Kennox Strategic Value Fund Quarterly Investment Report

June 2015

Since the end of the quarter, we have seen the result of the Greek referendum, with its people voting to reject the terms on offer. Where this will lead we would not try to predict – will we see a new offer? Will Greece exit? The only certainty is that we can expect to see the recent market volatility continuing and perhaps amplifying. Some of the impact of recent market volatility (both in equity markets and foreign exchange markets) is discussed in the performance commentary below.

In periods such as these, it is worth focussing on two things. First, returns from equities come from two sources (capital and income); and second, it is volatility that produces opportunities.

We are reminded of the whimsical nature of capital gains: they can dissipate as quickly as they arrive. For Kennox and the market as a whole, the majority of gains from the first quarter of 2015 were erased in the second. Income received by way of dividends is permanent, and effectively reduces the risk of an investment by reducing the amount of capital that has been committed to take ownership of a share of the company's cash flows.

Kennox's favourite type of company in which to invest is one which has resilient cash flows, and which returns sizeable portions of that cash flow to shareholders. There are several examples in the portfolio. Take M1 in Singapore. M1 IPO'd in 2002 at $1.25. In less than 10 years, they returned more than $1.25 in dividends. At that point, the theoretical cost of that position was zero. Newmont is another interesting example (and perhaps in an industry where you wouldn't expect to find one - gold miners have traditionally been stingy about paying out dividends). Newmont has committed to a dividend level tied to the gold price. If the gold price does recover, we will see a share of the ensuing cash flow ($1 a share if the gold price reaches $1,400, and $2 if the gold price exceeds $1,800). The list of similar companies within the portfolio is a long one - 11 of our 29 holdings have trailing yields over 5%, and the median yield of the portfolio is over 4%.

It is important to note, however, that we are not an income fund. We like companies to pay dividends when they can afford to, and to suspend when they can't. A 3% dividend yield doesn't make a company good value (it could be on 30x earnings after all). Rather, we like buying sustainable cash flows at excellent valuations, from companies that believe in distributing their cash flows as dividends, and believe that those dividends reduce the risk of that investment.

In terms of opportunities, perhaps we have seen the first exceptional one already. Neopost, the most recent addition to the portfolio was exceptionally weak over the quarter, falling 26%. It is not unusual for us to see companies in our portfolio below our entry prices. Importantly, a falling share price does not necessarily trigger a sale or a purchase. Rather, it triggers additional research to re-assess our conviction in the investment thesis. If it is market volatility rather than a change in value, there is an opportunity. In Neopost's case, the fundamentals have not changed - the business remains highly cash flow generative and continues to experience fast revenue growth and margin improvement in its newer digital marketing services segment. We have added significantly and it is now a 4.1% position.

In many ways, we look forward to continued volatility. Whilst uncomfortable in the short term, the opportunities it presents is what will drive future returns. Volatility has been notable in its absence over the last 5 years, and attractive valuations have become scarce. The reduced investable universe that has resulted has led to a cash holding in the Fund of around 17%. This leaves us plenty of firepower as that universe broadens.

Stock of Interest

Koninklijke KPN

KPN is a provider of internet, fixed line and mobile telecommunications in the Netherlands. In 2013, at its lowest share price since 2002, the company announced a 2 for 1 rights issue to pay down some of their substantial debt. As existing holders, Kennox participated fully, and since that point the shares have returned over 90%. How do the valuations and debt look now?

First, the earnings have become significantly distorted from free cash flows: capital expenditure has been falling from peaks of €1.6bn to €1.0bn in 2014, whilst depreciation remains at €1.8bn. Even allowing for an increase in capex in 2015 (to c. €1.2bn), that means that free cash flow is systematically stronger than earnings. When looking at today's investment thesis, free cash flow (assuming it is sustainable) is more important than accounting profits.

Second, there is still net debt of €8bn at the end of 2014. However, KPN have recently announced the sale of their Belgian operation (BASE) to Telenet for a consideration of €1.3bn, and they own 20% of Telefonica Deutschland after the sale of their German operation (E-Plus). That stake is liquid, and worth around €3.1bn at today's market price.

Considering the investment from this perspective, the debt looks very manageable, and the shares are trading on a 7% free cash flow yield despite the rally in 2015 (shares are up 21% in sterling terms, and over 30% in euros in 2015). We are happy holders of this market leading company.

Performance Commentary

Since highs in early April, markets have reacted to continued uncertainty in Europe culminating in Greece's default on 1st July. The Fund ended the quarter down 7.5%, reducing returns for the first 6 months of 2015 to just 1.9% (the MSCI World index is up 2.0% having fallen 5.2% in the quarter).

The economic uncertainty has also led to increased volatility in exchange rates. Despite our relative proximity to mainland Europe, the pound has been strong: up 8.6% against the euro in the last 6 months, and even stronger against the yen, up 7.5% in the second quarter alone. Of the major currencies, only the Swiss franc has strengthened against sterling in 2015, though even that has seen the majority of its 20% gains in January eroded (it is now up only 5.4% against sterling for the year). This has had a substantial impact on returns of overseas assets when measured in sterling terms.

Against this backdrop, the most significant positive contributor for the Fund has been Star Micronics (a Japanese manufacturer of precision machines including lathes), up 15% in the quarter and over 30% during the year in sterling terms despite the weak yen. It continues to produce positive results as demand recovers since the collapse in 2007-2009. There is still scope for growth from here (revenues were 50% higher in 2008, and profits 70% higher), but with valuations rising (now at around 16x earnings) we have kept it as a small position in the Fund at 2.4%. KPN (the Netherlands telecommunication company) has also been strong, up 8% in the quarter and over 20% during the year (or over 30% in euros). Despite this recent rise in price, the shares remain attractive at a 7x EV-EBITDA multiple, and KPN remains a 4.1% position in the Fund. See above for a little more information on the valuations at KPN.

At the other end of the portfolio, the weakest stock has been Neopost. As discussed above, our confidence in the investment thesis has not altered and it is now a 4.1% position. Neopost trades at under 10x earnings (both trailing one year and trailing 5 years), has a near 10% free cash flow yield and a 10% trailing yield. Yamana Gold (a gold miner with operations in Central and South America and also in Canada) has also been weak after the acquisition of Osisko Mining earlier this year. It has seen an impressive increase in production, but not yet turned production into cash flow. Should cash flow catch up production, the shares look significantly under-valued at around 0.6x book value. It remains a higher risk investment (though one with attractive potential), and as such is just a 1.0% position.

Performance (total return net of fees) in Pounds Sterling to 30 June 2015

Period	Professional share class	Institutional share class	Class A share class
3 Months	-7.5%	-7.5%	-7.5%
6 Months	1.7%	1.9%	1.9%
1 Year	-3.5%	-3.3%	-3.1%
2 Years	3.5%	4.1%	4.6%
3 Years	20%	21%	N/A
4 Years	19%	20%	N/A
5 Years	40%	43%	N/A
Since launch of share class	67% (30 April, 2009)	37% (12 May, 2010)	5.4% (29 April, 2013)

Source: Bloomberg

Fund data as at 30 June 2015

Top 8 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	ADMIRAL	UK	Financials	6,100	5.5%
2	BP	UK	Energy	121,500	4.4%
3	WESTERN UNION	N. America	Technology	10,500	4.3%
4	KPN	Europe	Telecoms	16,400	4.1%
5	NEOPOST	Europe	Technology	1,500	4.1%
6	ROYAL DUTCH SHELL	UK	Energy	180,700	3.9%
7	SWISSCOM	Europe	Telecoms	29,000	3.8%
8	STATOIL	Europe	Energy	56,700	3.5%

KENNOX
TRUE VALUE INVESTORS

Unit Prices

As at 30 June 2015:

- Professional Share Class:
  - Income: 103.8 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 107.6 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 104.9 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 109.6 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 104.9 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 109.9 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.