KENNOX
TRUE VALUE INVESTORS

Kennox Strategic Value Fund Quarterly Investment Report

September 2015

Markets have once again been incredibly choppy through the third quarter of 2015. Asia was down 15% after more concerns regarding waning economic growth in China, Japan was off 9%, and the UK off 7%. The MSCI EAFE index was down 9%. North America is the only region that appears relatively unscathed, down just 3%.

It has not been an easy time for value investing, as the market remains driven by more expensive sectors (consumer stocks being one of the best performing) and regions (with the US significantly outperforming). The performance of the Fund during the quarter has been directly impacted, as areas in the market in which we have found the most attractive opportunities have continued to suffer, most notably our energy stocks.

Conversely, it is at times like these when real value arises. At Kennox, we look to buy high quality companies (often sector-leaders) at exceptional prices. These opportunities only arise when the short term future either for the markets, or for our specific target companies, is uncertain. At those times, investors willing to take a longer term view than the market will find that classic paradox: world class companies at great prices.

To afford ourselves the ability to buy companies with uncertain shorter term outlooks, we focus on risk. We have a clear preference for companies with low levels of leverage (or preferably cash on the balance sheet), that are trading on non-peak earnings, and that pay us dividends when they have the cash available to do so prudently. Short term uncertainty (and ensuing share price volatility) can often last longer than even a cautious investor predicts – cash allows the company to survive, and dividends allow the investor to be patient.

Looking at some of the stocks in the portfolio, it is possible to see the level of opportunity currently afforded. Delta Lloyd is trading at a 50% discount to its usual value (based on an actuarial measure of the company's worth); Fujikon is trading at approximately the value of the cash it holds on its balance sheet, allowing no value for its profitable operations; Games Workshop has a 9% covered dividend; Western Union is spinning off a free cash flow yield in excess of 10%; the prices of our gold miners could quadruple, and still be at a discount to the valuations from just 4 years ago; our three largest holdings in Japan trade with 60% of their value sitting in cash on the balance sheet. We could go on.

Our portfolio is trading at a significant discount to the market. Across our portfolio as a whole, the earnings yield[1] is 8.5%. This means that even absent any growth in operations, or a re-rating to more normal valuations, the portfolio can generate a return for our investors of 8.5%. The market as a whole trades at nearer a 5% earnings yield. This is a significant differential: after ten years, an investor compounding his savings at 8.5% will be 40% better off than investor compounding at 5%.

Holding quality companies at excellent valuations gives us full confidence that the portfolio will deliver very attractive returns going forward. The timing of those returns is near impossible to predict, but patience will be rewarded.

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[1] To take account of peak-earnings risk, Kennox defines an earnings yield as the average of the previous 5 years earnings divided by the current price

Stock of Interest

Delta Lloyd

The Dutch life insurance industry is going through turmoil as it prepares for the introduction of Solvency II in January 2016. The market is concerned that it may leave Delta Lloyd in need of a rights issue to re-establish a conservative solvency position.

Operationally Delta Lloyd is performing well (with cash flow covering its 10% dividend yield), but understandably this is not the market's focus.

This uncertainty has led to pressure on the share price, resulting in almost unheard of valuations. It is trading at a 60% discount to embedded value (the actuarial valuation of the company). Historically, the company has traded at between a 0% and 20% discount (and sometimes even at a premium).

It last traded at a similar discount to embedded value in 2012 (when there was a significant overhang in the market as Aviva was selling Delta Lloyd to relieve pressure on the Aviva balance sheet). That was the point at which the Fund first bought Delta Lloyd, and having trimmed about a third of our position at higher prices and taken €3.50 in dividends, our holding period return has been positive.

Following the recent drop in share price, we have been adding to our position cautiously. Cautiously, because if there is to be a rights issue, we may be offered a better opportunity yet. If we don't see a rights issue, today's prices could prove exceptional when normality returns.

Performance Commentary

Markets in the third quarter have been dominated by ongoing fears about the slowdown in economic growth coming from China. As a result, the sectors and geographies most closely linked to China have fared worst (Asia ex Japan down 14%, Japan down 9%, energy sector down 16% and materials down 17%). Against this backdrop, the Fund was down 9% (the MSCI was down 5%, held up by a large weighting in the US which was down just 3%)[2].

The Fund's performance has been driven in particular by our exposures in energy and materials. Our energy stocks (14% of the Fund) were off 12%, and our two gold stocks (4.8% of the Fund) off 30%. We have made some additions in both areas. We have increased our energy exposure moderately, and spread our risk by adding Exxon Mobil to the portfolio, whilst reducing our exposure to BP and Shell – both of which have significant stock specific risks (BP to Russia; and Shell to the BG deal). In gold mining, we have increased our holding in Newmont, a true blue chip in the sector. To help describe how extreme the pricing environment in that sector has become, it is now more expensive to build a mine from scratch than it is to buy a fully functioning miner (per ounce of annual production). This is unusual, as merger and acquisition activity starts to replace new discoveries.

In addition to these sector exposures, the Fund was negatively impacted by the performance of two specific stocks: Delta Lloyd (as mentioned above, hurt by the increasing possibility of requiring a rights issue), and Neopost (which cut its dividend at the end of the quarter as it continues to invest in new areas of the business that are yet to operate at full scale). The Neopost business and outlook remain strong and the post-cut dividend is still extremely attractive (8%). These two stocks resulted in a combined contribution of -3.1% to performance.

[2] All return figures in sterling terms

At the other end of the portfolio, our largest stock Admiral was also the best performing, up 12% against a UK market that was down 7%. Munich Reinsurance, Games Workshop and Kingmaker were also each up over 10%.

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

Period	Professional share class	Institutional share class	Class A share class
3 Months	-9.4%	-9.3%	-9.2%
YTD	-7.9%	-7.6%	-7.5%
2014	-1.4%	-1.2%	-0.9%
2013	15%	15%	4.3%*
2012	9.4%	10%	N/A
2011	-4.3%	-4.0%	N/A
2010	21%	12%*	N/A
2009	15%*	N/A	N/A

Source: Bloomberg

* Share classes launched mid-year: Professional on 30 April 2009; Institutional on 12 May 2010; and Class A on 29 April 2013.

Fund data as at 30 September 2015

Top 10 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	ADMIRAL	UK	Financials	6,400	4.9%
2	WESTERN UNION	N. America	Technology	9,400	4.5%
3	MUNICH REINSURANCE	Europe	Financials	31,100	4.4%
4	KPN	Europe	Telecoms	16,000	4.0%
5	NEWMONT MINING	N. America	Materials	8,500	3.9%
6	STATOIL	Europe	Energy	47,400	3.7%
7	NEOPOST	Europe	Technology	900	3.5%
8	SANKYO	Japan	Consumer Discr.	3,200	3.4%
9	GLAXOSMITHKLINE	UK	Health	94,900	3.4%
10	CHINA MOBILE	Asia	Telecoms	242,500	3.4%
	Total Top 10				39.1%
	20 Other Holdings				48.8%
	Cash				12.1%
	Total				100%

Unit Prices

As at 30 September 2015:

- Professional Share Class:
  - Income: 94.00 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 97.51 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 95.12 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 99.37 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 95.20 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 99.74 pence (unit price at inception, 29 April 2013: 104.3 pence)

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