Sanlam Investments

Sanlam Active UK Fund

Q1 2019 | Quarterly newsletter

Market recap

In our previous report covering the fourth quarter collapse in equities we remarked that the depressed investor sentiment prevailing at year-end already seemed to discount much potential bad news. We also suggested that “some moderation in US growth is likely, but this would not be unwelcome as it would encourage a more dovish Fed policy”. The strong equity rally we have seen this quarter can be precisely understood in this context. The risk of a policy-induced recession by an overly zealous Fed has all but vanished. Slower growth also sparked a strong bond rally, flattening the yield curve, and prompting some commentators to flag this as a harbinger of recession. However, sectoral returns within equity markets seem to suggest that a majority of investors take a more considered view, as evidenced by the broad based nature of the equity rally.

Bond proxy stocks predictably performed reasonably well, but there was no obvious “risk-off” defensiveness seeking by equity investors. This is also apparent from the short lived nature of the rally in the gold price, which petered-out towards the end of the quarter. Furthermore, industrial metals and the oil price have generally risen over the quarter, although exceptional supply factors contributed significantly to the spike in iron ore prices.

In summary, investors have been prepared to look through the current slowdown in global economic growth, at least so far. Even the shambolic political failure to get a Brexit deal agreed has been taken phlegmatically, and the gradual appreciation of Sterling against the Euro from around 1.11 to 1.17 might seem to reflect hopes for an eventual “softer” deal than the one that Mrs May has struggled to get approved by Parliament.

Fund review

The Fund outperformed the MSCI UK benchmark over the quarter. This is pleasing, particularly against the backdrop of slower economic growth and continuing Brexit uncertainty. We do not seem to have been hurt by the slight tilt in the portfolio away from defensive stocks in favour of more economically sensitive businesses, including several large holdings exposed to the UK domestic economy.

Performance data

	Inception	QTR	YTD	1yr	3yrs	5yrs	Since Inception
A Accumulation GBP	02/04/07	10.2	10.2	5.9	8.0	2.5	4.8
MSCI UK		9.4	9.4	7.6	9.8	5.8	4.9

12 Months to	Mar-19	Mar-18	Mar-17	Mar-16	Mar-15
A Accumulation GBP	5.9	1.3	17.4	-10.6	0.5
MSCI UK	7.6	-0.2	23.5	-5.9	6.1

Key facts

Fund AuM	£26.2m
Strategy AuM	£26.2m
Number of Holdings	35
Active Share	57.3%
Portfolio Yield*	4.6%

Fund Managers	Chris Rodgers Andrew Evans
Benchmark	MSCI UK
Fund Launch Date	02 April 2007
Domicile	Ireland
Base Currency	Sterling
Fund Type	OEIC, UCITS V
IA Sector	UK All Companies
Morningstar Category	UK Flex-Cap
Dealing Deadline	11:00 (GMT)
Settlement Time	T+3
Valuation Point	Midday (GMT)
Distribution	Semi-Annually

Past performance is not an indicator of future performance.

Source: Sanlam, Morningstar and Lipper as at 31/03/2019.

*Portfolio yield is calculated by adding the net dividend amounts for all dividend types that have gone ‘ex’ over the past 12 months based on the dividend frequency.

For professional investors only

Performance attribution

Sector allocation and stock selection were both positive in roughly equal measure. The largest sector factor was our large relative overweight position in the top performing information technology sector, albeit this is tiny as a proportion of the total UK index. This more than compensated for the impact of being underweight in the consumer staples group, which also outperformed.

The I.T. sector also provided our largest individual stock gainers and contributors, the most notable being holdings in Micro Focus and First Derivatives. Also benefitting significantly were several domestic UK businesses, namely Taylor Wimpey (a new holding in December), Lloyds Banking and Legal & General. Finally, we received a material relative benefit to performance from not holding Vodafone and being underweight in HSBC, both of which underperformed.

The main negative impacts came from holdings in International Consolidated Airlines and TUI. The former is ironically performing well operationally but the shares were hit by selling for technical reasons; in order to comply with EU rules ahead of Brexit the company capped the level of shares that non-EU investors can hold at 47.5%. Unfortunately this means that the stock fails to meet criteria set by MSCI for inclusion of many of their global equity indices, leaving index-tracking funds as forced sellers!

In the case of TUI, the stock was initially weak on modestly downgraded trading prospects in the current year, and then hit again as the company revealed the extent of significant exceptional costs from mitigating the grounding of their Boeing 737 Max aircraft. Other stocks dragging on performance were Paddy Power Betfair, Sophos, RELX and ITV.

Key Purchases:

- Rolls Royce (new holding): Rolls is one of only two global businesses (the other being GE) dominating the aero engine market for wide-body aircraft, presenting enormous commercial and technological barriers to entry. The company is now nearing the end of a heavy capital investment cycle and making good progress in a multi-year cost cutting program which together will produce strong free cash flow in the next few years. Thereafter growth in the installed base of engines and a business model structured around payments for engine flying time on the wing will produce a growing annuity income. We expect this to drive substantial share price appreciation over the medium and longer term.
- Intercontinental Hotels Group, IHG (new holding): IHG has evolved over the last 15 years from being an owner/operator of hotels to being mostly a global franchisor of hotel brands. This capital light model offers high cash returns with lower risk and attractive structural growth prospects. The key brands are Holiday Inn (60% of rooms) in the mainstream segment, and Crown Plaza and InterContinental in the upscale and luxury segments. A strong pipeline of new hotel openings (with a particular focus on Holiday Inn in China) is expected to deliver strong growth for the next several years.

We also made significant additions to existing positions in Taylor Wimpey and First Derivatives, and topped up holdings in Unilever, Integrafin and TUI. These purchases were funded from the disposal of holdings in Avon Rubber, BT, Bloomsbury Publishing, Crest Nicholson, John Laing and Sophos.

Outlook

Those investors fearful of an economic slowdown and recession risks, while fretting over Brexit and trade wars, will have completely missed the rally in equities this year. Many will be in denial that the outlook can improve from here, ignoring Chinese policy stimulus, the possibility of a resolution to trade friction and even maybe a relatively benign Brexit, eventually!

However, the key positive support is the revelation of a genuinely data sensitive Fed relative to the prior assumption of policy normalisation being on auto-pilot.

While equity sentiment has undoubtedly improved from the depths plunged at end 2018, most investors remain somewhat cautious, suggesting plenty of upside if a majority become relatively more optimistic.

Valuations are no longer stretched for many equity markets following market weakness and earnings growth last year, and equities certainly seem cheap relative to sharply lower, even negative, bond yields.

One source of concern might lie in the seemingly divergent expectations embedded in the strong rally seen in both bonds and equities. Equity investors must on balance believe that a recession can be avoided for the time-being whereas the fall in bond yields would appear to signal a much higher risk of recession. If the present economic slowdown proves ultimately to be the pause that refreshes then bond investors may have got ahead of themselves.

There is no worthwhile forecast to be made on Brexit at the time of writing. Suffice to say that a hard “no deal” Brexit would be chaotically disruptive economically, bad for Sterling and create volatility in equity markets. Against this, any deal would be welcome and more benign for the economy and equity market.

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The Fund invests geographically in a narrow range, there is an increased risk of volatility which may result in frequent rises and falls in the Fund's share price.

The value of this portfolio is subject to fluctuation and past performance is not necessarily a guide to future performance. The performance is calculated for the portfolio and the actual individual investor performance will differ as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. All terms exclude costs. Fluctuations or movements in exchange rates may cause the value of underlying investments to go up or down. Do remember that the value of participatory interests or the investment and the income generated from them may go down as well as up and is not guaranteed, therefore, you may not get back the amount originally invested and potentially risk total loss of capital. Therefore, the Manager does not provide any guarantee either with respect to the capital or the return of a portfolio. The Manager has the right to close any Portfolios to new investors to manage them more efficiently in accordance with their mandates. Collective Investment Schemes are traded at ruling prices and can engage in borrowing and scrip lending. Collective Investment Schemes (CIS) are generally medium to long term investments. A schedule of fees and charges and maximum commissions is available on request free of charge from the Manager, the Investment Manager or at www.sanlam.ie.

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