CRUX ASSET MANAGEMENT

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# TM CRUX UK Special Situations Fund

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## Market Conditions

Whilst the UK economic growth backdrop is below its long-term trend, it has recently outperformed previous expectations and the February Monetary Policy Report saw the Bank of England raise its profile for GDP growth across the forecast horizon. The latest GDP data suggests that the UK's 'very small recession' is already over, with surveys pointing to a recovery in activity around the end of last year.

UK inflation is falling faster than the Bank of England's forecasts published in November 2024 and wage growth has turned positive in real terms after the 'real incomes shock' of 2022. Inflation should continue to fall faster than real wage growth through 2024 and the falling gas price has stayed low, providing some relief to households. Consensus currently points to June 2024 as the beginning of interest rate cuts by the Bank of England.

The UK stock market has experienced 33 consecutive months of outflows and this has impacted investor behaviour in a number of ways:

1) There has been a significant rotation into defensive and large-cap companies. Bad news is punished disproportionately, even when a lot of bad news is already reflected in the share price.

2) Momentum has been outperforming value. Globally, capital has flowed into the US market which is led by the Magnificent 7 and flowed out of unloved economies such as the UK, with small and micro-cap companies hit hardest due to lower liquidity. The disparity in valuations between markets is well illustrated by insiders selling their own stocks in the US (Jeff Bezos $8.5bn, Mark Zuckerberg $135m in February 2024 & Peter Thiel, $175m in March 2024) and external institutions launching takeover bids in the UK with M&A activity up 88% YoY and almost half of approaches coming from overseas.


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3) Notwithstanding some remaining economic headwinds, out of favour cyclicals and small and micro-caps are frequently trading at cyclically low valuation multiples on depressed earnings. External buyers with a medium-term view are taking advantage of this through M&A.

Falling UK interest rates, currently expected to begin in June, should lead to a positive backdrop of value **and** momentum and a reversal of point 1 above. We have seen the start of a recovery in mid-cap cyclicals, but this is yet to flow down into the small and micro-caps which make up around a third of the fund.

## Fund Performance

Over the period under review, the TM CRUX UK Special Situations Fund (I Accumulation GBP) returned -3.2% against its performance comparator the IA UK All Companies Sector return of 2.9%.

After a rally towards the end of 2023, the UK market moved lower over the first two months of the quarter as the UK was confirmed to have entered a technical recession and overly optimistic interest rate expectations settled. The UK market picked up again during March following more encouraging economic data. The fund's large allocation to mid and small-cap, representing c. two-thirds of the fund, was generally unhelpful for performance over the quarter as these segments of the market were outperformed by large-cap. In particular, the AIM market, where the vast majority of the fund's small-cap exposure is invested, was down over the quarter, albeit on a more positive note UK small-caps experienced the first month of net inflows in February (March data TBC) after more than 2 years of net outflows. As discussed above, in an environment of improving economic conditions and falling interest rates, we would expect the mid and small-cap segments of the fund to outperform materially.

Performance was held back by three notable detractors which reported disappointing trading updates. Watches of Switzerland was the largest detractor over the quarter, down c.45% and detracting c.1.6% from performance, after reporting that sales were weaker than expected over the Christmas period and these trends were likely to continue for longer than originally expected into 2024. Management also noted that their original forecasts for 2024 were inaccurate due to overoptimism regarding the supply of higher priced watches from Rolex.

Small-cap Jadestone Energy was down c.35% during the quarter and detracted c.0.8% from fund performance. Jadestone announced that 2023 production was above guidance and that year-end net debt was lower than consensus expectations. However, the most material news was increased life of field cost estimates at 2 of their oil field assets, due to a higher work-scope and inflation. The resulting reduction in Core NAV to c.50p per share remains materially higher than the prevailing share price of c.24p. The company has recently entered into a process to acquire a large oil producing asset which could be transformational for the business.

One Savings Bank (OSB) was another poor performer during the quarter following softer guidance for 2024 and the shares down c.19% over the quarter, detracting c.0.7% from fund performance. A lower Net Interest Margin was guided for 2024, driven by the fixed deposit book repricing and the market getting more competitive in deposit taking. Although disappointing, the shares were already trading at a low level with difficult trading already priced in in our view. With a c.12% cash return


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expected in 2024, we believe investors are being well compensated whilst the shares are valued below book value which is far too low in the context of a return on tangible equity of c.20%.

Prudential has been a frustrating position in the fund with the shares having risen from c.£8 at the October 2022 lows to c.£14 at the beginning of 2023, only to get caught up in the China/Hong Kong outflows during 2024 and slip all the way back to c.£7.50. The shares were off c.15% during the quarter and detracted c.0.7% from fund performance. Prudential had a much anticipated trading updated towards the end of March and results were above expectations but the shares did not respond due to the announcement of further investment for growth and limited attention from management on the share price in the form of dividends or buybacks. The shares trade at a very significant discount to Prudential's closest peer and some analysts see >100% upside from current levels.

AdvancedADVT was the strongest performer over the quarter and was also a large position in the fund, up c.55% and contributing c.2% to fund performance. The shares recommenced trading in mid-January, having been suspended at 82p following the acquisition of 5 software businesses from Capita which constituted a reverse takeover. The shares were valued at a discount to cash at the time of suspension and bounced c.20% immediately on resumption of trading. Since then, the shares have made more progress as a trading update outlined performance that was ahead of expectations, significantly aided by pricing action taken by management. We expect further progress to be made with the acquired Capita businesses over the medium-term and with a substantial cash balance remaining, we expect additional acquisitions to be made at attractive valuations.

Barclays was another strong performer over Q1 2024, up c.23% and contributing c.0.8% to fund performance, following the announcement of ambitious growth targets, restructuring and £10bn of capital returns from 2024-2026 following the conclusion of a strategic review. Despite the recent rally, the shares remain well below NAV and should the goals of the strategic

## Transactions

In terms of transactions, the fund's position in Ascential was exited during the quarter, taking profits after the strategic break-up of the group acted as a catalyst towards the sum of the parts valuation thesis. The proceeds from this disposal were redeployed in financial solutions business Alpha Group which has performed very strongly and is up c.23% since its addition. Alpha Group's recent trading update was in line with expectations and the shares trade at a significant valuation discount to peers. Alpha Group are in the process of transferring the shares' listing from AIM to the main market which could act as a short-term catalyst as this opens up a broader investor base.

Vistry was sold from the portfolio during the quarter on valuation grounds following a strong run. A significant sale of shares from the CEO also contributed to our decision. Marshalls, Breedon and Savills were all added to the portfolio to add exposure to housebuilding and construction which should benefit from activity picking up as interest rates fall. We have particular conviction in Breedon which was added to the portfolio following the announcement of the firm's first acquisition in the US at an attractive valuation. We believe this represents the beginning of the next phase of growth for Breedon, transitioning from the UK aggregates market which has been through decades of consolidation to the US aggregates market which remains highly fragmented.


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Chemring was sold on valuation grounds during the quarter following a very strong run since October 2023. The proceeds were used to participate in a secondary placing of shares, by Private Equity backers, in TI Fluid Systems which took place at a c.20% discount. This was an attractive opportunity to add industrials exposure at a low price. TI Fluid Systems' management are delivering what they said they would deliver, with the 2026 revenue target now clearly in view. With even more ambitious targets set for 2030, this profile is not adequately reflected in an EBITDA multiple of <4x, notwithstanding economic headwinds remaining in the short-term.

Watches of Switzerland was sold from the portfolio during the quarter. Although we believe the share price is well below intrinsic value, the proceeds were used to increase the fund's exposure to the industrials sector further through buying shares in Victrex which is also materially undervalued in our view. The shares trade at the lower end of historic valuation multiples, on depressed earnings and also carry an attractive dividend yield. Despite destocking challenges in the recent past, there have been signs of volume progress in Q1. Small improvements in volumes have the potential to significantly improve profits.

Although still a holding in the fund with very strong prospects in our view, we took the opportunity to reduce the weighting to AdvancedADVT during the quarter to crystalise profits and redeploy the proceeds as above.

## Outlook

The fund is well positioned for an economic recovery and falling UK interest rates, currently expected to begin in June, which should lead to a positive backdrop of value and momentum and a reversal of the outperformance of large-cap defensives experienced over the past couple of years. The fund's process highlights undervalued cyclical and mid/small/micro-cap companies which have been through a difficult period but are primed to outperform as positive sentiment and earnings momentum returns to these shares.

Fund's managed by Richard Penny have historically outperformed significantly during economic recoveries with the L&G UK Alpha Trust returning c.173% trough to peak following the Global Financial Crisis in 2008/2009, outperforming the IA UK All Companies Sector by c.88% and the TM CRUX UK Special Situations Fund returning c.151% trough to peak following the COVID-19 pandemic, outperforming the IA UK All Companies Sector by c.75%. We believe that valuations being close to historic lows in the UK, 33 consecutive months of outflows depressing share prices and being on the cusp of UK interest rate reductions and an economic recovery sets up the potential for a similar phase of outperformance for the fund. External institutions launching takeover bids in the UK, with M&A activity up 88% YoY and almost half of approaches coming from overseas, is a strong indication of value and should help to mitigate the impact of outflows from the UK market in the interim.

Although the fund was 'too early' in pivoting towards a cyclical recovery, we believe that falling interest rates will be a strong catalyst to encourage investors to look through to the significant medium-term potential of cyclical businesses.

As has been the case in the past following downturns, we expect the small and mid-caps within the fund to be a key driver of performance in the event of an economic recovery. Small-caps outperform over the long-term, hence the 'small-cap premium', but are more volatile in the short-term and therefore historically periods of weak performance should have been seen as significant buying opportunities. We believe this is true of the current UK small-cap market having experienced the 4th worst AIM performance on record since 1995 in 2022 (down c.32%) and another negative year in 2023 (down c.8%). The 5-year return


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for AIM was c.-19% as at the end of Q1 2024. Historically, when the 5-year historic return for small caps turns negative, the average subsequent returns over the next 1, 3 and 5-year periods have been >50%, >120% and >260% respectively.


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