Kennox Strategic Value Fund Quarterly Investment Report

June 2014

Anyone reading our quarterlies over the last few years will know that we have been concerned about the foundations upon which this stock market rally has been based, i.e. interest rates at historic lows (300 years of history, not just the last decade or two) and quantitative easing, an untested policy experiment by central bankers. These monetary actions by the authorities may have been a sensible response to extraordinary times but no investor should feel that they aren't without substantial risk. The crux of the issue is that interest rates would not be this low if central banks didn't feel that significant risks persist. And if there aren't substantial problems, these stimulative policies will almost certainly distort asset prices. Either situation is far from ideal. When one matches this unprecedented monetary state of affairs with the VIX volatility measure at lows and with shares pushing highs again, even in the face of the troubles in Ukraine, Syria and Iraq, investors have to be wary of going all-in on a risky asset class. Buying conservative equities with a long term view as part of a rational asset allocation policy is sensible; buying equities believing that they can't go down in the short term is insanity.

It feels to us as though too many investors have come to believe that the government and central banks will bail out all trades when the times get tough. The government is bigger than any individual, company, or organisation and is seen as the first port of call in any trouble. This is often the correct course of action as the government can aggregate risks that any individual couldn't absorb. But this quickly leads to a dangerous trap – government cannot be the solution to all troubles. The reason is threefold: firstly, that government is much smaller than the rest of the economy, so cannot bail out all of the private sector. It simply cannot afford it. Secondly, governments and bureaucracy are inefficient, due mostly to the fact that they are sheltered from the Darwinistic forces of competition and the creative destruction inherent in the market economy. Lastly, the government is made up of fallible individuals so isn't any more likely to get it right than the rest of us. Don't forget Ronald Reagan's quip that the most dangerous words in the world are: "I'm from the government and I'm here to help".

This leads us to a key point. We at Kennox often sound bearish. As opposed to apologising for our bearishness, we would point out its usefulness. We are simply highlighting what we analyse every day in the investment process: risks that need to be managed. This is what drives our investment philosophy and style, and we know that we have a better chance of managing risks if we focus on them rather than ignoring them. At the end of the day, buying equities is an act of enormous optimism. To counter this, we focus on risks and aim to find opportunities in the form of stocks that look attractive even cognizant of the risks that these companies will inevitably face.

In short, being pessimistic in an optimistic asset class is a strength for investors of our style (this was the theme of our speech at the London Value Conference in May, so apologies to those in attendance for any repetition). This thinking helps us avoid the great danger of "drinking the cool-aid", i.e. of buying into the frenzy that can be the stock market, jumping on the run-away train of buying the fastest rising stocks when they are running the hardest. This is a great way to make money in the short term, as is seen by looking at times such as tech/TMT in 1999, financials in 2006/7, and emerging markets in 1996/7. It is enthralling while it lasts but often ends with enormous wealth destruction.

The great advantage of our style is that we can and do make money even if we are pessimistic. This is a joy of buying good companies at reasonable valuations. What investors must remember is that we aren't making predictions – we know that we have about as much chance of predicting the future as the next guy, i.e. not much. When investors read our pessimistic views, they should not think that we are doing anything other than what we always do: looking for companies with a good franchise which are trading at compelling prices. When we find them, ones that can overcome our pessimistic views of the risks, we will buy them. This has the best chance of providing the performance profile that we seek for the Fund – good absolute returns but achieved with lower risk.

Whilst it won't outperform every market, it should be attractive to the conservative investor who is genuinely thinking in time frames of ten or twenty years.

Stock of Interest

Newmont Mining and Yamana Gold

During the first quarter of 2014, we sold our physical gold position and replaced it with two miners. This is an unusual trade for us for a number of reasons. First, we are biased against commodity producers as they have no control over the price of their product, and second, we don't tend to make paired trades (i.e. pairing a buy with a sell). The investment thesis here remains about gold. The reasons we like gold are essentially unchanged since we wrote about it back in 2007 (see our thinking aloud paper if you would like to read more detail http://www.kennox.co.uk/thinking-aloud/why-hold-gold). In summary, we like it because it can produce positive returns when large sections of the market come under pressure. This is the way we always think, but it is particularly poignant at the moment when equities are expensive on almost any metric you chose to value the market and when the market feels unhealthily dependent on political stimuli. With gold prices off 30% and miners off approximately 70%, the risk to reward now looks more attractive in the miners, which is highlighted by the gold price falling to a level not far above the cost of digging it up (around $1,200 per troy ounce). Whilst this may not provide much support in the short term, it does in the longer term. From that starting point, and with a longer term investment horizon, defensively positioned miners should provide leveraged upside to any gold price recovery, with much of the downside already priced in.

We still believe that there is a significant level of stock specific risk in any individual miners, so we have decided the best course of actions is to own two. We see both as defensive (with low costs of production and little financial leverage), and their operations provide diversified exposure geographically (Newmont is focused in North America and Australia where Yamana's operations are in Central and South America). Our research also shows both to have taken a responsible approach to their environmental impact, so our political exposure ought also to be lower than for the industry as a whole.

At the end of the quarter, 2.7% of the Fund is invested in Newmont, and 1.7% in Yamana.

Performance Commentary

Over the quarter, the Fund was up 1.8% (1.7% for the professional class). For reference, the MSCI World returned 2.5% over the quarter.

After some volatility in the first quarter, markets returned to making steady gains through the period. After holding up better in the volatility in the first quarter, the Fund slightly lagged the rising markets of the second quarter, consistent with our performance in the past. Positive returns for the Fund were dominated by our energy holdings (Statoil, BP, Shell and Encana all returned over 8%) and by our Japanese stocks (Fukuda Denshi, Canon Marketing Japan and Star Micronics all returning over 15%). Games Workshop was also strong as their operations continue to perform (up 24%).

Performance (total return net of fees) in Pounds Sterling to 30 June 2014

Period	Professional share class	Institutional share class	Class A share class
3 Months	1.7%	1.8%	1.9%
6 Months	3.9%	4.1%	4.2%
1 Year	7.3%	7.6%	7.9%
2 Years	24%	25%	N/A
3 Years	23%	24%	N/A
4 Years	45%	48%	N/A
5 Years	77%	N/A	N/A
Since launch of share class	73% (30 April, 2009)	42% (12 May, 2010)	8.8% (29 April, 2013)

Source: Bloomberg

KENNOX

TRUE VALUE INVESTORS

Fund data as at 30 June 2014

Top 8 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	WESTERN UNION	N. America	Technology	9,300	5.2%
2	STATOIL	Europe	Energy	98,000	5.1%
3	ROYAL DUTCH SHELL	UK	Energy	268,700	5.0%
4	DELTA LLOYD	Europe	Financials	4,900	4.5%
5	ENCANA	N. America	Energy	17,500	4.4%
6	FUKUDA DENSHI	Japan	Health	1,100	4.1%
7	M6-METROPOLE	Europe	Consumer Discr.	2,600	4.0%
8	SWISSCOM	Europe	Telecoms	30,000	4.0%

Unit Prices

As at 30 June 2014:

- Professional Share Class:
  - Income: 109.4 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 111.7 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 110.6 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 113.3 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 110.7 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 113.4 pence (unit price at inception, 29 April 2013: 104.3 pence)

Charles L. Heenan
(Investment Director)

Geoff Legg
(Investment Manager)

If you have any questions on Kennox or the Kennox Strategic Value Fund please contact Peter Boyle on +44 (0) 131 563 5440 or email him at pboyle@kennox.co.uk.

Our website is www.kennox.co.uk.