KENNOX
TRUE VALUE INVESTORS

Kennox Strategic Value Fund Quarterly Investment Report

December 2015

2015 was not an especially enjoyable year for value investors large or small, with most underperforming. Even Warren Buffett himself had a hard time. Over the year many value stocks that started out cheap became even cheaper. Conversely, the price of the favoured growth stocks, especially those christened the "Nifty Nine" in the US[1], went from high to even higher, driving returns for the market and for growth investors, but leaving value investors trailing.

Effectively, with this continued narrowing of the market, the way to strong performance in 2015 was to jump on the bandwagon and pile into the small number of already fully priced stocks, driving them up further. It feels like the market could be treating stocks, certain ones at least, as Giffen goods - most prized when they are most expensive. This may be effective in the short term, but will not necessarily look rational in hindsight.

This is playing out at a time when there continue to be significant risks in the global economy. There are pointed questions about the health of the Chinese economy. The turbulence in the oil markets is disrupting high yield bonds. The situation in the Middle East looks especially uncomfortable. Certain emerging markets are looking fragile (Brazil, Turkey, South Africa), and potentially dangerous (Russia). The US has embarked on the first step of raising interest rates from rock bottom levels, the path of which is fraught with uncertainty. Alongside this, no asset class is cheap at present. Equities on average are trading at high cyclically adjusted earnings; investment grade bonds continue to be valued at historic low yields; most property offers similarly meagre yields, due to the hunt for income.

What can investors do to protect themselves in this environment? At Kennox, we are comforted knowing that we own sector-leading companies at exceptional prices. We must continue to focus on risk, looking for low levels of leverage, non-peak earnings, a history of dividends, to tide us through any short term uncertainty. All of our companies look attractive, and many are at a substantial discount even to a conservative valuation. We mentioned some last quarter: Delta Lloyd (see performance section below), the Japanese stocks, Western Union, Games Workshop as well as Asia Satellite (mentioned in this month's fund factsheet) and others. We still believe gold is especially interesting, and have written about Newmont in the stock of interest section below.

Importantly, the portfolio still trades at a significant discount to the market, as measured by the earnings yield[2], which means the portfolio can generate a higher return for our investors. This return can be enhanced if there is growth in the operations of the underlying companies, or a re-rating to more normal valuations for the shares.

Value investing works because it takes nerve to buy and hold when the valuations are most attractive. Whilst we are aware that there will be times of underperformance when momentum reigns, we take comfort in knowing that these periods always end.

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[1] Nifty Nine: Facebook, Amazon, Netflix, Google, Priceline, EBay, Starbucks, Microsoft, Salesforce

[2] 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

Stock of Interest – Newmont Mining

It is no secret there has been significant pressure in the gold mining industry. The gold price has fallen fairly consistently since peaking at around $1,900 per ounce back in 2011. It now trades at under $1,100 per ounce – below the industry-wide, all-in sustaining cost (AISC) of production. The market continues to value the industry on profits (of which there are essentially none), and so it is natural that since 2011 the price of many of the miners has fallen between 70 and 90%.

The miners have responded to this market pressure and are dramatically reducing costs and capital expenditure (the gold mining industry hasn't had a great track record in this department in the past). These actions are necessary for the industry to return to profitability, and, importantly for an investor, a continued decrease in supply will be a significant tailwind for the survivors.

Turning to Newmont in particular: it has a low cost of production (with an AISC below $900 per ounce), has reserves in safe jurisdictions (predominantly in Northern America and Australia), and has lower exposure to any single mine than many of its competitors. We like that the management has come from outside the gold industry (Gary Goldberg worked at Rio Tinto before joining Newmont in 2011), and is taking a more investor-friendly approach to shareholder returns – explicitly tying future dividends to the gold price, to avoid any gains from a rising gold price being spent entirely on increasingly expensive assets and capital expenditures as was prevalent in the last cycle.

The precipitous fall in share prices mentioned above leaves the price of miners at an inflection point. Per ounce of production, it is now cheaper to buy a fully functional gold miner that it is to develop a new mine from scratch. This is a very strong pricing signal, to industry participants (pushing them towards consolidation) and to stock market investors alike.

Short term performance of the miners is almost impossible to predict, but as a long term holding (and one that has the ability to perform even when equity markets as a whole are challenging), we are excited by the opportunity the currently depressed share price affords for a low cost blue chip such as Newmont, especially in a sector where supply is being constrained and new reserves are increasingly difficult to access. If any value is placed on reserves, as opposed to purely looking at profits, the mining industry is more attractively priced now than we have ever seen it.

Performance Commentary

After a painful third quarter, markets posted significant gains in October before retreating slightly in November and December. Aided by some currency movements, Japan and the US were the strongest (up 11% and 9% in sterling terms). Europe also posted positive returns, but lagged substantially, with the UK up 3% and continental Europe up 5%. The Fund was up 4.0% over the quarter. (For reference, the MSCI World index was up 8.5% over the period.)

In terms of individual stock contributions, the most positive was Taisho Pharmaceutical. It was up 27% during the quarter, contributing nearly 1% to overall performance of the Fund, after a well-received results announcement at the end of October. The company's earnings come predominantly from the production of self-medication products (energy drinks, cold remedies and hair loss treatments), and benefits from the ageing Japanese population and the increasing focus on health amongst that demographic. With 65% of the market cap covered by cash and investments, the valuations remain undemanding.

Other strong performers were Newmont (posting a 0.6% contribution – see Stock of Interest), Admiral (posting a 0.4% positive contribution, and up 34% over 2015 as a whole), Fukuda Denshi (also a 0.4% positive contribution and benefiting from similar tailwinds to Taisho as it also operates in the Japanese healthcare segment) and Munich Reinsurance (a 0.4% positive contribution as benign weather conditions reduced natural catastrophe claims in its 3Q results).

Delta Lloyd remains the weakest stock in the portfolio as the market reacted to the announcement of a (fully underwritten) rights issue to be finalised in February/March 2016. We continue to believe that this is one of the most undervalued assets currently available. The uncertainty over solvency II regulations (in force as of 1 January 2016) and its impact on the capital requirements of the business have led to a large discrepancy between the market valuation of the company and the underlying ("embedded") value of the business. Even adjusted for the impact of the rights issue (which will narrow the discrepancy slightly), the company trades at a 50% discount. Barring significant changes in the operating environment between now and March, we will fully participate in the rights issue.

Performance (total return net of fees) in Pounds Sterling to 31 December 2015

Period	Professional share class	Institutional share class	Class A share class
3 Months	3.9%	4.0%	4.0%
2015	-4.3%	-4.0%	-3.8%
2014	-1.5%	-1.1%	-0.9%
2013	15%	15%	4.3%*
2012	9.4%	10%	N/A
2011	-4.4%	-4.0%	N/A
2010	21%	12%*	N/A
2009	15%*	N/A	N/A

Source: Bloomberg. Performance figures are total return generated from the accumulation units since their launch (29 April 2013), and from the income shares prior to that.

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

The performance figures have been restated to reflect the actual final dividend paid on 29 January 2016, rather than the previously estimated amount. This data was updated on Bloomberg on 25th January 2016.

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Fund data as at 31 December 2015

Top 10 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEWMONT MINING	N. America	Materials	9,500	4.3%
2	NEOPOST	Europe	Technology	800	4.0%
3	WESTERN UNION	N. America	Technology	9,100	3.9%
4	MUNICH REINSURANCE	Europe	Financials	32,400	3.9%
5	ADMIRAL	UK	Financials	6,700	3.9%
6	EXXON	N. America	Energy	325,000	3.9%
7	TAISHO	Japan	Health	6,300	3.7%
8	GLAXOSMITHKLINE	UK	Health	97,800	3.7%
9	BP	UK	Energy	93,800	3.7%
10	CHINA MOBILE	Asia	Telecoms	225,000	3.6%
	Total Top 10				38.5%
	20 Other Holdings				46.4%
	Cash				15.1%
	Total				100%

Unit Prices

As at 31 December 2015:

- Professional Share Class:
    - Income: 95.97 pence (unit price at inception, 30 April 2009: 70.08 pence)
    - Accumulation: 101.3 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
    - Income: 96.61 pence (unit price at inception, 12 May 2010: 85.46 pence)
    - Accumulation: 103.3 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
    - Income: 96.91 pence (unit price at inception, 29 April 2013: 104.3 pence)
    - Accumulation: 103.7 pence (unit price at inception, 29 April 2013: 104.3 pence)

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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.

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