Orchard Fund December 2018

"A year end review"

At the end of each month we write a monthly commentary and provide a brief description of our top winners and losers. In normal times it allows us to communicate our thoughts as well as providing our investors with some insight into what is affecting the performance of the Fund. These are not normal times and as such we are not going to do that this month but instead are going to provide a series of questions and answers which we hope will give you a much greater insight into what has happened in the last year.

Before progressing any further, we would like to assure you that this is not a fancy piece of marketing fluff but an honest reflection on what has been a horribly difficult year for the Fund second only to 2008 in performance. It was as unwelcome as it was unexpected, and we have been asking ourselves what we could have done differently to achieve a different outcome. So lets start with the facts. In 2018, the Orchard Fund fell by 11.59% as equity markets worldwide fell. In December alone, we fell 6.70% as the US equity market in particular suffered a sharp sell off. We sent out an investor update during the month entitled "the Anti -Santa rally" which outlined our thoughts at the time.

What made this performance particularly disappointing was that we didn't perform as we would have expected to and as we did in 2008 when we were able to mitigate the majority of the losses. This year we were caught in the markets crosshairs.

There are, as ever, multiple reasons for the different performance in the two years and we will try to examine those in detail in the rest of this report. We believe that by presenting our investors with an honest appraisal of what has contributed to the performance, they are best positioned to decide whether the Fund is still the right fit for their portfolio.

We understand that performance talks but we believe that despite a tough 2018, there are significant reasons to believe that both equity markets in general and the Orchard Fund in particular now represent compelling value and that patience is likely to be rewarded.

In this document we have tried to answer the questions which we would ask of a manager. If we have missed any, please let us know and we will answer those. We have our money invested alongside yours and whilst last year was uncomfortable, we expect better times ahead. History shows that on the rare occasions where the Orchard Fund has suffered significant drawbacks, the next few months see sharp recoveries. We do not expect this time to be any different and believe that the Orchard Fund is well positioned to benefit from any bounce back.

Fund Facts

Launch Date
14 January 2003

Lead Fund Manager
Richard Harwood
MitonOptimal Jersey Ltd
(since inception)

Fund Structure
UCITS V

Domicile
Dublin

Currencies
GBP, USD, EUR, CHF

Administrator
CACEIS Ireland Ltd

Dividend Yield
Target 6.%
2018 Est 6.18%

Dividend Policy
Distribution

Dealing Days
Daily

Fund AUM
£47.5m

Min Subscription
50,000 for individuals, 10,000 for platforms and designated bodies

MitonOptimal

Orchard Fund December 2018

Why was 2018 so difficult for the Fund?

There were several reasons for last year's performance, some within our control and some beyond. The biggest single factor was that the area of the market in which we invest was one of the worst sectors in 2018, contrary to our expectations ,when markets fall. Value as a single factor lost over 14% last year at a time when traditional wisdom would suggest that is should have out-performed a falling market. For the second time in three years hedging caused us to under-perform our peers as sterling fell sharply and we did not enjoy the benefit those who do not hedge enjoyed. The third factor was that the decline came after an extended period of low volatility which meant that the margin of safety which we had been able to build into our trades, had fallen as we were not being paid as much for our commitments as we would be in normal market conditions. Finally, and this is where we have to hold our hands up, we misunderstood the magnitude and rationale of some of the declines in some of our holdings and in hindsight, we would have cut certain positions earlier.

So if value as a factor under-performed when it should have out-performed, why will it be different in 2019?

The market has fads and whims and certain factors will perform well at certain times but ultimately value is value. If you buy a good company at a good price, ultimately it will be a good investment. The sell off in December, which accounted for over half the year's losses was a combination of thin volumes and panic despite the spike in volume on the 20th and 21st. The rally in the US on the 26th, when the market rallied almost 5% in a day was equally illogical. During these periods, large liquid stocks which can be easily traded are the first stocks to be sold and then bought. As markets become more liquid, normality returns and investors regain a more normal sense of perspective. In that sort of market, value re-establishes itself. We have seen this post Christmas and in the first few days of January.

However, the most important reason to stick with value is that the world is changing. Value should be a solid and steady performer but in the period since QE commenced in 2009, it has been anything but. That is because if money is cheap, there is no reason to concentrate on value as a rising tide floats all boats and the promise of future earnings is easier to buy if the financing costs are cheap enough. One of the methods of valuing companies is to discount earnings back to present value. When interest rates are low, the value of earnings in five years is almost the same as those earnings now. As such companies which are not making money now but promise to make lots of money at some future date appear more attractive than a dull and steady stock churning out profits now. In more normal times which we are rapidly returning to, the old adage of a bird in the hand is worth two in the bush rings true.

Such concepts can appear abstract and difficult to quantify but there are real numbers to back this up. Using value as a single factor for choosing stocks would have seen you lose money over one year, broadly breakeven in real terms of 7 years but make a remarkable 144% over 15 years, which means that in the years between 2003 and 2011, despite the stock market crash of 2008, value added well over 100% return in just 8 years. Over that same period, growth lost 9% over the same period.

If hedging has impacted performance again, why do you persist with hedges?

Although our policy of hedging hurts relative performance, it does not impact actual performance. Others may have currency windfalls or losses but by hedging, we negate those. It would be very easy to choose to not hedge but with an outcome of Brexit looming, we know currency markets are likely to be volatile. By hedging, we ensure that our investors are not impacted by this and whilst that may mean we miss out on a potential windfall, more importantly, it means that we will not have to explain a decline in value if the Pound rallies sharply. It may be the conservative route, but we believe that hedging is the right route.

So what stocks did you get wrong and why did you not cut them earlier?

This has been a tough year and there have been plenty of stocks which cost us dearly. General Electric was one of the worst where we failed to fully understand the magnitude of the problems inherent in both the remaining and the sold businesses. We invested in the stock following the sale of the financial businesses believing that this left a focussed industrials business. Not only were we too slow to realise the inherent problems of the industrial business but we also failed to properly quantify the extent to which the disposed of financial services businesses would return to haunt the business with continued write offs for many years after the sale. We should have cut that position earlier and in hindsight we would have.

Unfortunately, cutting positions can often come back to haunt you as the recent takeover of Celgene by Bristol-Myers Squibb highlights. We held Celgene for most of last year and part of this year as we believed that the underlying business was sound but a series of disappointing results persuaded us that this was a vale trap that no matter how cheap it was seemed to get cheaper. We cut it and continued to see it struggle until Bristol-Myers Squibb made a takeover bid which recognised the value we had always seen in Celgene.

We pride ourselves on being driven by fundamentals rather than price action and so long as the fundamentals remain sound, we are inclined towards being holders of the stock but we are mindful of not being caught in value traps which are cheap stocks which just keep getting cheaper.

Why are you confident that the portfolio will recover ?

We have been running the Orchard strategy for many years and have gained many grey hairs along the way. It is rare that something happens now that we have not seen at some point in the last 17 years and whilst we acknowledge that history doesn't repeat itself, it has a habit of following very similar lines. The sell off we saw in December was driven by panic and low volumes. That has now passed and we are seeing more rational assessment of the markets and stability returning. We also know that when investors need to sell, it is the most liquid stocks that get sold first. This has again happened in 2018. Since the market has returned to more normal activities we are seeing those stocks benefit disproportionately and return to more normal levels. We have a portfolio which has real value. The P/E ratio is on average 15% cheaper than the market which has itself returned to more normal levels, and if we exclude our one growth holding in Amazon, that number falls dramatically further.

If you are a value investor, why do you own Amazon?

That is a fair question and any stock that trades on a forward P/E of 59 is most certainly not a value stock. However, in the portfolio as a whole we are most certainly at the cheaper end of the scale and we consider Amazon to be an exception to the rule, indeed to most rules. Amazon has a high P/E, not because it doesn't make profits, it makes plenty, but because it has chosen a path of massive investment spending almost everything that it generates. 2018 was the year when that started to change and the investment community is slowly starting to realise that Amazon is turning on the profitability tap. At the beginning of 2018, the average analyst expected Amazon to generate $8 of profit in 2018. By the end of the year that had increased to nearly $20 of profits for the year. Equally, they expected profits for 2019 to be $14 which have now been upgraded to $26 a share. I am sure that those numbers significantly understate Amazon's profitability, not because we are all buying more from Amazon, but because the millions of dollars of investments that have been made over the last decade are starting to be monetised. Once that stream of income starts flowing, it will be a very long time until it stops. We have agreed to buy Amazon at $1700 and $1550 until April 2019. The current share price is $1656.

Which stocks are you particularly excited by for the year ahead?

That is a good question and one which I could take up several pages on. From a value perspective, we have 13 stocks with single digit P/E ratios which all enjoy good earnings growth. Easyjet has never recovered from its Brexit inspired sell off despite an exceptional business model. Whilst Free Cash Flow will turn negative over the next couple of years as Easyjet expands its fleet further, this is not an issue for a company which has net cash on its balance sheet. Having been initially regarded as cheap and cheerful compared to the established airlines, the gap between the service has now diminished that I recently heard British Airways described as "Easyjet without the efficiency". Despite lower oil prices leading to lower jet fuel prices, Easyjet languishes towards the bottom of its one year range. We believe that greater clarity over Brexit and continued solid trading conditions will see a significant re-rating of Easyjet whose P/E multiple fell by over 40% in 2018.

In the US, Capital One Financial and Discover Financial Services are amongst our top choices for the year ahead. Both trading on P/E ratios of 7.43 and 8.4 respectively with earnings growth that will see those fall to 6.93 and 7.82 next year. Both companies have been hit hard this year by expected bad debt write offs associated with a significantly slowing US economy. We don't believe that the US economy is slowing anywhere near as much as the markets are predicting or that bad debts are likely to rise materially. Both of these stocks are pricing in the disaster scenario and it appears to us that is unlikely to materialise.

British Land is another victim of Brexit uncertainty. With some companies, it is difficult to quantify exactly how much bad news is baked into the price but with British Land, because it is a REIT, that uncertainty is removed. British Land is currently trading on a discount to net asset value of over 45%. That means that even if their retail offerings fell 65% and their office blocks and other industrial assets fell 30%, it would still not reduce the NAV down to the current share price. Markets hate uncertainty and with Brexit negotiations dragging on, it is easy to understand why the share price is depressed but regardless of your pessimism about the outcome of Brexit, it is hard to argue that the current share price is not baking in all the worst news and quite possibly more. A well covered dividend yield of 5.6% makes this an easy hold with the prospects of better times ahead.

The final stock we would like to note is Skyworks Solutions. Skyworks is a wireless semiconductor company who design and manufacture radio frequency and complete semiconductor system solutions for mobile phones. One of their big customers is Apple so as a result of Apple's announcement, their share price is severely depressed and that simply makes no sense given not only their existing products but also their pipeline of new offerings for 5G. They will undoubtedly be affected by the slowdown in the smartphone market but the market is currently pricing in a doomsday scenario which looks unrealistic.

** Update.

While this document was being drafted, Skyworks Solutions has issued a profit and revenue warning announcing that their profits and revenue would fall by 3-4% from previous estimates. This has seen the share price rise by 4%.

If you have been disappointed by the results this year, what will you do differently?

This has been a tough year and there have been plenty of times where we have questioned ourselves. Clearly, we did not factor in the multiple contraction which has been seen across all major markets. Ignoring company specific news, we have seen the S&P 500 P/E multiple contract by 30% this year falling from 22 to 16 as earnings rose and prices fell. In the UK that fall was slightly more dramatic with the FTSE 100 P/E ratio falling from 23 to 15. There is no point looking at the fundamentals for a particular stock if the market is going to re-rate by 30% en masse and take your holding with it. As such, we will be modifying our process to build market multiples into our process for deciding what is the appropriate level of safety we need on our future investments. Whilst it is difficult to predict where market sentiment will move at any given time, all major stock markets are now at levels which mean that unless earnings start to fall (they are currently forecast to rise 7% in the next quarter) then the markets as a whole do not look expensive and as such, it will be easier to focus at a bottom up level.

Will Brexit materially affect the Fund ?

Like most things to do with Brexit, it is very difficult to know. If the UK pursues a hard Brexit, the Pound will again fall and our hedging will once again negate a possible upside surprise. If things develop towards either a softer Brexit or even a second vote resulting in no Brexit, the Pound has significant upside and our hedges will serve us very well. At Company level, Easyjet and British Land are our two Brexit exposed holdings and could both suffer further in the event of a hard Brexit but we have insulated the Fund as much as we can from what we consider to be a binary outcome.

The Fund finished the year with a very high cash weighting. Why?

We are mindful of the saying that markets can remain irrational longer than you can stay solvent so in the last quarter of 2018, as commitments expired worthless, we did not re-commit that capital. Despite that, our delta, the measure we use for our effective exposure to the market which we target to be below 50% of the market finished the year above 60%. This is a reflection of the sell off in December which moves our delta higher. One of the advantages of the Orchard methodology is that our exposure to the market increases as the market gets cheaper and decreases as the market rises and becomes more expensive. Given that one of the basic premises of investing is to buy cheap and sell expensive this seems like a sensible way forward.

You have higher than average allocation to actual stock. What does that mean to the Fund?

As the markets have fallen, stocks have fallen below the levels at which we agreed to buy them and as such, we have taken delivery of a lot of stock. This is not an issue. We have cash to back up any commitment we make and we have only agreed to buy stocks at levels at which we considered they offered value. It is however, a double edged sword. We generally receive a much higher income for selling puts than we do for selling calls, but on the other hand, being owners of the stock, we receive the dividend and are able to write calls, but also importantly, we write calls well above the current market price which means that as the market rallies, we enjoy much of that upside unlike when we only have puts in the portfolio. We know that on a long term basis writing puts is the lower risk and more profitable strategy, but when the market has fallen as quickly as it did in December, it is a good time to position yourself to take advantage of any upside.

Why is the dividend policy so high and is it sustainable?

The simple answer to that is that we significantly under-estimated how long we would live in a low interest rate environment and we continue to be wrong. We had assumed that interest rates would have normalised by now. In a normal environment we would expect at least 60% of the Fund to be in cash to support our put option commitments. When we set the dividend policy, we assumed that neutral UK interest rates would return to 5% which based on the previous 30 year data was a neutral expectation. As such, we expected to generate 3% per annum of returns from our cash holdings. As investors know, that has not been the case and for a long time we earned nothing on our cash holdings. As such, our returns have been lower than expected.

If our assumptions had been right, the capital of the Fund would not have eroded and the dividend, which we have kept constant since inception, would not have risen to such a high level. We should have been quicker to address this situation, but we were reluctant to disappoint those investors who rely on the fixed dividend amount to live off. As such, we have not cut the dividend but in light of the poor year last year, that is no longer sustainable. Some share classes are now paying dividend yields of close to 10% and that is too high.

The best way to adjust this is currently under consideration and we will expect to be communicating with shareholders in the near future. The dividend change will be notified well in advance to minimise inconvenience to all involved.

Although a reduction in yield is inevitable the high income which the Fund produces will allow us to maintain an above market dividend yield whilst aiming to rebuild our investors capital.