Sanford DeLand

ASSET MANAGEMENT

Review of 2017

For professional investors and advisers only

Economic, Political & Stock Market Developments

After the shocks (to some) of the previous year, 2017 marked the fight back by the Establishment. The surge of so-called 'populist' parties in Holland and France failed to materialise, so no-one should hold their breath about how elections in Italy will go in 2018. Meanwhile, Angela Merkel is currently holding on by the skin of her teeth to power in Germany, and this seems to have allowed Emmanuel Macron, an avowed Europhile, to seize the initiative within EU high command. In the UK, there was the shock of Theresa May fighting an inept campaign and managing to snatch defeat from the jaws of victory in June's General Election. Despite over 80% of votes going to parties backing Brexit, the sight of politicians now putting party before country is leading to some pretty hypocritical posturing over the UK leaving both the single market and customs union. Such antics do not serve the country well, undermining its negotiating position. Notwithstanding, the prospect of a softer Brexit and the aforementioned developments on the continent have been favourably received by 'the market'. Indeed, almost every potential negative gets brushed aside as new market highs are scaled. With the world economy now acting in a synchronised growth phase, the issue of threats by 'Little Rocket Man' in North Korea gets ignored. As I have said before, global tensions remain high and global indebtedness is not getting any better. We are also into a monetary tightening phase, never good for markets, though the pace of interest rate rises is, I contend, likely to be gentle. However, with the VIX staying low, I do wonder whether we aren't witnessing complacency on a large scale. I am also concerned about the cryptocurrency phenomenon. To a veteran of the dotcom boom-and-bust, there is an eerie echo here of past follies.

Fund Performance

The outstanding performing sectors were Metals & Mining and Leisure Goods. Much of the gain for the latter came from Games Workshop (which we hold), the best performing stock of 2017. Our exporters continue to benefit from the weakness of sterling, though the one-off Brexit adjustment has now washed through. On the other side of the coin, those that experienced a one-off increase in cost inflation from this event – think retailers in particular – are set to see the going get better. Excluding cash, an approximate breakdown of our geographical earnings exposure at the end of the year was UK 45%, Europe 20%, Americas 21%, Asia-Pacific 6% and RoW 8%. By market capitalisation, the Fund owns holdings in 6 FTSE 100 companies, 8 FTSE 250s, 8 fully-listed smaller caps and 9 quoted on AIM.

The year ended with the largest Institutional Income (I) class share price ahead by 24.1% from 229.39p to 284.75p – a new all-time high – set against a 9.0% gain for the UK stock market. According to FE Trustnet, the gain on a total return basis, including dividends reinvested, was 25.9% compared to a total return for the IA UK All Companies Sector (our peer group) of 14.1%. This was enough to place the Fund in the top quartile for one-year performance at 16th out of 261 funds. Measured over a three-year period, it is 4th out of 246 funds and over five years, 3rd out of 222 funds. Accolades collected during 2017 included retaining Money Observer's best smaller UK growth fund award for the third year running and winning the Thomson Reuters Lipper fund awards for best UK Equity Growth fund over 3 and 5 years based on risk-adjusted returns. The fund was also included in the Investors Chronicle Top 100 Funds list for the fourth year running.

The Fund entered 2017 with £81.8m of assets under management. Net inflows in each of the 12 months were positive and totalling £139.4m. Together with the investment performance, this meant that AUM at the year-end was £258.7m. Portfolio turnover was 7.2% (2016: 2.4%).

Keith Ashworth-Lord

5th January 2018

Investments

The higher than normal portfolio turnover was due to (relative) hyperactivity on my part. We lost Lavendon Group to a takeover by Loxam SA in March but in addition, I chose to sell our holdings in WYG and Provident Financial. In the case of WYG, I was partly concerned about the nature of a profit warning early in the year but more so about its exposure to EU financed projects. My concern is that the company will be frozen out of awards under the next five-year budget plan. In the case of Provident, it was the change of operating model at home collected credit that has exacted an awful toll on impairment and profitability. I doubted the wisdom of replacing self-employed collection agents who know their clients intimately with professional employed agents. Changing a business model that has stood the test of time since 1880 did not seem sensible to me. In both cases, I thought there were further profit warnings waiting to happen (correct as it transpired).

I should point out that we reinvested in Provident later in the year. So, why go back in? Firstly, I had sold out at prices between 2040p and 2103p per share and have now paid an average of 800p in reinstating the holding. I think the shares are oversold. Secondly, I was satisfied that the poorly executed change of business model in home collected credit had been entirely the decision of the previous (now ex) senior management, i.e. not a regulatory necessity. Thirdly, the group has reappointed Chris Gillespie as head of Consumer Credit to rectify the problem. Chris left the business in 2013 and if anyone can sort out this mess, it is him. I wouldn't be surprised if some of the self-employed, part-time agents who have left the business may be tempted to return.

Coming into the portfolio were five new investments: Revolution Bars, Next, Craneware, Dignity and RELX. Revolution operates two formats, Revolution and Revolución de Cuba. The beauty of the business model is very high rates of return of around 40% on capital invested in the 5-6 openings p.a. (i.e. a 2½ year pay-back). The expansion is funded internally from the strong operational cash flow of the business and the balance sheet sports net cash. Revolution rebuffed a bid from Stonegate Pub Co. late in the year.

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Next needs no introduction being an instantly recognisable brand name. The share price had halved from its peak of over £81 in late 2015 in reaction to challenging conditions on the high street, and the effects of the weakness of sterling and national living wage on input costs. However, the margin resilience has been remarkable and the returns on equity and cash generation are superb. All the growth is coming from the online presence; bricks and mortar outlets are in decline. I have the utmost confidence in Simon Wolfson and his team to navigate Next through the current choppy waters.

Craneware is a US business domiciled in Scotland. It sells software to American hospitals that track all aspects of patient care and billing. Its customers are sticky with 3-5 year contracts and renewal rates of over 85%. Its return on capital is around 20%, it converts 120% of earnings into cash and has a strong balance sheet sporting net cash. It spends heavily on R&D and sales and marketing.

Dignity for me is one of the most predictable business models around and the only issue has ever been the entry price. My assessment was that we were offered a workmanlike price rather than obtain a bargain to invest on this occasion. This followed subdued first half results caused by, to put it crudely, not enough people dying. The shares had lost about a third from their peak and have now lost nearer half. Timing is obviously not my strongest suit!

RELX, once known as Reed Elsevier, has successfully navigated a period of challenge to its traditional print publishing and advertising businesses, evolving to become an owner of key digital assets and a provider of analytics and workflow solutions. It owns proprietary technical content and data sets that are indispensable to many professional and business customers, notably in the scientific, medical, legal, and insurance sectors. It is a high-quality, archetypal Buffettology business with economically resilient assets. It has been a steady compounder, growing EPS and dividends at a CAGR of around 8.5% for the last ten years and buying back shares for cancellation. With advances in IT making its data sets increasingly valuable, RELX's earnings power seems set to accelerate from here.

The stand-out performers among the ownership interests in the portfolio were:

Holdings	Share price	Comment
Games Workshop	+272.7%	multiple upgrades and dividend declarations
Bioventix	+83.3%	continuing excellent operating performance
AB Dynamics	+82.2%	recognition of dominant supply position to global auto industry
Dechra Pharmaceuticals	+55.1%	performance and well received acquisitions
Hargreaves Lansdown	+48.1%	likely beneficiary of a buoyant stock market
Air Partner	+42.9%	good recovery underway and well received diversification efforts
Dart Group	+39.0%	performance ahead of market expectations
Croda International	+39.0%	return to meaningful growth
Victrex	+37.1%	capex requirements abating and favourable tax planning boosting EPS
MJ Gleeson	+35.2%	intention to double rate of housebuilding over next 5 years

The main detractors from performance were:

Holdings	Share price	Comment
Dixons Carphone	-43.0%	slower replacement of handsets by mobile users
Dignity	-20.6%	concerns about higher competition harming margins
Revolution Bars	-18.7%	failure to control operating costs satisfactorily
GlaxoSmithKline	-15.6%	sluggish growth and worries about dividend cover

Past performance is not an indicator of future returns. The value of your investments can go up as well as down and you may get back less than you invested.

Outlook

Brexit negotiations will mean a more volatile UK stock market as each twist and turn is seized on by Remainers and Leavers to bolster their cause. However, whilst there had been some evidence of slowing economic activity late in the year, most recent data suggests the UK economy is on course to grow by 1.6%-1.8% in 2018. Hardly the instant DIY recession predicted by Mr Osborne and his entourage at the time of the referendum. Yet market expectations are riding high and there is no room for disappointments with company valuations often suggesting a bit of exuberance in the mix. Add in gently rising interest rates and continuing global tensions, and there is every reason to be cautious. As ever, I shall cautiously commit fresh capital to outstanding companies where I believe pricing opportunities prevail and avoid those that look fully valued. In other words, more of the same.