DYNAMIC
FUND

Macroeconomic Commentary[1]

Global equity markets were relatively flat over the quarter as much of the quarter's initial gains were erased in September when several risks came to the surface, such as increasing inflation, supply disruption and concerns over peak economic growth. The S&P 500 and FTSE 100 were up 0.6% and 1.9% respectively whilst the Euro STOXX 50 was down 0.1%. Central banks around the world delivered a hawkish shift with the Federal Reserve announcing it would start tapering asset purchases and the Bank of England suggesting it may put up interest rates, both before the end of the year. On the back of this narrative, combined with the progress of the vaccine rollout around the world, September saw a selloff in government bonds. Yields on US and UK 10-year bonds increased by 2 and 31 basis points respectively. Brent crude oil increased by 8.5% due to rising global demand being met with tight supply due to global lockdowns. The pound was down against the euro and the US dollar by 0.2% and 2.6% respectively.

Fund Commentary

We are pleased to report another positive quarter in both absolute and relative terms for the Credo Dynamic Fund (Dynamic), which returned 2.4% over the period. The same period saw the IA Flexible Investment Sector (the benchmark and peer group) rise by 1.3%. This performance puts Dynamic in the top quartile of its peers over the last three months and since inception where it leads the peer group by 13.4%.

Tinkering under the bonnet

With a little less gusto in the markets than we have recently become accustomed to, it was unsurprising to see less volatility in our holdings. Indeed, Liontrust Asset Management plc (Liontrust) was the only position to impact Dynamic's return by over half a percent. With little to write about in terms of contribution or attrition, we will use the opportunity to talk a little more about the changes within the portfolio at both the stock and asset class level, where we were quite active.

Typically, when we enter a new position, it is identified as a long-term hold or a short-term trading opportunity, but sometimes these lines can blur. Liontrust is a great example. This was acquired earlier this year, and as we wrote about the stock last quarter, we won't dwell on its merits again. As a brief reminder, this high-quality asset manager was bought due to its modest Price/Earnings (P/E) ratio and expected tailwinds from its popular range of ESG funds. The summer period saw strong inflows for the group, and Liontrust caught the attention of some deep-pocketed investors sending the stock up from our entry-level of around £13 to over £20 in just a few months. Liontrust has traded on multiple earnings between 13-17x P/E for many years, and this move took it right to the top of that range, where we started selling on valuation grounds. Typically, we build or exit a position to finesse the entry or exit price; this can be over a day or even weeks for a larger position such as Liontrust, a top ten holding. Fortunately, in this case, the stock kept on rising, and we kept on selling up until an intraday peak of £25.30 per share, where we exited the tail of our position. We purchased Liontrust with long term intentions; it is a fantastic company that one day may reappear on our roster, but after nearly doubling in six months and trading at a premium valuation, we felt there could be better opportunities elsewhere.

(1) Source: Bloomberg.

Fortuitously, while Liontrust seemed to be peaking, an opportunity appeared in another high-quality asset manager. We have followed Gresham House plc (Gresham) for several years now. We were drawn to Gresham not only because of its high-quality management who are well known to us, but its focus on sustainable investing, its strong historical earnings growth and due to the esoteric nature of the assets it manages. This includes everything from residential housing, energy storage for the national grid and tax-efficient forestry assets. These illiquid assets typically have higher fees, and investors must commit to long term lockups. Forestry is the best example of these characteristics; investors have a time frame of 15 years or longer linked to its relief from inheritance tax. Lastly, it was not lost on us that these assets are much less correlated than the typical asset manager, which felt prudent after such a strong market run.

The above rationale gave us good reason to think Gresham could outperform its peers, including the likes of Liontrust and to a greater degree in a weaker equity market. In September, we took part in Gresham's institutional roadshow meetings, as they raised money for the earnings enhancing acquisition of Mobeus VCT. We took the opportunity to recycle all the cash from Liontrust into Gresham, putting this company in our top 10 holdings. Regularly switching large parts of the portfolio increases turnover but is part of the active management style we embrace in a portion of the portfolio. Although it is very early days, Gresham finished the quarter roughly around our entry price, while Liontrust has fallen almost 16% since our final sale at the quarter-end. Liontrust's falls are partly due to a weaker UK stock market, giving some credence to our theory of lower equity-related risk.

Whilst we would describe the above situation as a switch, in the main Dynamic was a seller of shares over the quarter. Liontrust wasn't the only position we felt might have run its course for the time being. A combination of supply chain issues, climbing stock prices, increasing energy costs, bond yields and increasing Covid-19 cases (this last issue being more UK specific), we felt it prudent to take some equity risk off the table and protect some of the notable gains made during the last 16 months. The supply chain issue felt to be the most significant concern. We reduced the position size of several UK holdings that manufacture in Asia, where freight costs seemed to be getting highly problematic. Furthermore, we sold out entirely of Superdry plc, which we felt was our most exposed holding and had performed very strongly in the previous quarter. Additionally, we said goodbye to several positions of a smaller holding size to concentrate on our core conviction holdings. All in all, this led to a roughly 8% reduction in our equity exposure over the period, which takes us down to an allocation of 56.6% for Dynamic. One shouldn't infer from this that we have turned bearish on equities. There are many reasons to point to further strength in markets, such as strong economies, negative real bond yields and an incredibly accommodating Federal Reserve.

Takeover activity

Perhaps more importantly to the UK equities we own, which account for most of our equity portfolio, is the continuing trend for highly rated overseas companies and well-funded private equity houses acquiring lowly rated companies in the UK. Our most relevant example, Augean, was the number two contributor in the second and third quarters of this year after receiving a private equity firm bid in May. A small bidding war then erupted in August, culminating in an auction for the company and sending it higher again before its expected departure from the stock exchange in October.

An area that appears particularly ripe for consolidation is the sports betting market due to changing regulations in the US. Sports betting is one of the few areas where the UK is a global leader, and it wasn't too surprising to see a bid emerge this quarter for our holding in Entain plc (Entain). The acquirer (DraftKings Inc) caught some by surprise as this is a loss-making company with limited cash flows. Whilst Entain bounced on the news, it is still trading significantly below the £28 offer by DraftKings as the general perception is that the offer is too reliant on DraftKings' shares and too light on cash to get over the line. Whether it is DraftKings or other suitors such as MGM Resorts International, we think it's likely that Entain will at some point be swallowed up due to its strong cashflows and leading technology for online betting. We also took the opportunity to add 888 Holdings plc, which, if Entain does disappear from the stock market, could be the next takeover candidate. It is encouraging to see overseas buyers finding value in our domestic market.

Tapering

Each passing day takes us closer to the end of the exceptionally loose monetary policies which we have become accustomed to. November is seen as the most likely month for the US to start tapering its bond-buying programme and the UK to raise rates. The last 12 months have seen our fixed income exposure decline quite notably to a low of 20% of the portfolio as at the previous update. This is mainly due to the miserly yields available, especially with the tightening policy backdrop. Our current positions form a barbell portfolio where we have high yielding preference shares on the one hand, from a variety of quality UK financial issuers, and on the other hand, we hold short-dated corporate bonds with minimal credit or interest rate risk, which significantly outperform cash and help reduce the portfolio's volatility. Sourcing these bonds can be time-intensive for both the managers and our dealing team, as short-dated bonds are not easy to come by. The short-term maturity schedule increases turnover, but as managers, we focus on the total return after costs.

Our fixed income holdings ticked up from 20% to 22%. However, this is due to increasing exposure to short-term bonds ahead of several maturities in the fourth quarter. Our fixed income holdings are likely to breach the 20% low in the coming quarter, taking into consideration maturities, which feels sensible until we can digest central bank actions and commentary in November from both sides of the pond.

Transport and Tankers

With a notable reduction in our equity holdings and cash burning a hole in our pockets with negative real returns, we are highly reluctant to hold a significant cash pile. It became apparent to us to increase our exposure to alternative assets. We only access this asset class by listed funds. The investments tend to be slightly esoteric and apart from a small position in private equity, offer higher yields than the fixed income portfolio yet lower volatility than the equities, whilst also providing further diversification to the portfolio. We added to several holdings as well as introduced new investments over the period. Hipgnosis Song Fund Ltd is an old holding that is the largest owner of music royalty in the UK; it should have a minimal correlation to markets and will continue to benefit from the trend to streaming. Another holding we added to was Digital 9 Infrastructure plc, which takes its revenues from stable utility-type plays in the technology space such as data centres, subsea fibre cables and 5G networks.

We initiated a position in a property play, Aberdeen Standard European Logistics Income plc, which owns last-mile logistics warehouses in Europe. We think this could follow a similar path to our successful investment in the UK operator, Urban Logistics REIT plc, benefiting from the e-commerce trend where Europe trails the UK.

Taylor Maritime Investments Ltd (Taylor Maritime) is another holding to which we added. This investment will probably be a shorter-term play but, as discussed above, the lines between short term and long term can sometimes blur. As mentioned above, one of the main risks concerning us this quarter was the logistical issues of a post pandemic world. In the UK, it's probably the lack of HGV's that makes the front-page news, but the big issue globally is shipping. Whilst the Suez Canal accident had a severe impact there are simply too few container ships to deal with a huge upturn in global demand. The problem is worsened still as companies are drawn to the routes with the highest fees rather than the largest amounts of cargo. It became apparent that we might be able to find a company that would not only benefit from this increased demand but at the same time hedge the portfolio against this emerging risk. Initially we looked for a single stock and ran the slide rule over Maersk as an obvious candidate but felt too much of the good news had been priced in as this stock, which was historically anchored to its book value, was now trading at a notable premium to its assets. Within a few weeks of deciding against Maersk, we met the management of Taylor Maritime. This recently listed fund run by a dynamic and seasoned team, with deep expertise in the sector has a portfolio of ships they were renting out on a yield of approximately 20% from a portfolio of second-hand ships that could be bought below depreciated replacement value. With a high yield, exposure to a theme we wanted to play, and without the premium to book value we felt this was an exciting opportunity and the way we were going to play this out.

The increase to our alternative holdings has been quite material, moving from approximately 10% to 20% over the quarter. In total, we now hold 16 different holdings. We feel highly confident this will reward investors whilst significantly reducing the overall risk in a world where bonds, in their solitude, can no longer do both. The way we think about these holdings is that they have approximately half the risk of the equity market on average and help us deliver our mandate of equity-like returns (see target returns below) with lower drawdown than the equity markets. To give investors some understanding of the diversity and the dividend income return profile, we attach a breakdown of all these funds at the end of this update. The top ten holdings, along with our asset allocation, can still be found on the factsheet.

Tomorrow

Although assets remain high and headwinds to markets have marginally increased, we see nothing to change our view that equities will outperform all other assets in the long run as they have done throughout history. With a low weighting to fixed income over recent months, we feel our increased exposure to listed alternative assets leaves the portfolio in excellent shape and continues to offer the appropriate balance between opportunity and caution.

Rupert Silver, Lead Portfolio Manager

Listed Alternative Holdings

Asset Description	NAV %	NAV	Dividend	Target Return
Digital 9 Infrastructure plc	Digital Infrastructure	2.7%	5.6%	10%
Hipgnosis Songs	Song Royalty Income	2.4%	4.3%	>10%
Taylor Maritime	Ship Leasing	2.4%	5.5%	10-12%
Biopharma Credit plc	Drug Pharma Royalties	2.0%	5.1%	8-9%
Cordiant Digital	Digital Infrastructure	1.7%	3.0%	>9%
Aberdeen Standard European Logistics	European Mid-Box and Urban Logistics Warehouses	1.4%	5.0%	7.50%
TwentyFour Income Fund Ltd	Asset-Backed Securities	1.3%	5.7%	6%
Urban Logistics REIT plc	UK Urban Logistics Warehouses	1.2%	4.4%	7.50%
Oakley Capital	Mid-Market Private Equity	0.9%	1.2%	>8%
Gore Street Energy Storage	Battery Storage	0.8%	6.0%	10-12%
Real Estate Credit Inv. PCC	Property Lending Income	0.8%	7.8%	8-10%
Home REIT plc	Supplying to Homeless	0.7%	4.9%	7.50%
Downing Renewables Infrastructure Trust plc	Solar / Wind / Hydro Assets	0.6%	4.5%	6.5-7.5%
Supermarket Income REIT plc	Rental from Supermarket Stores	0.4%	5.0%	6%
Literacy Capital plc	Private Equity	0.4%	0.0%	>8%
Tufton Oceanic	Ship Leasing	0.2%	5.3%	12%