CRUX ASSET MANAGEMENT

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FP CRUX UK Special Situations Fund

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Welcome to the first commentary for the new FP CRUX UK Special Situations Fund, launched on the 1st October. There are two parts to this commentary; an introduction to the fund and holdings followed by a review of performance in October.

Introducing CRUX UK Special Situations Fund

The aim of the fund is to achieve long-term capital growth through active management, by bottom up stock picking. The fund has the flexibility to buy any UK stock, regardless of market cap, with a hard limit of 30% in the small cap space. The differentiating factors of the fund include an ability to buy companies under valuations of £200 million. This focus on smaller businesses gives us the opportunity to target recovery and uncorrelated growth situations that we believe are unavailable higher up the market cap scale. Another differentiated feature of the fund is the emphasis on alignment of management both of the fund and in the invested companies. Many of the fund's investments involve taking calculated decisions and investing alongside management is reassuring.

The UK stock market and economy

The fund is a stock picking fund; we believe fundamentals of the businesses are far more important than macro economic considerations. Currently there is heightened uncertainty around politics and currency due to Brexit. Investors will, I am sure, want to know how we are positioned with this in mind. The UK stock market is not highly valued and has yielded over 4% throughout October and early November. Investor concern seems to be focussed on the sustainability of those profits.

Much has been written about Brexit and at this stage, many factors remain "known unknowns". We think the following observations provide a little insight.

1. Roughly, 60% of the profits from the UK stock market are derived from overseas. A "bad"outcome to Brexit for the domestic economy would likely lead to a fall in Sterling, and overseas earnings would rise to offset any domestic decline.
2. As recently as 2014, 54% of the UK stock market was owned by overseas investors. These investors suffer a currency loss should sterling fall, and the volatility seen in October may have been these investors taking evasive action, by changing to an underweight UK exposure.

Although there may well be an emotional response to any "no deal" outcome, the removal of uncertainty may well prompt underweight investors in off the sidelines and any sell off would most likely be a buying opportunity in domestic stocks.

Our positioning:

Brexit offer some difficulties for the UK economy but we feel the concentrated CRUX UK Special Situations Fund does not need to confront these issues head on.

Initially we have no investments in banks, property, house builders and retail; there may be opportunities over the next 6-12 months to invest in these domestic sectors opportunistically. We have invested 45% of the fund in large overseas earners e.g. Royal Dutch Shell, Vodafone, Whitbread, BATS, and Rio Tinto with a view to switching this more domestically in coming months. The fund has c20% in the mid-tier of the UK market. This mid cap sector, mostly comprised of UK focussed companies, will most likely be the core of the fund in future years but at this time has some very expensive growth stocks. We have over 25% invested in smaller companies, and the themes here are company specific growth, which should transcend UK economic headwinds, and recovery or deep value situations, which have already been impacted by adverse trading.

The fund's initial investments can be separated into three main categories (excluding the large overseas earners), which are used to illustrate how the fund can be viewed at this time.

Recovery stocks:

Commodities have been under pressure due to concerns on global trade. Due to this weakness, we have bought shares in Centamin, a world class gold miner, Premier Oil a North Sea oil producer which is managing its debt back to normal levels, and Central Asian Metals, a low cost base metals producer that is highly cash generative and a good yielder. Northbridge is a small oilfield services company that is benefitting from the recovering oil price after a difficult few years. During October, we initiated a position in healthcare stock Convatec following a profits warning. The company is involved in long-term growth areas and although faltering now looks very cheap against international competitors. Stock Spirits is a London listed Central European drinks producer that should benefit from the change in management seen over the past 2-3 years. We acquired Hydrodec, a small company which has promising technology in waste oil refining, as it was being refinanced having struggled until recently. The business has had a management change and in Q3 started to trade profitably. Market difficulties meant that this deal completed at a big discount to assets and we believe profits could improve significantly. We believe that if the economic difficulties continue this will give rise to more distressed opportunities, which may benefit the fund.

Management stories:

These are the companies where tried and tested management teams establish or continue to run companies and own substantial ownership of shares. When management teams own large amounts of shares they behave like owners and are more likely, we believe, to make the right decisions for the long-term shareholders. Management share ownership is also a common theme in the recovery and growth companies we own. DCC has been a great performer with management continuing to be very significant investors and they should continue to make acquisitions at attractive prices. We also made two investments in Jadestone and Savannah Petroleum, oil producers in Australia and Nigeria respectively. These companies have both bought assets at highly discounted prices from a large conglomerate and indebted vendor.

Growth opportunities:

When economic times are tougher, growth becomes more difficult to find for all companies, but we believe by investing throughout the market cap scale and with no sector bias the ability to find growth stocks increases. We added Prudential for its Asian Life insurance division, which is one of the best global insurance franchises. In the software sector, we have invested in Instem (regulatory software for the pharma industry), Tax Systems (compliance automation) Cloudcall (customer engagement) and Smart Space (desk management software).

In addition, we invested in Cakebox and Franchise Brands. These operate franchises in the field of selling cakes and drain clearance respectively. Franchise operations usually have excellent returns as they use third party capital, and are generally capital light. In the healthcare space, we acquired NMC (IVF and hospital operator in the Middle East), Consort Medical (drug delivery systems), Oxford Biomedica (gene therapy) and UDG (out sourced services for the pharma industry). Other growth stocks added in the service sectors were Bilby (building services), I-Energizer (Business Process Outsourcing) and Alpha FMC (financial markets consultancy).

October performance:

October was a difficult month for global stock markets. The FTSE All Share Index lost 5.12% during the month, whilst the fund returned -5.78%.* A generally nervous market saw a "risk off" attitude and a sell-off of higher priced growth stocks and out performance from utilities and other "risk on" sectors. During the month, there were positive trading updates from Alpha FMC and Cakebox both of which prices fell. Centamin's gold production figures were slightly worse than expected, but the shares performed slightly better than the market. Generally, the sell-off in US tech growth stocks lead to a de-rating of the UK's mid tier growth stocks. Although we avoided the majority of these companies, shares in Oxford Biomedica and Homeserve were negative contributors. Premier Oil was the worst performer as the oil price declined. The purchase of Convatec after a profits warning added some value during the month. In general, the fund's average cash holding of 10-15% offset the lack of defensive more stable sectors within the fund.

*Source: FE 01.10.18-31.10.18 Bid-Bid, net income re-invested. Benchmark: FTSE All Share GBP.

Sector: IA UK All Companies