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TRUE VALUE INVESTORS

Kennox Strategic Value Fund Quarterly Investment Report

September 2014

The US stock market has been wonderfully strong. In US dollar terms, the S&P500 returned over 30% in 2013 and over 20% in the twelve months to end of September 2014. Continuing conflict in Ukraine, sanctions against Russia, and troubles with the Islamic State (which led to a re-engagement of the western military in Iraq) have done little to stop this party. The deceleration of Quantitative Easing (tapering) has not put any major dampener on the mood either. Alibaba broke all sorts of records for an IPO. In the words of Chuck Prince, "if the music is playing…". Certainly, many are still dancing in the US stock market.

It's not a dance that attracts us. Value investing consists of taking a view on intrinsic values, often contrarian, and building in a margin of safety. Time frame is an important aspect of this – one must look out five or ten years or more to get an idea of an intrinsic value. In the short term, markets can often build on their own momentum – recent winners are attractive to many, pushing prices to even higher levels. But in the longer term, estimating a conservative intrinsic value (especially one that takes into account the natural cycles of businesses), buying at a discount to this price, and building in a further margin of safety, is a sensible and conservative investment strategy. For this style, there are very few attractive opportunities in the US.

We are disappointed by the Fund's performance this quarter (down 2.4%), as we and our fellow investors always like to see positive returns, even over short timeframes. However, the timing of returns is beyond our control and we must focus on what we can do – to analyse the stock market for individual opportunities, remain conservative with our stock picks, build a diversified portfolio, and always think for the longer term. Tesco and BP, two of the principal drags on this quarter's performance, are classic examples of where we think the long term outlook for the stocks and their prices are attractive, but the potential value is obscured to many by the uncertain short term outlook. It is this uncertainty that offers up the opportunity to buy at attractive prices – you do not get excellent companies at great prices when everything is going swimmingly. It means that we are typically buyers when press and general sentiment are overwhelmingly negative. When investments move against us (even if only in the short term), we face criticism, as the risks were well documented when we decided to buy. However, it is also this same approach that has allowed us to make excellent returns over the longer term.

Looking at the troublemakers, BP has been weak of late (down over 10% in the quarter). It was wildly out of favour when we bought in 2010 (after the Macondo disaster), which allowed us to make our initial investment at severely depressed prices, meaning that we are still nearly 40% up on the investment. We continue to have full confidence in BP's longer term prospects and have added shares to maintain our weighting. With all our investments, we try to enter after all the bad news is priced in. With the benefit of hindsight, it is clear that we added Tesco too early (after the first profits warning in January 2012). As we advised at that time, the company's short term future was not straightforward, but looking five to ten years out, we expected Tesco to be a very worthwhile investment. The road has been rougher than even we expected but our long term view has not changed. We know that perfect timing is not possible and therefore it is unavoidable that sometimes problems will continue longer than we expect. Over time, when a sector (such as UK food retail) is facing problems, it naturally heals itself as the individual players take capacity off-stream, focusing on what is going well and shutting down what isn't. This transition can appear glacial in its progress, but being patient and holding one's nerve are essential for a long term, fundamental value investor.

At Kennox, we will continue to be patient, and invest where we see long term value, regardless of short term sentiment. It will be uncomfortable at times, but effective in the longer term.

Stock of Interest

M6 Metropole

M6 Metropole is one of the largest free-to-air television broadcasters in France (behind TF1, but ahead of France 2). The Fund first bought M6 Metropole in June 2012 at around €10.30, and we have since received €2.70 in dividends. The price reflected market concerns that internet advertising was eroding the value of broadcasters' principal revenue stream (alongside general negative sentiment towards Europe at that time). In spite of these headwinds, the company's operations continued to perform well. They produce original content more efficiently than their competitors (measured by advertising revenue per euro spent on production) and critically, they attract larger audience shares during prime time where the majority of advertising revenue directed. Valuations were exceptional with a free cash flow of more than 10%, a price/earnings multiple of less than 9x, a 10% dividend yield and significant levels of cash on the balance sheet. The share price peaked in October 2013 at around €17, at which point we partially trimmed our position.

Moving forward a year to 3Q 2014, and the market has renewed concerns. This time they are regarding the French economy, and about subscription-based content delivery (services such as Netflix and amazon prime) entering the French market. During the period since our first investment, M6 has continued to take market share from TF1 (and increased their lead over France 2), and their newer digital channels (W9 and 6TER) lead that market. Despite the excellent operational performance, the share price has fallen below €13, and valuations are once again exceptional (substantially net cash, with a 7% dividend yield and a double digit free cash flow yield). It is undoubtedly a competitive market, but we believe that the valuations and quality of business more than offset the risks. It is a 4.5% position in the Fund.

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Performance Commentary

The Fund was down 2.4% (2.6% for the professional class) over the quarter. The Fund's weak performance has been driven by three of our larger holdings having disappointing quarters, namely Tesco, BP and M6 Metropole. Those three stocks alone have produced a negative contribution of almost 2.4%. BP and M6 have both retreated from recent highs, and are significantly above our entry prices. We continue to believe in their long term value and have maintained our exposure to BP, and increased our exposure to M6. Likewise we continue to believe that Tesco will pull through its travails. Whilst our position size in Tesco has decreased due to the extreme price movement, we have recently added significantly to our holding at what we believe are exceptional prices.

The Fund is not benchmarked, but for comparison purposes we usually mention MSCI World performance. As you know, we expect to outperform the MSCI over the long term, but do not place much credence in shorter term comparisons – the significant differences in weightings/exposure between the Fund and the index means that short term performance can, from time to time, diverge significantly. This quarter is one of these times: the MSCI returned 3.3% over the period. The principal reason for the divergent performance is the respective exposure to the US market. It makes up over 50% of the MSCI World index, but just 11% of the Fund. The Fund's weights reflect where we find value, with no consideration given to benchmark exposure. This approach leads us to have significant exposure to Europe and to the UK where prices have been more attractive. During the quarter, regional stock market performance has been wide-ranging, and heavily impacted by exchange rate movements. The S&P 500 index in the US was up over 6% in sterling terms (the underlying market rise being compounded by the strength of the dollar). Returns from other regions were much less favourable with Europe (ex UK) down over 3% and the UK market down nearly 2%.

A quarter is a short period of time and recent volatility in the market and in our own established positions, has given us an opportunity us to better position the portfolio for future performance.

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

Period	Professional share class	Institutional share class	Class A share class
3 Months	-2.6%	-2.4%	-2.4%
6 Months	-0.9%	-0.7%	-0.6%
Year to Date	1.3%	1.6%	1.7%
1 Year	2.2%	2.5%	2.8%
2 Years	18%	19%	N/A
3 Years	29%	30%	N/A
4 Years	31%	33%	N/A
5 Years	49%	N/A	N/A
Since launch of share class	68% (30 April, 2009)	39% (12 May, 2010)	6.2% (29 April, 2013)

Source: Bloomberg

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Fund data as at 30 September 2014

Top 8 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	WESTERN UNION	N. America	Technology	8,500	5.3%
2	ROYAL DUTCH SHELL PLC	UK	Energy	244,900	5.0%
3	STATOIL	Europe	Energy	86,100	5.0%
4	DELTA LLOYD	Europe	Financials	4,900	4.9%
5	M6-METROPOLE TELEVISION	Europe	Consumer Discr.	2,000	4.5%
6	SWISSCOM	Europe	Telecoms	29,400	4.4%
7	ENCANA	N. America	Energy	15,700	4.4%
8	CHINA MOBILE	Asia	Telecoms	235,500	3.9%

Unit Prices

As at 30 September 2014:

- Professional Share Class:
  - Income: 106.6 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 108.8 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 107.9 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 110.5 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 108.0 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 110.7 pence (unit price at inception, 29 April 2013: 104.3 pence)

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