Active Banking Fund

THE ACTIVE BANKING FUND

Annual Performance Report

August 2018 – July 2019

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Fund’s Performance in last 12 months

Performance review period: August 1st 2018 – July 31st 2019	
Fund’s gross performance (after trading commissions and hedging costs)	**-5.88%**
Charges • Investment management fee • Administration fee • Other charges (regulatory & compliance fees)	 1.00% 0.72% 0.10%
Net Fund Return	**-7.70%**

A very volatile period – Markets impacted by trade war fears

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Period	Fund performance
Aug 2018 – Dec 2018	-20.1%
Jan 2019 – July 2019	+15.5%
Jan 2019 – to date	+16.7%

- As US-China trade war fears started intensifying in the last quarter of 2018, US stock markets dropped sharply in December 2018 on fears of a global recession and higher US interest rates. December 2018 was the worst December for US stock markets in almost a century.

- Recession fears subsided substantially in the first quarter of 2019 as the US Federal Reserve indicated a pause in interest rate hikes and as US economic data continued to be strong. By April 2019, most of December's US stock market losses had been recouped.

- Despite the recovery in stock markets and investors sentiment in 2019, short-term volatility reemerged in May and August 2019 as the US announced additional tariffs on Chinese imports. Volatility will persist for as long as the trade war continues, however the sharp December pullback was a one-off event unlikely to be repeated as recession fears were excessively overblown.

Fund's performance by portfolio/geography

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The Fund remained invested in US banks, European banks and Canadian banks throughout the 12-month period. The fund's investment mandate remains unchanged, to be a diversified fund investing in various geographies in high quality banking stocks which are undervalued or fairly valued. The fund has substantially outperformed the benchmark indices in all geographies during the 12-month period.

Portfolio/geography	Average size over 12-month period (% of Fund's NAV)	Fund's performance for reporting period	Benchmark index performance
USA	43%	-4.3%	-7.2%
Europe	22%	-17.7%	-24.6%
Canada	15%	+5.3%	-2.4%

US banks portfolio

❑ The Fund's US banks portfolio outperformed its US banks index benchmark (KBW Nasdaq Bank Index) during the 12-month period, primarily by taking short-term positions and locking in profits on stock rebounds; the US banks index dropped sharply in the period August to December 2018 (-22%) but recovered substantially in the period January to July 2019 (+19%) as US economic data remained strong despite Chinese imports tariff hikes. The recovery was also helped by sizeable share buybacks and dividend payments announced by all big US banks in June 2019 (driven by capital surpluses and ongoing strong profitability).

European banks portfolio

❑ The Fund substantially outperformed its European banks index benchmark (SX7E Stoxx Index) during the 12-month period; the Eurozone banks index dropped 24% in the period August to December 2018 driven by global trade wars escalation fears, Brexit and the ECB indicating that it would delay eurozone interest rate hikes well into 2020 because of persistently low eurozone inflation and anaemic eurozone GDP growth. Unlike its US counterpart, the Eurozone banks index failed to recover in 2019 (down 0.6% in the period January to July 2019). The fund's outperformance vs the Eurozone bank's index during the period (by 7%) is because of continuously being invested in high quality French, Dutch and Belgian banks paying substantial dividends. The fund received an average 4.5% net dividend yield on its European stock holdings in this 12-month period. Most problematic southern European banks are still unable to pay dividends.

Canadian banks portfolio

❑ The Fund substantially outperformed its Canadian banks benchmark during the 12-month period (by 8%), partly because of a net dividend yield of approximately 3% on its Canadian banks investments and partly due to short term profit-taking on share price rebounds and re-entering at lower prices. The fund's benchmark is the average arithmetic performance of the share prices of the big four Canadian banks.

Outlook - US

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US banks now fairly valued

- US banks are now fairly valued following the rebound in the US banks index in 2019. We remain a bit cautious on US banks over the last quarter of 2019 until we get more clarity on the outcome of the US-China trade negotiations and on US interest rates. The Federal Reserve has cut its benchmark interest rate by 0.5% year to date but it is unclear if more rate cuts are coming.

- Moving forward, the share prices of US banks will be positively impacted by a further steepening of the US yield curve (which has now normalized after becoming negative earlier this year) and by sizeable share buybacks which support share prices by reducing the share count. The major risks for US banks are a substantial slowdown in US growth driven by higher US tariffs on Chinese imports and higher inflation. However, the US economy has not yet been particularly hit by higher tariffs and it is expected that a trade deal with China will be reached within the next 12 months (before the US presidential election in 2020) as president Trump would not want to jeopardize his re-election chances by keeping tariffs in place (tariffs on Chinese imports have already started hitting US consumers).

Fund's US strategy

The fund's strategy regarding US banks remains unchanged. For as long as volatility persists and US banks remain fairly valued, the Fund aims to outperform its US benchmark by taking short-term positions and locking in profits on rebounds. US stock market pullbacks and rebounds are now highly correlated with trade war news which provides short-term investment opportunities for actively managed funds. The Fund only enters US banks on a more long-term horizon (3-6 months) whenever there are sharp price pullbacks like the one in December 2018.

Outlook - Europe

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European banks likely to remain undervalued – Fund has cut its European banks exposure by 40%

- European banks remain very undervalued having failed to recover in 2019. The main reason for this has been the ECB indicating that it will keep eurozone interest rates in negative territory until at least late 2020.

- European stocks continue to substantially underperform US stocks as almost all fund managers (the Fund included) have lost patience with the eurozone despite extremely low stock valuations. Persistently negative interest rates by the ECB are now seen as a curse for the eurozone as they penalize savers and insurance companies and hit European banks profitability, thus curtailing lending growth.

- The current P/E and P/B valuations of most European banks are at their lowest ever but there is still no catalyst to drive share prices substantially higher. The Eurozone banks index hit its lowest level ever on August 15th 2019 before rebounding. However, with Eurozone interest rates persistently negative, and based on past performance of the Eurozone banks index, 10%-15% rebounds from new lows are unlikely to last for more than a few months as investors are now extremely negative towards the sector and European stocks in general.

Fund's European strategy

The Fund has finally given up on persistently underperforming European banks which have been negatively impacting the fund's returns since we re-entered European stocks in May 2017. In view of the ECB stubbornly refusing to increase eurozone interest rates from the current -0.6%, the Fund decided in May to reduce its Eurozone investments by 40% (from 26% of the fund's NAV at the time to 15% currently) and increase exposure in Canadian banks where performance has been consistently vastly superior.

Outlook - Canada

Canadian banks an attractive long-term investment

Canadian banks remain a very attractive long-term investment and look fairly valued right now on a P/E basis. The fund's Canadian banks P&L hit an all time high in late September 2019 due to a successful combination of buy hold to earn dividends coupled with short-term position taking on price pullbacks. Canadian banks share prices are less volatile than US and European banks and tend to be range bound which makes them very attractive investments on price pullbacks, aiming to exit within 1-3 months from entry.

Fund's Canadian strategy

As from May 2019, the Fund increased its total exposure to Canadian banks (buy hold plus short-term positions) from 10%-15% to 20%-25% of the Fund's NAV, to make up for the 11% reduction in its European exposure.

Fund’s top 10 holdings in the 12-month reporting period

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Bank	Country	Current P/E	Dividend yield	Investment rationale
Citigroup	US	9.6	2.9%	One of the most undervalued big US banks; annual share buybacks amount to 8% of market capitalization
Wells Fargo	US	10.4	4.0%	Remains undervalued vs its long-term average P/E of 12; has just appointed a very competent new CEO
Goldman Sachs	US	8.8	2.4%	Remains extremely cheap despite profits becoming less volatile following its movement into retail banking
JPMorgan Chase	US	11.9	3.1%	The world’s best bank; massive profits, wide product range and ongoing product innovation
Morgan Stanley	US	9.3	3.3%	Undervalued despite a substantial increase in profits in the last two years; a very high quality investment bank
Bank of Nova Scotia	Canada	11.5	4.7%	Share price has rebounded recently following strong performance in its international business
Bank of Montreal	Canada	10.4	4.2%	A well managed and conservative bank with a very solid retail banking business in Canada and the US
BNP Paribas	France	7.3	6.8%	The best of Europe’s diversified megabanks; very profitable with a very high dividend yield
ING Groep	Netherlands	8.1	7.1%	A very profitable bank with very low non-performing loans; growing its customer base via digital innovation
KBC	Belgium	10.1	4.2%	Voted “Western Europe’s best bank 2019” by Euromoney; has a very good CEO and a diversified product range