VT Lyndon Fund

Quarterly Commentary 31st March 2021

ContraCapital

Selling England By The Pound?

After the surfeit of "excitement" last year, the first quarter of 2021 was mercifully free of any further wrenching shifts in the political, economic or financial landscape. The maelstrom of events that unfolded in 2020 may make it hard to recall precisely where we started the year, but the net result of the pandemic panic and subsequent vaccine bounce was that the UK's FTSE 100 index ended the year -14% lower than where it had started it, with this its worst calendar year performance since the depths of the GFC in 2008. Given where we were in March 2020 the final outcome felt like something of a relief, albeit once again the UK lagged much of the rest of the world, with the commonly cited MSCI World Index up by +11% (in GBP terms) over the course of the year.

The momentum of the strong finish to last year continued into the first quarter of this year, with global equity markets making further gains (the FTSE 100 was +4%). Even more propitiously, Q1 2021 saw a continuation of the trends that had kicked off in November last year on the back of the positive vaccine news. So, the more lowly valued and out-of-favour areas of the equity market that had fared so poorly for much of 2020, have now performed strongly for two quarters in a row. This has made for a far more favourable environment for the VT Lyndon Fund, which was up by a little more than 10% over the quarter, with this in spite of the portfolio's market hedges holding back performance in a rising market.

Some of the portfolio's individual holdings recorded sizeable gains, notably supplier of temporary power generation equipment, Aggreko (up by +39%), online gaming group, 888 plc (+39%) and steel pipe manufacturer, Tenaris (+45%). The first named of these, Aggreko, was on the receiving end of a (now agreed) bid from private equity in February, making it the second portfolio holding to be acquired in this manner over the last few months. It follows the acquisition of retirement home builder, McCarthy & Stone, which was completed in January this year. The head of the acquirer, Lone Star Europe, said that "McCarthy & Stone represents an attractive opportunity in a market underpinned by clear fundamentals: a rapidly ageing population and a structural undersupply of suitable housing options for older people." Quite so, that is why we had owned the shares too.

The last few months have seen a more generalised pick-up in the level of corporate activity in the UK market, which is not really at all surprising. Corporate valuations in the UK are relatively bombed-out, the economy should be on the road to some sort of recovery, Brexit-related "uncertainty" is considered (wrongly) to be behind us and potential acquirers have access to plentiful and historically cheap capital. Private equity, in particular, is awash with cash that it needs to spend in something of a hurry, so we would not be in the least surprised if our portfolio – composed as it is of lowly valued, lightly indebted and solid businesses – were to be in receipt of more takeover approaches over the next year or two.

Offsetting the better performing holdings in the fund was a marked lack of fallers; quite remarkably not a single direct equity holding was down during the quarter. There were some holdings in the red though, with the portfolio's positions in silver and gold both down, as was the exposure to Latin American emerging markets, the Blackrock Latin American Investment Trust.

There was not a huge amount of portfolio turnover during the quarter, with the most significant piece of trading activity being the sale of the fund's position in clothing retailer, Superdry plc. Following the group's FY2021 H1 update and management's uninspiring comments on recent trading, our confidence in the promised design-led turnaround crumbled. The AW20 collection that is currently on sale is the first for which the returning CEO and co-founder, Julian Dunkerton, is definitively 100% responsible, so the group reporting significantly weaker online sales than all of its major quoted peers (Boohoo, ASOS, Next, M&S), and with no good explanation for this weakness, seriously undermined our investment thesis.

Two good quarters does not an investment summer for value-oriented investors make (or something like that), but we may only be in the very early foothills of a potential reversal. Beaten down value stocks have a *lot* of relative performance to make up on their more richly valued brethren and the huge underperformance of the last few years means that value is still available at a historically steep discount to growth. The rally from the lows last November could ultimately prove to have been a significant inflexion point from which sustained and substantial outperformance will flow. Likewise, the UK's underperformance of most other markets has left UK equities looking as cheap relative to the rest of the world as at any time in the last 50 years.

So, value and even more especially UK value looks like it should be a highly fertile hunting ground for rewarding investment opportunities, which is helpful, as that is precisely where we do much of our hunting. However, don't just take our word for it. In a recently published piece by US asset manager, Research Affiliates (who manage c. $157bn of global assets out of California), the authors refer to UK equities as representing "The Trade of the 2020s."
They observe that:

The long-running saga of Brexit and the more-recent drama of the COVID-19 lockdown crisis have combined to generate unique investment opportunities. In particular, UK equities are now trading at valuation levels comparable to EM equity markets. A major difference, however, is that the United Kingdom is a developed market with a sophisticated economy. The recently finalized Brexit deal means that UK businesses can operate with much less uncertainty. The Brexit deal also opens additional markets to UK firms.

An additional positive is that the United Kingdom is among the world's champions in leading the COVID-19 vaccination charge. The current low valuations of UK stocks, combined with the tailwinds of the Brexit deal and tremendous progress in vaccination, imply that UK stocks should be especially attractive going forward. Further compounding the investment opportunity of UK value stocks is that value investing in general has suffered significantly over the last nearly 14 years, trading today at bargain-basement multiples. Both UK and EM value stocks may prove to be the trades of the decade.

And, incidentally, their last named "trade of the decade" was Emerging Market value stocks back in 2016, which returned +80% in the following two years. They still like Emerging Markets, as do we, they just like the UK even more. In contrast, Research Affiliates project that the US equity market will be lucky to match inflation over the next decade. However, this is positively bullish compared to the forecasts of another major US investment manager, GMO. As at the end of March GMO are forecasting that US large cap and US small cap stocks will return -7.3% and -8.1% in real terms over the next seven years *on an annualised basis*. That is, their expectation is that from this point investments in US stocks will lose more than -40% of their real value over the next seven years. GMO do not disclose their thoughts on the UK equity market (it's rather too small to qualify as an asset class for global investors these days), but we can note that the only positive forecast they currently have (out of the eleven asset classes they publish details for) is Emerging Market value equities.

David Lynch, Fund Advisor, VT Lyndon Fund, April 2021

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