Sanford DeLand

ASSET MANAGEMENT

Business Perspective Investors

CFP SDL Free Spirit Fund Annual Report to 29 February 2020

Investment philosophy and process

The investment objective of the fund is to seek to maximise total returns over the long term by investing in the equity of UK-quoted companies. The fund is unconstrained in its ability to invest across all sizes of company, although its focus is on small and mid-sized companies, defined as those with a market capitalisation of less than £5bn. The fund manager applies the methodology of Business Perspective Investing. Investee businesses must possess a strong customer proposition with pricing power and growth potential, with sustainability assessed by reference to identifiable economic moats. Required financial attributes include high returns on capital employed, sound balance sheets, strong conversion of earnings to free cash flow and rational allocation of capital by management. The fund will have a concentrated portfolio of between 25 and 40 holdings when fully invested and the fund manager aims to keep portfolio turnover to a minimum.

Performance

Free Spirit's accumulation class share price rose by 16.3% from 119.41p to 138.89p in the year to 29 February 2020. This compares favourably with the 1.4% fall in the wider UK market on a total return basis. The fund outperformed the average 1.03% return of its peer group, the IA UK All Companies Sector, where it was placed 8th out of 252 funds. The fund reached its third anniversary on 3 January 2020, achieving a 3-year return of 46.6%. This compares with a return of 23.2% for its peer group, where it was placed 14th out of 243 funds.

Change of fund manager

Rosemary Banyard resigned as manager of the fund and was replaced by Andrew Vaughan with effect from 1st July 2019. Keith Ashworth-Lord is co-manager. Andrew has over twenty years' investment research experience, with a specialisation in Business Perspective Investing and having first worked with Keith on the 'Analyst' research publication in 2005. He joined Sanford DeLand in 2017, contributing research ideas for Free Spirit from soon after the fund's inception.

The fund experienced outflows as a consequence of Rosemary's departure, announced in mid-April 2019. Weak investor sentiment towards UK smaller companies may also have been a contributory factor. The fund's assets under management fell from £15.04m on 15 April 2019 to a low point of £6.08m on 11 December 2019. This was despite net asset value per share advancing from 125.77p to 137.79p. As at 29 February 2020, the fund held AUM of £7.98m, assisted by inflows, stronger markets and further outperformance.

Change of objective

In Autumn 2019, regulatory approval was granted for changes to the fund's objectives. The focus on mid and small-size companies is now expressly stated, while maintaining Free Spirit's unconstrained 'all cap' remit. The revised objective does not result in, or stem from, any change to the portfolio's composition, but it now describes it more clearly. The second change has been to remove the objective of achieving growth in excess of inflation, defined as UK Consumer Price Index (CPI) +2% per annum. This was felt either to imply a specific level of return on investment or a lack of ambition to do more than match inflation, which was never the case. It has been replaced with the simple objective of maximising total returns.

Portfolio review

It was very much a year of two halves. For the six months to 31 August 2019, generally prices of small companies were in decline and prices of mid-cap companies were flat. Although focusing on these two out-of-favour areas, Free Spirit benefited from its unconstrained ability to hold some large cap overseas earners such as Unilever (+30.8% to 31 August), Aveva (+23.4%) and Relx (+15.3%). These gains were driven in large part by currency weakness, with the pound sterling losing 8.5% against the US dollar between February and August. This swung around in the autumn, with the pound strengthening on greater political clarity and Unilever and Relx giving up much of their first half gains. UK-focused small and mid-caps came roaring back into favour after the general election in December. This drove Free Spirit's strong performance, spoiled only in the last few trading days of the fund's year by the impact of the coronavirus pandemic. Inflows into the fund in January and February coupled with our reluctance to pay high prices resulted in the fund holding a high cash balance of 19.7% of AUM, close to the maximum permitted 20%, when the market downturn hit in the closing days of February.

Looking at the year as a whole, the top five gainers were Avon Rubber (+105.3%), Games Workshop (+103.9%), London Stock Exchange (+70.5%), Kainos (+56.4%) and Tristel (+47.0%). The top five losers were Craneware (-27.6%), SSP Group (-22.2%), AG Barr (-21.5% to when sold), Trifast (-14.9% to when sold) and Revolution Bars (-12.8% to when sold).

Avon Rubber (+105.3%) struck a deal to acquire 3M's ballistic protection business, extending its product range into the adjacent area of armour protection and further entrenching its importance as a supplier to the US Department of Defence. The deal was funded without issuance of additional shares in Avon Rubber, ensuring that any longer-term benefits of the deal will flow to the shareholders of Avon rather than the vendor, 3M. A strong year for Avon was topped off with large new orders for its M69 aircrew masks and next generation body armour products for the US Army.

(Continues overleaf)

Past Performance is not a guide to future performance. Investment in the fund carries the risk of potential loss of capital.

Games Workshop (+103.9%) achieved another strong year operationally. Sales grew across all three channels (trade, retail and online) and the increasing significance of royalty income underscored the broadening appeal of Games' intellectual property. It has deployed cash into expanding manufacturing and warehousing capacity to support the next phase of growth, while maintaining a debt-free balance sheet.

London Stock Exchange (+70.5%) was only added to the portfolio in February 2019. It quickly performed strongly, rising to become a top ten position for the fund by the end of July. This was initially on its proposed acquisition of Refinitiv and subsequently on merger interest from Hong Kong Exchanges and Clearing. LSE is a uniquely positioned asset, but the added debt and complexity of the Refinitiv transaction led us to scale back the holding at the summer's higher prices. It remains in the portfolio, but now amongst the five smallest holdings.

2019's drawn-out political psychological drama surrounding Brexit affected the share price of Kainos (+56.4%) perhaps more than the fund's other holdings. The business is headquartered in Northern Ireland, moves its staff around Europe and depends on central government spending for a large part of its revenues. Fortunately, it has some enduring economic and financial strengths including a debt-free balance sheet. This gave us the resolve to keep holding while the Brexit impasse was at its peak and the share price fell by c.35% between June and September, then going on to rise by c.70% by the fund's February year end. A clear example of the importance of focusing on businesses rather than share price movements.

Price movements in Tristel (+47.0%) and SSP Group (-22.2%) were driven by the unfolding coronavirus pandemic. Tristel, whose business is decontamination and infection control, was a perceived winner. We sold SSP, which operates food outlets at airports and rail stations, immediately after the fund's year end when the likely extent of travel restrictions first began to take shape. At the time of writing, SSP's share price has dropped from above 500p, when the fund sold, to around 150p and Tristel has risen to become one of our larger holdings. Debt-free balance sheets have come into their own these days. Tristel has cash and no debt, whereas SSP has debt and operational gearing, of which we were always aware of the latent dangers in a downturn.

Looking at the other losers, we continued holding Craneware through some operational challenges surrounding the introduction of its Trisus cloud-based range of software products. Rosemary had spotted the resulting deterioration in working capital and reduced Craneware, which had become the fund's largest holding at the start of the year and a little over-sized at 6.12% of the fund's assets. The damage to the portfolio was therefore much reduced by the time Craneware appraised the market of these issues in June and the shares fell heavily. Two subsequent updates from the company have provided comfort, although valuation is perhaps still elevated. Craneware occupies a strong niche in a US healthcare system which is increasingly drawn to IT solutions that can help hospitals better understand their costs and maximise their revenues.

Portfolio changes

The portfolio started the year with 31 holdings and ended the year with 27. In the early summer we reviewed all holdings for their continuing conformity with our Business Perspective Investing methodology. Stemming from this, we felt the need to make only two changes. Dunelm (+9.9% for the year to when sold) had been a strong performer for the fund, but we consider that ever-evolving consumer tastes, the impact of easy price discovery on margins and operational changes between store-based and online channels deprive retail businesses such as Dunelm of the predictability we require. However, the fund continues to hold Games Workshop, which is in part a retailer, because of the embedded nature of its customer base and the non-complex nature of its fulfilment channels. The other disposal was Chemring (+26.5% for the year to when sold) for the reason that it is a potential recovery situation, rather than a company that has already met our financial shape requirements.

In the summer, we took the decision to reduce overlapping holdings between Free Spirit and UK Buffettology so that investors can hold both funds side-by-side without undue concentration at the individual company level. This has been a gradual process, involving only two outright disposals (AG Barr and Trifast). We have not sold a holding if we felt either that the price was too low or that prospects for the duplicated holding were better than for an actionable replacement. At the end of February 2020, 17.5% was in holdings also held by UK Buffettology, down from 29.5% at the end of June 2019.

We added one new company to the fund in July 2019 and then made no further additions until late February 2020. The addition in July was Bloomsbury Publishing, which is using digital formats such as e-books and digital subscriptions to better commercialise its enduringly in-demand titles and reduce its reliance on retailers. Bloomsbury is debt-free, with a long track record of self-funded acquisitions and a steadily compounding dividend.

When markets began selling off in February, we took the opportunity to add three new businesses to the fund – Intertek, YouGov and Elecosoft. Intertek is a FTSE100 company which provides assurance, testing, inspection and certification of products, operations and supply chains to businesses in almost every sector around the world. YouGov is an AIM-quoted provider of public opinion and data services and Elecosoft is an AIM-quoted developer of specialist software for the construction industry. Our approach has been to accumulate these slowly and by our year end the three combined accounted for just 4.17% of the fund's assets, equivalent in size to just one of our larger holdings.

At our February year end, 16.1% of the fund was invested in companies in the FTSE 100 Index, 23.5% in the FTSE 250, 40.8% in the FTSE Small Cap, Fledgling and AIM, and 19.7% was held in cash.

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Outlook

Mid-March 2020 is an ill-advised moment to be writing an outlook statement, but it would be remiss not to say something about our thoughts on the future. As ever, we are determined not to stray outside our circle of competence. That would preclude us from forming any view of how the human health issues of the coronavirus may play out. Without that knowledge, and particularly of the related timescales, it is impossible to form an evidence-based assessment of the economic environment in which our companies may find themselves. Suffice to say that significant change lies ahead and that many long and deeply held assumptions may be challenged.

This has naturally driven us to re-examine Free Spirit's holdings. We were always mindful of the operational and financial gearing in SSP Group – which served investors well when the business was growing – and acted swiftly in light of the new reality facing the business, sparing the fund from losses which it would otherwise have sustained. Beyond that, at this early stage, the traits for which our companies were selected are providing the resilience which is now being demanded – recurring revenues from embedded customers (for example from long-term software contracts and subscriptions models), zero or easily manageable debt and experienced management teams, many of whom are also significant shareholders in these businesses.

This resilience can cut both ways. For example, Auto Trader is providing its advertising service free of charge for one month and granting 30 days of deferred payment of advertising charges for the preceding month in a bid to help its customers. That is the bad news. The good news is that Auto Trader is uniquely well-placed to do so. Research today from Stifel suggests that Auto Trader could extend this offer by a further two months before operating margins would dip much below 60% (an extraordinarily high profit margin) for this disrupted year as a whole and still deliver a free cashflow yield of 3-4%. This may prove optimistic and we will keep Auto Trader under careful review. The flipside of these strong attributes is that they have tended to be highly rated in the market, and therefore prone to a derating when markets are fearful. However, we would rather own companies that are vulnerable to a share price derating than ones that are at risk of going out of business.

Just as we selected companies with strong cash positions, we maintain a strong cash position within the fund. In good times this enables us to add new holdings or top-up existing holdings when price opportunities arise. In bad times it enables us to meet redemptions from the fund without having to sell our precious holdings. Free Spirit went into the steep market falls of March 2020 with 19.7% of the fund in cash, close to the maximum permitted level of 20%. Three weeks later and with the market some 25% lower, this cash position has helped push the fund towards the top of the performance tables relative to its peers in the UK All Companies Sector.

Andrew Vaughan
20 March 2020