hot. Aspiring to higher inflation and achieving it are of course two very different things, but against this backdrop of shifting monetary policy, it is worth noting that over time gold has acted as a good store of wealth and has performed particularly strongly in periods of higher inflation.

There are a multitude of factors that influence the gold price, with sentiment and speculative activity especially prevalent in the short-term. This can result in bouts of volatility which may serve to deter certain investors. We acknowledge that it is hard to accurately predict the behaviour of the gold price in the short-run and so try and stay focused on the longer-term reasons for owning gold:

- an increase in the amount of fiat currencies circulating around the global economy (otherwise known as "debasement") in contrast to the supply constraints gold faces;
- persistent and growing levels of government debt that increase the likelihood of this debasement, while ensuring prevailing yields available for money remain low. In other words, the "opportunity cost" of holding gold is likely to remain low for some time.

How do the Hawksmoor Funds express this view?

We have a valuation-led investment process, seeking to own assets that offer a margin of safety and/or diversification benefits to our portfolios. Whilst physical gold as a currency cannot offer a margin of safety, it is a liquid asset that bears no credit risk and one that has outperformed all major fiat currencies since the end of the gold standard in 1971, so a small allocation does bring diversification benefits to our overall currency exposure.

The tendency of bullion to attract safe haven flows during times of stress, and its long term negative correlation with risk assets such as equities, bring further portfolio construction benefits. The majority of our exposure to the precious metals complex, however, is via funds that invest in gold and silver mining companies, which can be easily valued, and where we can apply our disciplined investment process and identify a clear margin of safety.

Despite the very strong performance of these companies since our last note, they continue to offer very good value. Costs for these companies are not as variable as their revenue – the latter being a function of the gold price. Major costs such as fuel prices, wages and cost of extraction can vary, but profit margins can expand very quickly when the gold price rises.

Current valuations of gold miners imply a gold price some way below current levels. Meanwhile the rating that these stocks trade on (the price investors are willing to pay per unit of profit) remains very low indeed.

We thus have a potential double whammy of catalysts for continued strong performance from our Funds exposed to such companies. The longer the gold price stays elevated, the more quarters of strong earnings these companies will deliver, leading to price appreciation. If investors then determine that the quality of these cash flows is sufficiently high, they may decide that these stocks deserve to trade on higher ratings – i.e. they will pay a higher price per unit of these higher profits.

Indeed, in prior gold bull markets, the rating that these stocks commanded was several times higher than it is today. We suspect this is what has led the famous investor, Warren Buffett, to make his first foray into gold equities (an area he has hitherto always shunned) via a stake in Barrick Gold.

Mine closures, as a result of the pandemic, have meant the current strong revenue-generating environment has not yet been reflected in recent earnings announcements, but with mines now open, that should change and provide a potential catalyst for further strong performance.

Thankfully, the more disciplined governance at these companies that we highlighted in our note three years ago seems to show no sign of slipping. Management teams appear determined not to repeat the mistakes of the past by increasing capacity too quickly. This is resulting in higher cashflows being passed through to shareholders via higher dividends and gold miners now offer very attractive yields.

We concluded our 2017 note as follows: "at a time when most assets are highly valued, and it is hard to build diversified portfolios, we believe investors would be well-advised to consider the merits of gold funds. Indeed, we believe gold is one of the best ways of insuring against some of the most serious risks in the global economy and financial markets. Albeit, as with any insurance we hope it will not be required, but it is prudent to have it."

This conclusion still stands, but today we view the gold mining sector as far more than just insurance: it is **arguably one of the cheapest valued sectors in equity markets globally** combined with a very strong underlying operating environment. We thus expect investment interest in the sector to continue to increase.

HAWKSMOOR
FUND MANAGERS

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IMPORTANT INFORMATION

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