Kennox Strategic Value Fund Quarterly Investment Report

June 2016

Risk is always present in the global economy, and the shock from Brexit is simply an example of one of these risks turning from theoretical to stinging reality. Markets shuddered, with UK and European stock markets and financial stocks being particularly hit. The value of the British pound plummeted to post war lows. Through this tumultuous period, the Fund held up well (see performance commentary below).

Looking forward, what are the implications from the Brexit referendum? The effects were not limited to a small island to the north west of mainland Europe. This referendum forces pointed and difficult questions about the very core tenets of the European Union. There is a dissonance between the political elites who are working towards ever closer union, a United States of Europe, and many voters who still primarily believe in their national identity whether that be Dutch, Italian, Czech, or any other. For these people, being a part of the European Union is important but secondary to their national identity. If the political elite of the EU decide that “more Europe” is the answer, larger troubles loom. The British referendum highlighted this disjoint, and encourages thoughts as to what an unwinding of the European experiment might look like.

It is impossible to know what will come next – a soaring US market to lead gains across the world? A European meltdown as the EU disintegrates? Something in between? We will leave these types of predictions to the strategists, pollsters, macro-driven funds and forecasters (i.e. those who believe they are good at it).

Trying to protect against individual risks is notoriously difficult to achieve consistently. We believe it is much better to relentlessly prepare for a wide range of risks. Central to this is our bottom up approach to stock selection. We look for conservatively financed, high quality companies that can generate sustainable earnings over a long period of time, and buy them only when they are priced at low valuations (on 10-12x these sustainable earnings). This gives us the all-important margin of safety on margin of safety – our estimates of sustainable earnings are conservative (making no heroic assumptions about the growth of those earnings) and there is no froth in the earnings multiple.

We also consider risk through a sensible and distinct approach to portfolio management. To that end, we focus on ensuring that our companies have truly differentiated underlying profit drivers. If the profit drivers of our holdings, the core factors that drive the profits that our companies will make, properly diversified, then we are well positioned to weather storms regardless of origin.

The individual companies, which comprise the portfolio, are inexpensively priced, sectors leaders, many well positioned in industries where supply has been cut, leading to the possibility of improving profitability. In other words, the upsides are attractive. Moreover, we have dry powder in the form or 13% cash and continued volatility will inevitably lead to an increase in attractive value opportunities. We look forward to finding these.

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Stock of Interest

Neopost

Neopost is a good example of the type of attractive opportunity that we seek out. Neopost is well positioned in the oligopolistic industry of postal franking machines, being the second largest player globally, and the biggest in Europe. The franking business is based on long term contracts, meaning the business is robust as was seen in the turbulent period of 2008/9 when a minimal number of Neopost's clients defaulted on their contracts.

The share price has been under pressure as investors fret about the future of post and its effect on the company. The company is pursuing the sensible strategy of moving into other products and services such as parcels and selling digital and marketing solutions to its wide SME customer base of over 800,000 businesses. Neopost is trusted and well placed to achieve this transition but the market is focussed on the shorter term risks and not the longer term potential. The company also took the conservative decision to cut the dividend during this period of change.

This business is available at an extraordinarily attractive price, with a yield of over 7.5% (after the dividend cut), a price-to-earnings multiple and cyclically adjusted PER both around 5x, and cash flow generation in the double digits. With valuations discounting a tremendous amount of risk, a strong business and distribution network, and underlying profit drivers almost entirely differentiated to most of the rest of the portfolio, Neopost's qualities are very appealing to a value manager.

Performance Commentary

The Fund performed well during the quarter, up 12% (institutional share class) over the period. For reference sake, the MSCI was up 9.8% (helped by the weakening of sterling).

The best of the Fund's performers were our gold miners (contributing 5.1% to performance), our energy majors (contributing 3.4%), and our two healthcare stocks in Japan (Taisho and Fukuda Denshi contributed a further 2.3%), which benefitted from their exposure to the Japanese domestic market and the strengthening yen (up 17% against sterling).

Short term performance has been good, but six months is a short period of time for a long term investment such as equities. In the long term, we aim to outperform global stock markets. To outperform, we need to be truly active, and the Fund needs to be properly differentiated, which means not tracking any index. In other words, we will not drift from our discipline and style. The attractions of this strategy were evident in this quarter as we were able to generate returns from across our global portfolio of non-consensus names.

The uncertainty that surrounds Europe and the UK after the Brexit referendum will not dissipate quickly and we are still very much attracted to assets such as the energy majors which have a long history of resilience in difficult economic times. They are particularly attractive as investment has been so heavily cut in the last few years due to the low oil price. Falling supply will lead to improving profitability and the majors are robust enough to survive until improvement materialises.

On the other side, two of the weakest stocks in our portfolio were two European insurers, Munich Re (down 6%) and Delta Lloyd (down 18%). Although not as unfortunate as European and British banks, these too were hit by the Brexit referendum result. With both trading at discounts to book value, we feel the risk to reward for each is very attractive.

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Performance (total return net of fees) in Pounds Sterling to 30 June 2016

Period	Professional share class	Institutional share class	Class A share class
3 Months	12%	12%	12%
YTD	22%	23%	23%
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.

Fund data as at 30 June 2016

Top 10 Stocks

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEWMONT MINING	N. America	Materials	20,500	7.8%
2	TAISHO	Japan	Health	9,400	4.9%
3	EXXON	N. America	Energy	386,000	4.4%
4	STATOIL	Europe	Energy	55,200	4.1%
5	NEOPOST	Europe	Technology	800	4.0%
6	CANON MARKETING	Japan	Consumer Discr.	2,700	3.9%
7	BP	UK	Energy	109,000	3.9%
8	ROYAL DUTCH SHELL	UK	Energy	220,000	3.8%
9	GLAXOSMITHKLINE	UK	Health	103,000	3.6%
10	WESTERN UNION	N. America	Technology	9,300	3.5%
	Total Top 10				43.7%
	19 Other Holdings				43.3%
	Cash				13.0%

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Unit Prices
As at 30 June 2016:

- Professional Share Class:
  - Income: 117.0 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 124.0 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 118.3 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 126.7 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 118.3 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 127.4 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

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