Sanlam FOUR Active UK Equity Fund

Performance Review

The fund outperformed its benchmark by 1.2%, with performance driven broadly equally by stock selection and sectoral allocation. The Fund's overweight allocation to the UK's rather small technology sector bore fruit, and our stock selection within the sector added value additionally. IQE and First Derivatives maintained their strong runs of 2017, through a combination of broad strength in global tech stocks, and improving idiosyncratic fundamentals. Lower weightings in the resource-led sectors detracted somewhat, but we also experience company-specific disappointments in GKN, ITV and Kenmare.

We added three new positions to the portfolio in Strix Group, Bloomsbury and Ibstock, each of which was trading on material discounts to intrinsic value while offering well-covered, growing dividend yields. We exited three troublesome mid cap companies which had experienced various company-specific issues in Telit, Dialight and Tungsten. Following price appreciation, we sold the positions in Worldpay and Rolls-Royce.

Fund Characteristics	
Size	£60.1m
Tracking error	2.6%
VAR (ex-ante)	5.1%
Cash	1.3%
Holdings	40

	QTR	YTD	1 Year	Ann. 3Yrs	Ann. 5Yrs	Ann. since Inception
A Acc GBP	6.2	15.3	15.3	7.0	7.7	5.6
FTSE All Shares	5.0	13.1	13.1	10.1	10.3	6.1

	12 months to Dec 17	12 months to Dec 16	12 months to Dec 15	12 months to Dec 14	12 months to Dec 13
A Accumulation GBP	15.3	5.5	0.8	-5.5	24.8
FTSE All Share	13.1	16.8	0.9	1.2	20.8

Source: Sanlam FOUR, Morningstar and Lipper as at 31/12/2017.

Past performance is not an indicator of future performance.

Market Recap

The UK equity market ended the year on a high note with a strong year-end rally led by Resource stocks helping the Mining and Oil sectors to be the best performing groups over the quarter.

Stronger global growth has been a continuing theme with positive surprises most evident in Europe and Asia. The US, by comparison, has been a laggard as reflected in a weaker US dollar, particularly against the Euro. Stronger growth has been good for corporate earnings with positive revisions a broad feature (perversely, less so in Europe, no doubt largely due to currency effects), and these trends have been the key driver for equity markets.

Economic strength has, of course, also prompted a creeping concern that monetary stimulus will eventually be tempered in both Europe and Japan. In tandem with tightening in the US, including the draining of previous QE stimulus, the new growth environment has become less friendly towards bonds. The move higher in government bond yields has been modest so far but enough to impact on sentiment towards "bond proxy" equities.

Thus, the sector laggards this last quarter are Healthcare and Utilities (although some stock specific moves have been notable in both).

Internationally, the key event was the passing of Trump's US tax reform bill, bringing a significant reduction in the basic corporate tax rate. This will provide a boost to corporate after-tax earnings and so was predictably well received by the stock market.
The year-end also saw the first vaguely encouraging news on Brexit, as outline terms were agreed for the "divorce" settlement, allowing talks to progress to the next stage. This prompted a modest rally in Sterling, and supported some of the more domestically oriented UK sectors such as Real Estate.

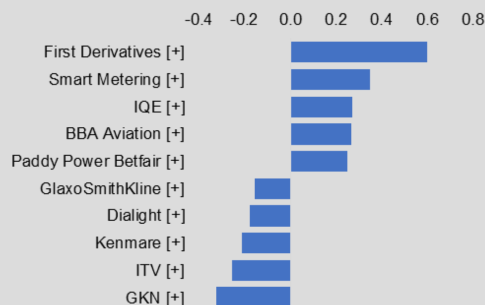
UK equities saw only a marginal difference in the average performance by company size this quarter. Stock specific factors have become relatively more important, however. Negative trading updates have met with a harsh market response, prompting sharp falls, for example, in Centrica, Merlin, Saga, Dignity, Ultra Electronics and IWG (previously "Regus").

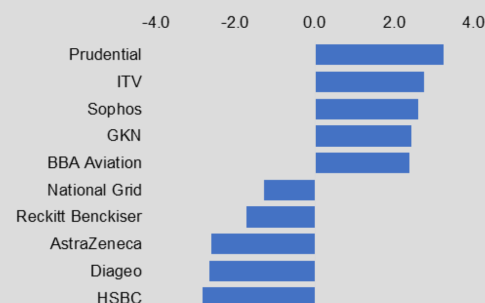
Performance Attribution

The Fund's excess return this quarter was driven broadly equally by sector allocation and underlying stock selection. The Technology sector, a relatively small component of the FTSE All Share, echoed the bumper returns seen across the Atlantic with the added kicker of strong company specific progress in their respective niches. The Fund's largest active sector position is in Technology, and while the allocation effect was supportive, stock selection within the sector helped tremendously. First Derivatives, a real-time 'big data' analysis software firm is posting accelerating organic revenue growth and winning initial contracts in brand new markets.

IQE, the Fund's best performer in 2017, outperformed the market, albeit navigating some profit taking towards the end of the year. As valuations have risen in the Tech sector, we have reduced the Fund's exposure commensurately, while retaining enough exposure to reflect our longer-term conviction. Smart Metering successfully raised capital to continue its next-generation smart meters roll-out in the UK, with a view to expanding internationally in time. TUI also performed well as the company transitions from a phase of merger integration towards growth and cash generation.

There was no single thread linking the laggards in the period. GKN disappointed with the announcement of large inventory write-offs in Aerospace, resulting in the dismissal of the company's heir apparent before he reached the CEO post. ITV continued to lag as investors grow fearful of an arguably structural shift of ad spend from broadcast to new media channels. Kenmare Resources also dragged, tracking weakness in the prices of the Titanium precursor ores which form the basis of its mining revenues.





Source: Bloomberg as at 31/12/2017.

Key disposals

- **Dialight:** the persistent delays caused by the relationship with its new outsourcing partner, puts the long-term investment case at risk.
- **Telit Communications:** We feared that an inbound CEO would likely rebase expectations materially as a result of poor past corporate governance issues.
- **Tungsten:** After a short run of strong performance Tungsten has yet to make EBITDA break-even so we exited at an attractive price level.
- **Rolls-Royce and Worldpay** had reached their Intrinsic Value targets.

Key purchases

- **Strix Group**: The world's leading manufacturer of temperature switches and safety controls in kettles. Cash generative with a strong dividend yield.
- **Bloomsbury Publishing**: Publisher of the Harry Potter and Sarah J. Maas series. Attractively valued with a growing dividend.
- **Ibstock**: The UK's leading brick manufacturer in an oligopolistic market with structural undersupply. Attractive valuation and solid dividend yield.

Market Outlook

Putting the UK idiosyncratic risks of Brexit to one side for a moment, the global economic outlook has rarely looked so benign. Growth is gently accelerating, with rising global consumer and corporate confidence providing a positive feedback loop. In particular, stronger company profits should prompt the much longed for increase in capex that is sorely needed if productivity growth is to recover. Provided that inflation remains under control (requiring continued wage restraint), then the so-called "Goldilocks" environment of recent times should be extended for a while longer.

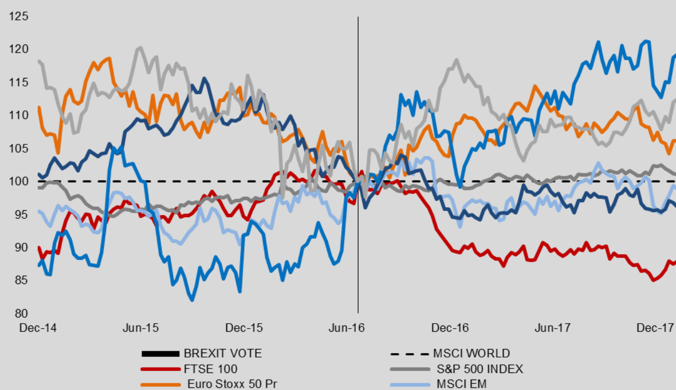
The risks to this happy equilibrium state are growing, however. In the US, as the labour market tightens it is probably only a matter of time before higher wage growth is seen. If modest and controlled this would be a welcome source of sustainably stronger demand. If, on the other hand, higher headline inflation were to result, then the Fed might need to accelerate the pace of monetary tightening. Investor concerns would be reflected first in the bond market, but the rosy consensus now evident in equities also leaves them vulnerable to a setback. Even if these concerns are exaggerated this is still likely to be a source of volatility this year.

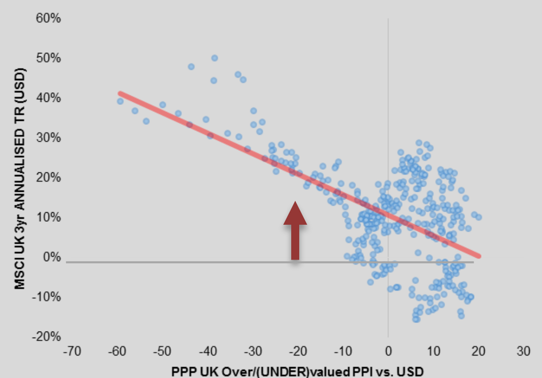
In the meantime, the UK equities will continue to reflect sentiment and progress on the Brexit negotiations. From a market standpoint, any consensus that forms around a "softer" variant, with a pragmatic trade deal, would be positive. The downside risks are that no deal is agreed, and that Conservative party in-fighting plays into the hands of a potential Labour government. Given this uncertainty, it is likely that the UK economy will continue to underperform, and some valuation discount for these risks will remain appropriate. That being said, relatively modest valuations for many UK listed but internationally exposed large cap stocks provide potential upside, with stronger earnings growth underpinning attractive dividend yields.

UK Equities – Untouchable or Undervalued?

The question on investors' lips at the end of 2017 was "how repeatable are this year's bumper returns?" All too often, the same fund managers who preach adherence to classical value investing principles are the first to dismiss challenged companies as value traps. Individual companies aside, the broader UK equity market seems to be subject to the same attitude today.

Since the Brexit vote, UK equities have de-rated in relative terms by the highest margin of any key equity market. While it is fair to say that UK equities provided handsome returns to investors in 2017, we believe that in relative terms the UK equity market will rarely present a better entry opportunity.





Source: Bloomberg as at 31/12/2017.

As we know, low P/E valuations multiples are a wonderful indicator for prospective long-term returns. However, as a market timing tool, the metric is far less useful. Having said that, when paired with buying into a fundamentally undervalued currency as measured by purchasing power parity (see chart 2), overseas investors ought to take great comfort in accumulating UK equity positions at these levels.

At such levels of currency undervaluation, prospective three year USD returns in UK equity markets have never fallen below 15% CAGR. If nothing else, this tells us that an undervalued pound is seldom an indicator of weak UK equity dollar returns to come in the short term.

We do not intend to churlishly dismiss the momentous task ahead of the UK and the risks associated with a 'no deal' scenario. Indeed, the risks are about as well-flagged as they come. Given the extent of the relative de-rating witnessed in UK equities since that fateful day in 2016, we assess the risks to be adequately discounted and believe that underweighting the UK hereafter will yield meagre, if any, alpha in relative terms.

Even the FTSE 250, home to some of the world's finest capital goods companies, has lagged global indices since June 2016. Manufacturing PMI surveys in the UK are instructive of strong demand, driven by the competitive edge on the global stage imparted by the weak(er) pound.

As we saw towards the end of 2017, any semblance of progress with Brexit negotiations is likely to spur frenetic buying of UK stocks. Additionally, there remains a very strong case for an uptick in inbound M&A activity, driven by a desire to hurry deals across the line before the exit deadline and before credit spreads (which remain at historical lows) begin to widen in earnest. Perhaps Melrose's courtship of GKN, a top 5 portfolio position, in early January is a sign of things to come.

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The fund price is calculated on a net asset value basis, which is the total value of all assets in the portfolio including any income and expense accruals. Trail commission and incentives may be paid and are for the account of the manager. Performance figures quoted are shown net of fees. Performance figures for periods longer than 12 months are annualized. The fund performance is from 12 noon to 12 noon, whilst index performance is close of business to close of business.

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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. JR0118(06)0618 UKSA Inst.