Macroeconomic Commentary[1]

Global equities maintained their upward momentum throughout the second quarter as progress of the global vaccine rollout allowed many economies to gradually reopen. The MSCI World, S&P 500, FTSE 100 and Euro STOXX 50 indices were all up 7.7%, 8.5%, 5.6% and 5.2% respectively over the quarter. As markets rallied, rising inflation became a concern for investors as increased consumer demand, coupled with supply chain disruptions across the world, contributed to rising output prices. As a result, many central banks took a more hawkish tone. Although the US Federal Reserve sees the rise in inflation as transitory, it acknowledged the possibility of tapering bond purchases. Brent crude oil was up 20.7% over the quarter driven by increased demand and continued production cuts by OPEC+. In the UK, Prime Minister Boris Johnson announced the delay of "Freedom Day" until July 19th, due to a rise in new coronavirus cases caused by the Delta variant. Yields on UK and US 10-year bonds decreased by 13 and 27 basis points respectively over the quarter. The pound ended the quarter up 0.3% against the US dollar and down 0.7% against the euro.

Fund Commentary

We are pleased to report another successful quarter in both absolute and relative terms for the Credo Dynamic Fund (Dynamic), which returned 7.5% over the period[2]. The same period saw the IA Flexible Investment Sector (the benchmark and peer group) rise by 5.1%[3]. Dynamic's lead over its peer group currently stands at 11.8% since inception, where it ranks in the top quartile, as it also does over the last three, six- and twelve-month periods.

The solid performance over the period and last twelve months can be attributed to a combination of strong bottom-up investment selection as well as three core themes coming together:

1) Buying British

Having focussed our attention on the UK markets for almost twenty five years, we have built a deep network of trusted brokers, banks, analysts and salesmen, giving us access to high quality advice and to the UK capital markets be it for secondary fund raises, IPO's or simply a face to face update with the executive management team (pandemic permitting). Whether fixed income or equities we feel our main expertise lies in the UK hence this is where we tend to buy directly rather than via other funds as we do for our overseas holdings.

At the outset investors were informed that Dynamic will always retain a strong sterling bias. Many investors think in sterling, and international investors have earmarked their holding in Dynamic as a sterling allocation, so having a healthy dose of the portfolio in British companies avoids costly currency hedging or being at the vagaries of the FX market.

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(1) Source: Bloomberg.

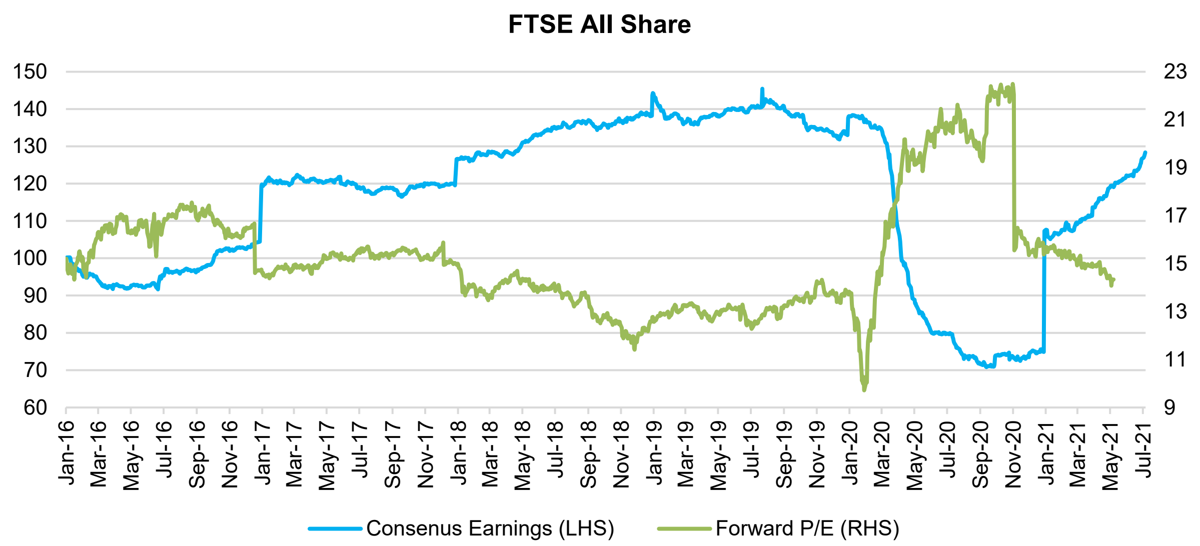
(2) Source: Bloomberg. Performance of the Credo Dynamic Fund A Retail GBP Share Class over the period 31/03/2021 to 30/06/2021.

(3) Source: FE Analytics.

The above are compelling reasons for Dynamic to have a substantial weighting to sterling and UK companies over the long haul. This, combined with relatively cheap valuations of UK companies, has encouraged us to add to our weighting in recent times. With the grey cloud of Brexit lifting, global companies and private equity have also noted the valuation disparity. Since January this year the UK has seen a combined value of £23.3bn worth of UK companies acquired. This is the fastest pace of deal-making since 2007. Canaccord Genuity's comments on the recent Morrison's takeover summed it up well by saying: "another week, another private equity offer".

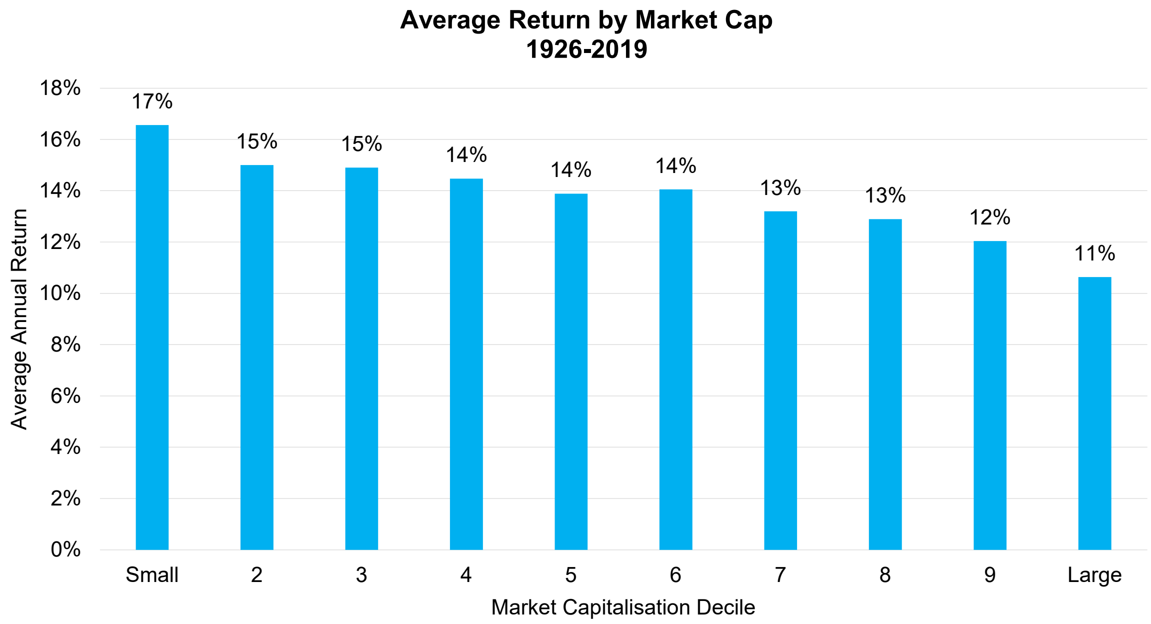
In the UK, we miss some of the glamour of the technology titans (which we can and do still access within Dynamic), but in a world of little value, we find the FTSE All-Share to be a breath of fresh air. The graph below illustrates that although we have seen a strong rebound in share prices, the earnings upgrades for the market as a whole have increased further than the share prices, leaving the market cheap on a 14.3x forward P/E.

Approximately a third of Dynamic's assets are UK companies and two-thirds remain in sterling.



2) Small is beautiful

As access to information and stock coverage become broader and better disseminated, it becomes harder to find an edge over the crowd. However, as one works down the market capitalisations, this information becomes more opaque, presenting an opportunity for dedicated investors to unearth some special situations that are not yet mainstream and might provide greater opportunities. Reduced liquidity and smaller balance sheets create more risk within our smaller company holdings, but greater risk often equates to better rewards; as evidenced in the chart below, the smaller the company, the higher the return over the long term.



Although smaller companies can prove more volatile, they tend to be driven more by underlying fundamentals rather than macroeconomic trends (certainly in normal conditions). Thus, in a highly diversified portfolio like Dynamic, it can be complementary to the broader portfolio. For this reason, the managers prefer a healthy exposure to smaller and midsize (SMID) companies, which roughly make up a third of Dynamic, although we should point out this is at the top of our range of comfortability. We have begun to trim some holdings in recent days and will continue to do so in the coming weeks due to outperformance of small over large-cap companies.

3) Bonds must have yield

In this exceptionally low-interest rate world, finding bonds that produce an attractive return is trickier than you might think. Although down from its peak of $18tn, there is still $13tn of negative-yielding debt. Although sterling and US dollar denominated government bonds can still generate a positive return, this is still notably lower than expected inflation. As yields are meagre, the capital prices can whip around more like an equity than a traditional bond. The below graph illustrates that a long-dated Austrian bond more than doubled from its launch in 2017 to the end of last year but has subsequently fallen 35% at its low point in May 2021. This type of volatility would have been somewhat unthinkable in recent years. Additionally, the negative correlation between bonds and equities has been called into question of late evidenced notably in the Covid-19 related melt down last March when Treasuries fell (albeit briefly) along with the market at a time they were "supposed" to have bounced. Finally, given the complexity and unknown benefits of negative interest rates, as things currently stand, it does not appear in the current thinking of the Federal Reserve or Bank of England rate-setters giving limited capital upside to bonds which are inversely correlated to rate moves.

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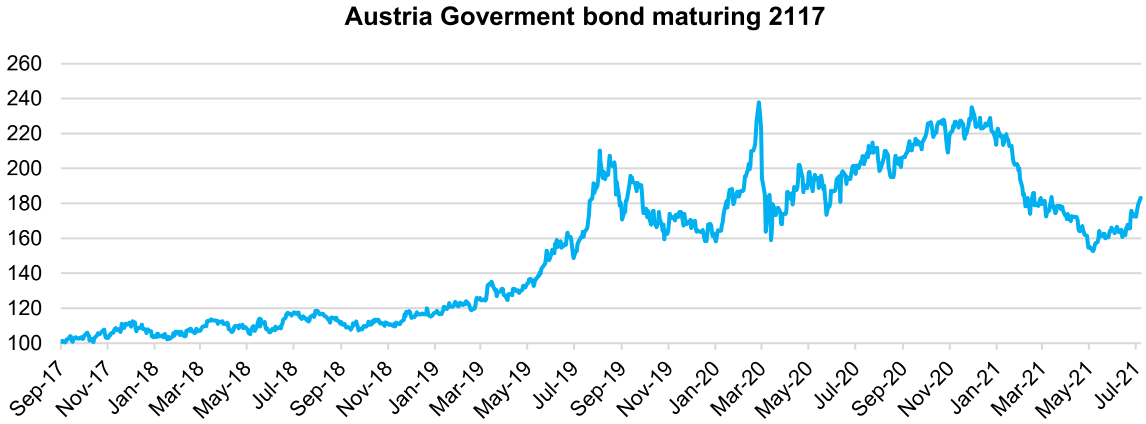

With such low yields and limited upside in a shaky market, we believe the risk-reward pay-off of government bonds looks unattractive both in their own right and in a broader portfolio context. The income bearing assets within Dynamic focus on corporate bonds due to their notably more attractive return which the managers favour over reducing volatility, which we do still achieve in a small way by investing in short-dated issues. Additionally, we seek exposure to income bearing, listed and liquid alternative assets. This income can be generated from a portfolio of supermarkets, digital infrastructure (for e.g. data centres), or a portfolio of battery assets aiding grid balancing. At the end of the period, approximately a third of Dynamic was invested in income-bearing assets such as alternatives or bonds, with the majority being in corporate bonds. We have no exposure to government debt bar a small tail position in a long-dated Mexican issue.

Winners and Losers

The quarter saw a broad breadth of winning positions with the ratio of stocks generating a positive return around 6 times to those with a negative return. As has been a common trend over the last twelve months, the largest returns have come from our domestic SMID holdings. This is particularly notable as these tend to be smaller weightings than the core equity holdings, which invariably tend to be other funds. Liontrust Asset Management plc (Liontrust) was the biggest contributor to performance with a gain of over 30% in the quarter. This UK based fund manager has had an enviable track record since its formation in 1984. A high-quality asset manager with 83% of its wide range of funds either first or second quartile over the last five years. This is partly a play on investing in the UK as a market because of the reasons above but additionally a play on ethical investing. The ESG arm (Environmental, Social and Governance) of Liontrust has been in full swing since the highly successful acquisition of Architas and this is a trend that is expected to continue as the next generation takes hold of the financial reins. Liontrust was bought at an attractive valuation towards the bottom end of its range at just 13x P/E. With a notable gain in a short space of time, we have top sliced the position as some of the valuation gap has closed and the position size has grown but we believe this could be a long-term compounder for years to come.

With the UK being very much in focus for corporate activity it was good to see two of our companies held announce bid talks with private equity over the period. Augean announced a takeover situation in May and was the number two contributor to performance. Another UK based value play, this small company provides waste management solutions and is the market leader in the highly specialised areas of nuclear waste. Whilst happy to see the shares spike on the news, private equity does not create the synergies that might occur with a trade buyer and therefore the price tends to be lower. No terms have yet been announced, but we are watching with interest.

Looking at the overseas portion of the portfolio, we had strong performance from Google after comfortably beating earnings expectations in April and enjoyed strong performance in our newest overseas position, Novo Nordisk, which plays on the global obesity market.

As mentioned, losing positions were minimal with the only notable upset being Best of the Best plc (BOTB). The company started life as the organiser of raffling supercars in airports. I have squandered a few pounds myself when waiting for a plane over the years. By luck, BOTB moved towards a digital format just before the pandemic struck, and results had been quite outstanding. We took a position when we felt the business was due a more "growthy" rating, but a concerning outlook statement not long after saw shares slide as demand for the game appears to be waning as the country reopens. It is too early to say whether we made a mistake in buying, but our confidence and conviction in the company was undermined. Thus, it felt prudent to reduce our position. BOTB cost Dynamic around 0.4% over the quarter, which was our costliest play since Covid-19 struck but palatable in the context of such a strong gain in the portfolio since that time.

Positioning

Overall, there was no meaningful shift in positioning over the period. Equities did creep up to 65% but this was down to strong performance rather than an addition of capital.

In fixed income, two of our issues have effectively been retired. Burford Capital Limited tendered for its 2022 issue. The position served us well but yielding under 2% at the tender price we were happy to move on to pastures new, especially as the 2024 issue in the same name offered us more than double the return. Additionally, Punch Taverns called its 2025 issue. This operator and owner of pubs was at times a nervous holding through the pandemic and its ensuing ramifications for the pub sector, but the company refinanced the bonds in recently kinder market conditions. Although bonds were tendered at a premium to market prices, our feelings were mixed as on the one hand we enjoyed a jump in capital, but on the other hand, we are unable to replicate the yields in the current climate without taking undue risk.

For reasons discussed above it does not feel like an ideal time to recycle the allocation into the bond market, so we have further increased the weighting to listed income-generating alternatives. Such funds offer a yield higher than bonds, less volatility than equities, and notably reduced correlation to the markets. Several funds are presently raising cash from the institutional market, allowing us to enter a position at a discount to the prevailing market price. The timing is serendipitous, and we expect to invest a large cash holding of 6.7% in this space in the coming weeks.

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Looking Forward

With markets continuing to make new highs, we have spent much time looking at valuations that are undoubtedly high by standard valuation methods. Whilst we have done some tinkering under the bonnet, we are not tempted to take wholesale profits. The Credo ethos is that timing markets cannot be done with regular success and the most likely path to this result should be to remain invested for the long haul. Whilst there will always be two sides to every coin, the current risks on the horizon include inflation and new Covid-19 strains. However, as mentioned, we do see value in the UK market as a whole and regularly come across situations that we believe are materially mispriced. Whilst expensive markets do not necessarily cause bear markets, they do tend to lead to lower long-term returns. Whilst we remain optimistic about the long-term opportunities, it would be realistic for investors to assume lower returns in the future compared to that achieved since the nadir of the pandemic.

Dynamic is currently loosely split between a third income bearing funds and bonds, a third global large-cap equities and a third UK SMID. We believe the portfolio is well-diversified and positioned, and this split offers an appropriate balance between opportunity and caution. As usual, a more granular breakdown is posted below.

Rupert Silver, Lead Portfolio Manager

Positioning

UK Equities	%
Aberforth Smaller Companies Trust plc Fcp	3.2
EKF Diagnostics Holdings plc	2.4
North Atlantic Smaller Companies Investment Trust plc	2.2
Liontrust Asset Management plc	2.1
K3 Capital Group plc	1.8
Total UK Equities	37.1

International Equity Funds	%
DBX S&P 500 Equal Weighted	4.3
Allianz Technology Trust plc	3.4
Veritas Funds Plc Asian Fund	2.3
iShares MSCI World	2.3
Worldwide Healthcare Trust plc	2.2
Total International Equity Funds	23.4

Overseas Equity	%
Alphabet Inc	1.8
Amazon.com	1.7
Novo Nordisk	0.8
Alibaba Group Holding-Sp ADR	0.5
Total Overseas Equity	4.8

Alternatives	%
Biopharma Credit plc	1.9
Digital 9 Infrastructure plc	1.4
TwentyFour Income Fund Ltd	1.2
Supermarket Income REIT plc	0.9
Real Estate Credit Inv. Pcc	0.7
Total Alternatives	9.4

Fixed Income	%
Co-operative Group Ltd 11.00% 20/12/2025	2.0
Aviva plc Preference Shares	1.6
Burford Capital plc 6.125% 26/10/2024	1.6
RSA Insurance Group plc Pfd	1.4
Lloyds Banking Group plc Preference Shares	1.2
Total Fixed Income	18.7

Cash	%
GBP	6.7
Total Cash	6.7

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