KENNOX

TRUE VALUE INVESTORS

Kennox Strategic Value Fund Quarterly Investment Report

June 2013

The ever-upward market momentum stalled in May. At the height on 22 May 2013, the market had gained over 35% in twelve months (figures are total return of the MSCI world index in GBP). Given the "less-than-straightforward" economic background that has been well documented both in our quarterlies and in the press as a whole, this is a remarkable return, and shows the power of the combination of quantitative easing and low interest rates. The huge political support that equity markets have enjoyed has provided investors with a wonderful opportunity to produce good absolute returns for their investors. But, as the last 6 weeks of the quarter have shown (the markets fell nearly 10% before a brief rally in the last week of the quarter), the disconnect between valuations and the underlying operating reality has now resulted in an investment arena fraught with risk.

In terms of our view on valuations, we believe in the mantra "the bigger they are, the harder they fall". One of our favoured valuation metrics is 5-year earnings multiples as this takes into account both the value that the market is putting on a stock and how close the company's earnings are to peak levels. Very high 5-year PERs imply that investors' expectations are high, and they believe that earnings will continue to grow from these peak levels. While some stocks will match these expectations, woe betides the stocks that don't – it is most painful to have high expectations run unsuspectingly into a decline in earnings. At present, we are often confronted with companies valued at an excess of 20x these earnings. To us this is excessive, even for the best companies. Given that we are searching for companies where the price implies significantly lower expectations, it is unsurprising that our portfolio seldom looks like that of other managers – "popular" stocks do not tend to trade at valuations that match our investment philosophy. We were interested to read an article in Citywire in April entitled "The top 16 stocks powering the best global equity managers"[1]. It listed stocks that appeared in portfolios of a large number of the best-performing global fund managers, and the list contained companies such as Nestle, Diageo, Coca Cola, Unilever and British American Tobacco. The median 5 yr PE of the 16 stocks listed is 22x. For our portfolio, it is 14x. Much as we agree that all the companies listed are excellent, at those valuations we own none of them.

The run in prices has been fairly broad-based given the nature of the fiscal stimulus, and we find ourselves faced with a narrowing opportunity set of undervalued companies. We have cash at high levels (currently 18.5%), and retain our position in gold (currently 4%). As well, we have been fairly aggressively trimming those companies where valuations have run furthest (in particular GlaxoSmithKline, Johnson & Johnson and Munich Reinsurance which have been large holdings for the Fund, but are now all around 3% of the portfolio). We have used the majority of the proceeds to top up those that have more favourable valuations (Western Union, M6 Metropole, Delta Lloyd, Fukuda Denshi). This refreshing of the portfolio over the last year or so is a core part of our process, injecting new ideas into the Fund and allowing us to take money off the table where prices, and expectations, have risen.

We remain happy that this is the best way of delivering defensively-oriented equity exposure.

[1] Brooks, H, April 08 2013, *The top 16 stocks powering the best global equity managers*, www.citywire.co.uk

Stock of Interest

Fujikon

Those of you who follow Kennox will know that one of our favourite stocks has been Fujikon – an acoustic headset/headphone manufacturer in Hong Kong. They have at points been offered to us at exceptional value, trading below $1.50 (or a market capitalisation of approximately HK$600m) as recently as August 2012. When we consider that they have over HK$400m in cash on the balance sheet, and that they have produced an average of HK$80m per year in earnings over the last 10 years, this is extraordinary, and that at those prices, we were happy for Fujikon to have a large weight in the Fund at around 4%.

During the year to March 2013 (Fujikon's financial year-end), expectations began to rise as sales and profits recovered from a trough in 2010. The company was re-rated, and the price peaked at over HK$4.00. Whilst we still rate the company very highly, these valuations narrowed the margin of safety in the investment. We sold over a third of our holding, and effectively trimmed more by not adding as the Fund has grown, reducing the holding size to under 2.0%.

In the last few weeks Fujikon announced results to March 2013 with revenue up over 40% and operating profit up over 90%. The expectations were such that this was viewed as disappointing, and the price was down 30%. The stock is now trading back at around $2.40, representing a PE of around 9x (without adjusting for the cash), and a supportable dividend of around 7.0%. At these prices, it is becoming attractive again.

Performance Commentary

The Fund returned 0.2% over the quarter (0.1% for the professional class). For reference, the MSCI World returned 0.8% over the quarter.

At its peak in mid-May, the market was up 7%, performance which was mostly wiped out in the subsequent fall. As is usual for our style, we lagged the rising markets in the first half of the quarter, and outperformed as they fell in the second half. That we didn't outperform by more is in some part due to our regional allocations. We hold little in North America (currently just 12%), one of the most resilient markets and we hold a higher weighting (currently 17%) in Japan. Our weightings reflect where we are finding undervalued opportunities. For example, whilst Japan is no longer providing as many interesting ideas as it did 18 months ago, we remain very comfortable with our holdings which are still, as a group, trading at less than book value, paying reasonable dividends and are conservatively financed with approximately half of their market capitalisation in cash.

Performance (total return net of fees) in Pounds Sterling to 30 June 2013

Period	Professional share class	Institutional share class
3 Months	0.1%	0.2%
6 Months	11.3%	11.5%
1 Year	15.7%	16.2%
2 Years	14.7%	15.7%
3 Years	35.4%	37.3%
Since launch of share class	61.0% (30 April, 2009)	32.1% (May 12, 2010)

Source: Bloomberg

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Fund data as at 30 June 2013

Top 8 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	M6-METROPOLE TV	Europe	Consumer Discretionary	2,000	5.3%
2	DELTA LLOYD	Europe	Financials	3,900	5.3%
3	WESTERN UNION	N. America	Technology	9,400	5.2%
4	SWISSCOM	Europe	Telecoms	22,600	4.9%
5	ROYAL DUTCH SHELL	UK	Energy	206,400	4.4%
6	SANKYO	Japan	Consumer Discretionary	4,600	3.9%
7	TESCO PLC	UK	Consumer Staples	40,600	3.9%
8	ETFS PHYSICAL SWISS GOLD	Gold	Gold	N/A	3.6%

Unit Price

As at 30 June 2013:

- Professional Share Class:
  - Income: 103.9 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 104.0 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 105.1 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 105.1 pence (unit price at inception, 29 April 2013: 104.3 pence)

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If you have any questions on Kennox or the Kennox Strategic Value Fund please contact Peter Boyle on +44 (0) 131 240 3870 or email him at pboyle@kennox.co.uk.

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