VT Lyndon Fund

Quarterly Commentary 29th December 2023

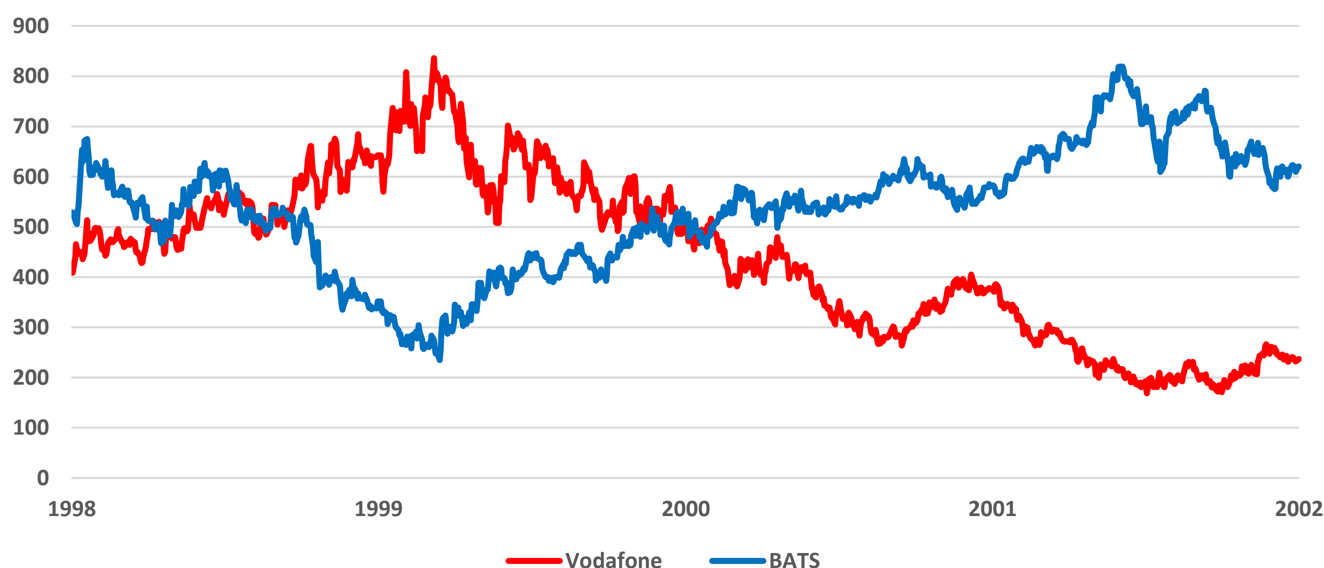
ContraCapital

Following a generally soft Q3, the last quarter of 2023 was the year's strongest for many global equity markets, with the series of bank collapses we saw in the spring now just a distant memory. The UK equity market was no exception and rallied into the year-end, with the impetus behind higher equity valuations both in the UK and in other developed markets being the growing consensus that interest rates have peaked or are at least very close to a peak. Inflation, whilst still running at double its target rate in the UK has declined substantially from the 10%+ it stood at for much of 2022 and early 2023. This decline was more or less inevitable, once the base effects of higher energy costs had annualised and Covid-era constraints in the global supply chain had eased.

All equal, energy costs will continue to fall and consumer price inflation will come down with them. So, following a series of 13 rate rises from a starting point of 0.25% at the beginning of 2022, the Bank of England has stayed its hand for the last four months in a row, with base rates currently being held at the 5.25% they were raised to at the beginning of August. With expectations of further rate rises having receded, longer-term interest rates have also declined significantly from earlier in the year. For example, the benchmark 10-year gilt ended the year yielding 3.65%, down from a recent high of 4.85%, and mortgage rates have also consequently eased a little.

Rather less positively, economic growth is still proving hard to come by and the UK continues to flirt with technical recession (i.e., successive quarters of contract in output as measured by GDP). However, notwithstanding this absence of growth, the UK economy has not been quite as dreadful as widely feared and expected. This dismal but still better than expected outcome has helped lift the sentiment on smaller, domestically-focused UK stocks from utterly dreadful to merely very bad. This so far minor inflection in investor sentiment saw UK mid-cap stocks perform strongly in Q4, delivering their best quarter relative to the wider market for three years. The underperformance of small and mid-cap stocks over those three years was massive, though, coming within a hair's breadth of the worst ever recorded, which was during the TMT bubble of the late 1990s. The potential for a similarly large rebound remains very much in play and this was precisely what happened in the early 2000s, as previously unpopular and undervalued old economy stocks soared, whilst the wider equity markets in general and TMT stocks in particular, slumped.

The savage swing in market sentiment over this period is perfectly exemplified by the divergent performances of Vodafone, perhaps *the* poster child of the TMT bubble in the UK, and British American Tobacco, the grubbiest imaginable old economy stock (and not one we would ever own). Many UK stocks, especially those further down the market cap scale are every bit as undervalued now as BATS was at the turn of the millennium.



Source: S&P Capital IQ

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The Fund is naturally heavily invested in these unpopular, beaten-down and undervalued UK stocks, which was beneficial for performance during the quarter (and also for large parts of the year). The Fund was up by +7.1% for the quarter and was +24.0% for the year (figures cited are for B Accumulation shares).

The best performing stock in the quarter was the sofa and carpet retailer, ScS Group (+54% over the quarter), which accepted a takeover offer from its Italian peer, Poltronesofa. Another of our undervalued stocks, Vitesco Technologies, was similarly on the receiving end of a takeover bid. This offer was not so agreeable to management and many shareholders, who believed that the price offered, €94 per share, materially undervalued the business and that the bid was opportunistic, with the acquirer, Schaeffler, already owning just under 50% of Vitesco's shares. In any event, the bid has succeeded and whilst €94 per share may not have been generous, it constitutes a decent return on the €29 we paid less than two years ago.

Coming the other way, we welcomed our first new stock of 2023 to the portfolio as late as December, when we took a position in the UK commercial property developer, Helical plc. The commercial property sector has huge, well understood challenges, but Helical is far better placed than most of its peers and looks to be more baby than bath water. The group is a well-established, yet highly entrepreneurial and nimble property developer, with a long history of adding significant value through the cycle and outperforming its larger peers. The group has, where appropriate, partnered with a highly impressive array of co-investors over the years, perhaps most notably Seth Klarman's Baupost Group. Helical has very recently tied-up with TfL, which has a large and very well-positioned (near to or literally on top of transport hubs) property portfolio that has huge development potential.

Helical's property portfolio is nearly 100% office space, but this is new, high quality, 'best in class' office space of the sort that remains in high demand and for which rents are still going up. The office market has been bifurcated for many years now, but Covid has only widened the gap between the winners and losers. Helical's well-located and top quality portfolio should see it on the winners' side. The share price performance and valuation tell a very different story, as the group is trading at below half of its book value and the balance sheet is not overly leveraged, meaning that there is plenty of potential reward on offer for the risk being taken.

The other piece of notable portfolio activity during the quarter was an addition to our position in Headlam Group, the UK's largest distributor of floor coverings. This is a simple, readily understood and highly cash generative business, with a very strong market position, a robust balance sheet and no obvious structural threats. That's the good news. The bad news is that approximately two-thirds of group exposure is to the residential market and one third to commercial, with the former especially weak over the last couple of years as the consumer has come under increased pressure. This is readily explicable, as the replacement of a worn, tatty or just unfashionable carpet (or other floorcovering) is much more easily deferred by a hard-pressed householder than, say, the replacement of a broken oven or fridge or the repair of a leaking roof. Headlam's management say that market volumes are as low now as they were at the worst point of the post-GFC period.

The bad news is in the price, the good not so much. Whilst the dire level of activity in the floor coverings market owes much to consumers being cash-strapped, it has also been heavily impacted by the deeply depressed rate of transactions in the housing market, which are also now plumbing post-GFC lows. Save for 2021, when they rebounded following 2020's lockdowns, housing transactions in England & Wales have never approached the 1.5m per year that they averaged in the decade prior to the GFC. We have seen the impact of this across a wide range of stocks and believe that it is a potential source of significant upside surprise, should a more intelligent approach be taken to the all-important, indeed overmighty, UK housing market by policymakers. There are many policy levers that could be pulled that would get the housing market (and people) moving again, which would be greatly beneficial to the UK economy, to say nothing of portfolio holdings such as Headlam, Foxtons, Wickes, Kingfisher *et al*. This is a theme we are very likely to return to in subsequent quarters.

(Source for equity returns and index movements is S&P CapitalIQ and are quoted in local currency unless otherwise noted).

David Lynch, Fund Advisor, VT Lyndon Fund, January 2024

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