Kennox Strategic Value Fund Quarterly Investment Report

March 2014

The mood of the markets in the first quarter of 2014 felt very different to the elation of 2013. The market in 2013 was characterised by rising prices, rising optimism and general bullishness. In short, the market was becoming complacent. The first quarter of 2014, especially January, felt quite different with a wariness and an awareness of risk that was lacking in 2013. While the markets wobbled, they didn't move sufficiently to produce an abundance of opportunities. We continue to be cautious.

It is important to understand that this caution comes directly from the paucity of high quality, differentiated opportunities, and not our predictions of what the market will do next. The positioning of our portfolio is at best mildly coloured by our outlook – we spend little time attempting to predict the future.

We are cautious because, as value managers, we are conscious that the majority of the market is trading at lofty valuations. These valuations can only be justified by assumptions of ever-increasing earnings and margins. Whilst the occasional company can achieve this, history and economics tell us that the majority cannot. Against that backdrop, we continue to refresh the portfolio with companies that are less optimistically priced, but that are more attractive investments on a longer investment horizon.

Regarding areas that are out of favour, we are often asked about two segments of the market that have not fared so well recently: emerging markets and commodities. We have been very wary of buying into these two sectors. Why? Let us remind you of two of our core tenets at Kennox: price and time. On price, the importance of not overpaying for stocks is a key part of our process, and our initial in-price is very important, where we look for under 10x earnings or over 10% free cash flow yield. A second, and perhaps less discussed, part of our process is the role of time. In the stock market, participants often feel that a week is a long time, a quarter is an age and a year is an eternity (especially for an investment that is underperforming). However, in the "real" world, these are still all short periods of time (remember that company accounts list assets and liabilities as short term if their duration is up to a year). What an investor must always keep in mind is that change in industry is often slow. It takes time for a cycle to play out, for sentiment to change enough that capacity is shut down and taken off stream, for demand to recover, whether it is due to the replacement cycle or pent-up demand, and for corporate cultures and bureaucracies to evolve and react.

In both the cases of emerging markets and commodities, we have felt that it was still early and that not enough time has expired. Both have gone through a super-cycle with strong upswings since the early 2000's. In the last few years they have turned down, and we are wary of jumping too soon, lest this be a turning of the cycle rather than a mere blip in the growth trend. If it is a change in the cycle, a much more significant amount of time needs to pass before it is safe to attempt to catch the falling knife.

Another salient point on both is that they have "high-beta" operational profiles. What this means is that when things are going well, they do very well. But when things turn down, it is very difficult for them. This is the case for emerging markets as they are so exposed to trade (services are a much smaller percentage of their GDPs than developed markets), and they also have much less developed government support networks and automatic stabilisers (such as unemployment insurance which increases flows of money into the economy when times are difficult). Commodities are very operationally leveraged, with high fixed costs and very long lead times for projects coming on stream. Thus any problems in demand are magnified. Both commodities and emerging markets will tend to be more volatile and prone to significant stumbles when times turn difficult.

For these reasons, we have had nothing in the materials sector and in emerging markets. Whilst we still think it is early to seek wide-spread exposure to either sector, we are finding individual ideas worth investigating. In December, we took our first position in emerging markets, in the form of China Mobile (see our stock summary below). This is very much in line with our style, waiting for the prices to be attractive, and for time to do its work.

Stock of Interest

China Mobile

China Mobile is the world's largest mobile phone operator by some margin. With 750m users and 70% of the Chinese Market (both figures growing), it dwarfs its two competitors. The network effect in the mobile industry is seen clearly in this market. Despite having the least competitive network (home-grown technology they have been saddled with by the government), China Mobile continues to win more than its share of new customers as the benefit of their coverage and range of services outweighs the detriment of the slower 3G performance.

They have recently been granted a 4G license which should reverse the technological disadvantage in the longer term. However they face an uncertain period as they roll out the new network. This uncertainty has been a drag on the shares' performance, and they now trade at very attractive levels for those willing to be patient: 10x trailing earnings (and under 10x the average of the last 5 years' earnings), a 4% yield and an enormous $65bn in cash.

We have invested 3% of the Fund in China Mobile. A larger position could be justified by the quality of the earnings stream and the valuations, but we have limited our exposure due to the vagaries of the Chinese government who are majority owners of China Mobile and play an active role in the industry.

Performance Commentary

Over the quarter, the Fund was up 2.3% (2.2% for the professional class). For reference, the MSCI World returned 0.7% over the quarter.

The Fund's performance over the quarter was in line with what we expect, holding up well in the drawdowns and especially at the end of January. Several stocks helped drive the return over the quarter, including two of our energy names (Encana and Statoil), where expectations were excessively low, and two of our large holdings in Europe (Swisscom and Delta Lloyd), on strength in their operations. These stocks rose between 10% and almost 20% over the quarter (measured in sterling).

Performance (total return net of fees) in Pounds Sterling to 31 March 2014

Period	Professional share class	Institutional share class	Class A share class
3 Months	2.2%	2.3%	2.3%
6 Months	3.1%	3.2%	3.4%
1 Year	5.6%	5.9%	N/A
2 Years	23.3%	24.3%	N/A
3 Years	23.0%	24.4%	N/A
4 Years	37.7%	N/A	N/A
Since launch of share class	69.8% (30 April, 2009)	39.6% (12 May, 2010)	6.8% (29 April, 2013)

Source: Bloomberg

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TRUE VALUE INVESTORS

Fund data as at 31 March 2014

Top 8 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	SWISSCOM	Europe	Telecoms	31,700	5.4%
2	STATOIL	Europe	Energy	89,900	5.2%
3	DELTA LLOYD	Europe	Financials	5,300	5.1%
4	WESTERN UNION	N. America	Technology	9,000	4.9%
5	ROYAL DUTCH SHELL	UK	Energy	239,900	4.7%
6	M6-METROPOLE TELEVISION	Europe	Consumer Discr.	2,700	4.4%
7	ENCANA	N. America	Energy	15,800	4.3%
8	TESCO	UK	Consumer Staple	40,000	3.8%

Unit Price

As at 31 March 2014:

- Professional Share Class:
  - Income: 107.6 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 109.7 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 108.9 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 111.3 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 109.0 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 111.3 pence (unit price at inception, 29 April 2013: 104.3 pence)

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