Kennox Strategic Value Fund Quarterly Investment Report

March 2016

The start to 2016 was anything but comfortable for global stock markets with the worst opening to a year in decades. The positive January effect was conspicuous in its absence.

Investors rightly worried about everything and anything: China's growth, the price of commodities, ongoing redemptions from oil producing countries' sovereign wealth funds, US growth, rising interest rates, negative interest rates. For a moment the markets panicked, off 8% in the first 3 weeks and 11% by mid-February. Since then, unease has decreased and markets have recovered all the ground briefly lost.

The troubles may have been discounted, but they have not gone away. (We would especially highlight one point: the increasing occurrence of negative interest rates. Who can know the outcome of this unprecedented monetary experiment?) Enough doubt and caution remain in the market to see safe haven assets (bonds, utility stocks, gold, the Swiss franc and the Japanese yen) continuing to hold up, even as the market rallies.

The volatility seen in this first quarter has re-ignited the debate as to whether the bull market in place since 2009 has finally run its course. We won't speculate on market direction, but would discourage any complacency: "*Every five to seven years, investors forget that there is a recession every five to seven years*".

Our objective is to tune out shorter term market noise to deliver a consistent approach that uncovers sector-leading companies at exceptional valuations, irrespective of market sentiment. In a reasonably efficient market, there are not often many companies that combine a significantly attractive valuation with a strong long term outlook offering us a substantial margin of safety. To uncover these rare opportunities, we can be expected to be found trawling the most unpopular sectors of the market. Examples within the portfolio are in energy (where we hold Exxon, Shell and BP - companies that have thrived through numerous energy crises, currently trading at a huge discount to historic reserve multiples); in gold miners (where prices have just started to recover from the precipitous falls which saw 80% of value wiped away since highs in 2011); and in UK car insurance (where Admiral has a structural cost advantage in an industry that is loss making overall). To be able to buy the very best companies at discount prices is hugely attractive and can be very rewarding.

Our contrarian approach should result in a portfolio that is significantly different and that can be expected to deliver differentiated performance. This can include good returns in difficult stock market conditions. Companies within tougher industries cut costs and supply and refocus on rebuilding profitability, meaning that the survivors (and the sector) emerge leaner and stronger. This is an industry dynamic that is not predicated on general economic conditions, nor on the vagaries of market sentiment.

We are often asked whether companies whose share prices have fallen substantially "have become interesting value propositions". Recently the questions have been about Serco, Volkswagen or Rolls Royce, and just now the questions are about Valeant.

Valeant has been a fascinating story, but the truth is that it has never been a realistic proposition for our style of value investing. Although it has fallen by nearly 90% from its peaks (which were as recently as August 2015), fundamental value metrics remain unappetising: it has not once produced earnings that make sense of its current $10bn market cap (let alone its $90bn market cap last year); it pays no dividend; and has substantial levels of debt. Ignoring these fundamental metrics made for a very good investment for the best part of a decade (the stock price was up 7 times between 2011 and 2015), but the risks inherent in investing where price reflects high expectations are all too clear in hindsight.

We will continue to invest where there is less fervour, and where valuations are based on sound metrics: cash flows, earnings, dividends and assets.

Stock of Interest

Kingmaker Footwear

Kingmaker is a high quality shoe manufacturer of casual, "rugged" and children's shoes for an A-list of clients including New Balance, Wolverine, Skechers, Clarks and Asics. It has been making significant efficiency gains in recent years, slowly migrating production facilities from China to Vietnam, and is likely to be a beneficiary of Trans Pacific Strategic Economic Partnership Agreement (TPP) negotiations.

We bought Kingmaker at $0.50 in 2009 and it is currently trading at $2.30. We are happy to retain a position as valuations remain appealing (13x earnings, 30% net cash and a 5% yield).

Kingmaker is a good example of how our small caps can make significant contributions to our overall performance. With a market cap of just $200m, liquidity dictates that it is a relatively small position in the Fund. Over the past year, Kingmaker has contributed nearly 1% to the Fund's performance.

We hold almost 10% of the portfolio in companies with market caps below $1,000m including Kingmaker, Fujikon, Tradelink and Games Workshop and will continue to look for exciting opportunities amongst smaller companies that are ignored by the majority of the market.

Performance Commentary

The Fund performed well during the quarter, up 9.8% (institutional share class).

Markets proved to be particularly volatile over the period – by mid-February the MSCI World index was down 10% before recovering to finish up 2.2%. Foreign exchange rates were also volatile, with fears over the impact of a possible "Brexit" pushing the pound down 2.6% against the dollar, and further against other currencies.

The portfolio held up well through the market weakness, creating a good platform for our 3 month returns. We saw positive performances across the portfolio (25 of our 29 stocks contributed positive returns) and our two gold stocks were exceptional. We added to Newmont back in August 2015 at below $16, making it the largest stock in the portfolio (see Stock of Interest in the December 2015 quarterly). In Q1 2016 it rose 51%, contributing 2.5% to the portfolio's performance. Similarly, our other gold miner (Yamana) was up over 50%, contributing a further 0.9% to performance. We remain comfortable with the mid-term view on gold due to the huge cuts in investment that have been seen in that industry, and the inevitable reduction of supply that will ensue. The sector remains one of the most unloved and undervalued. We hold two low cost producers that are well placed to thrive even if gold prices remain under pressure.

Elsewhere, Tesco shares were up 28% over the quarter (contributing 0.9% to Fund performance). Tesco is so unloved and market expectations have been so low that that what can only be described as a "reasonable" operating performance has resulted in Tesco shares re-rating by almost a third. We believe there is substantial upside available from here.

A further 4 stocks (Admiral, Statoil, Kingmaker and Taisho Pharmaceutical) were all up over 15%.

We are currently participating fully in the Delta Lloyd rights issue. The company is raising €650m to ensure it comfortably meets the new Solvency II capital adequacy requirements introduced in January 2016. Delta Lloyd shares were volatile in the period leading up to the rights issue. We were able to take advantage of the extreme weakness in mid-February to add approximately 1% to our position (the price has risen approximately 45% since). Overall, the stock is up around 8% during the quarter, adjusting for the impact of the rights issue.

Following the rights issue Delta Lloyd will be a 4% portfolio position. Trading at around a 50% discount to book value (post rights issue), the stock is exceptional value.

Performance (total return net of fees) in Pounds Sterling to 31 March 2016

Period	Professional share class	Institutional share class	Class A share class
3 Months	9.7%	9.8%	9.8%
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.

KENNOX
TRUE VALUE INVESTORS

Fund data as at 31 March 2016

Top 10 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEWMONT MINING	N. America	Materials	14,100	6.0%
2	EXXON	N. America	Energy	352,000	4.1%
3	WESTERN UNION	N. America	Technology	9,700	3.9%
4	MUNICH REINSURANCE	Europe	Financials	33,800	3.9%
5	CANON MARKETING	Japan	Consumer Discr.	2,600	3.9%
6	ADMIRAL	UK	Financials	8,000	3.8%
7	TAISHO	Japan	Health	7,200	3.8%
8	STATOIL	Europe	Energy	50,200	3.8%
9	GLAXOSMITHKLINE	UK	Health	98,900	3.6%
10	ROYAL DUTCH SHELL	UK	Energy	195,000	3.5%
	Total Top 10				40.5%
	19 Other Holdings				45.4%
	Cash				14.1%
	Total				100%

Unit Prices

As at 31 March 2016:

- Professional Share Class:
  - Income: 105.1 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 111.1 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 106.4 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 113.4 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 106.4 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 113.9 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.

KENNOX

TRUE VALUE INVESTORS