KENNOX

TRUE VALUE INVESTORS

QUARTERLY INVESTMENT REPORT

September 2016

2016 has been an interesting year thus far. With the looming US Presidential election, preparations for Brexit and the uncertainty surrounding EU banks we can be assured that the next few months will be equally as intriguing for investors. In this environment, it is no surprise that there has been a renewed interest in value investing.

With this has come increased awareness that value investing is practiced in a myriad of ways, producing very different portfolios with very different risk profiles. Maybe now's a good time to take a closer look at what drives our approach - high quality companies, excellent valuations and patience. A rare combination, but all essential elements in de-risking any equity investment.

We will only buy top quality. Our take on quality is different from most. We are not interested in short term earnings growth. Rather, our interest is in the underlying health of the company. Is it well positioned to survive and thrive over the next 10 years? For us, the key hallmarks of quality include a strong franchise, conservative management, low levels of debt, all backed up by a long term track record demonstrating the ability to survive through multiple cycles. True quality is a must for us because it is this quality that will protect us in difficult times.

We buy quality but only when it becomes available at exceptional valuations. We manage valuation risk by making sure we don't overpay. Going back to basics on valuations - essentially the valuation of a company breaks down into two components: your assessment of a company's earnings; and what multiple to pay for those earnings. Getting this right determines if you really are holding good value.

How to assess a company's earnings? Basing any investment decision on current earnings is asking for trouble - it is far too short a period for any rational assessment. We explicitly look through short term fluctuations in earnings (both positive and negative) to assess the earnings we believe a company can realistically sustain over the long term: its "Sustainable Earnings". We achieve this by in-depth analysis of the past financials, going back two cycles or more, and by factoring in potential disruptors (new entrants, changes in laws and consumer preferences and working practices, costs) that contribute to the future success or failure of a business. Drilling down into all the fundamentals that will drive a company's profits on a long term view takes time but, for us, is essential.

Turning to the price we are being asked to pay, what multiple of earnings makes sense? Today the market is routinely asking over 25x current earnings for quality. Make no mistake, paying 25x for any stock, no matter the perceived quality, is risky. This is a risk we minimise by paying only up to 12x Sustainable Earnings. This multiple makes sense to us – it projects a high single digit return (an earnings yield of about 8%), a return we believe justifies equity risk (unlike the market multiple of 25x which gives an earnings yield of just 4%).

Sticking to our 12x Sustainable Earnings discipline gives us the best opportunity to pick up the highest quality at exceptional valuations.

Every year we look at hundreds of companies which have seen a fall in price and/or appear to be undervalued by the markets. Yet each year only one or two make it into our portfolio. How do we

make the distinction between the very few buys and the remainder? We buy a stock only when we have full conviction (rarely reached) after having the necessary time researching. It is not easy to judge the outlook on a ten-year view, and we are very selective.

Our recent research activity has many examples of stocks that have not made the grade – we simply weren't convinced by the numbers and, as a result, were unable to achieve the conviction necessary. Car companies are an example. Ford, for instance, currently trades on 5x earnings. At first blush this appears cheap. The research we undertook suggests otherwise. With peak numbers of cars sold in the US and globally, increasing competition and supply, the risks to earnings are high. Add into the mix excess financing in the industry as a result of rock bottom interest rates and what emerged was a highly risky picture.

Our distinct style of value investing directs us away from these types of "value traps" and offers us the ability to identify genuine conviction buys in a world which feels as risky to us as it ever has. With QE, Brexit, euro banking weakness, strife in the Middle East, and a distinct shift to populist politicians (President Trump, anyone?), investing long term savings for the next decade looks to us like a risky endeavour. Investing in the highest quality companies available at excellent valuations based on long term sustainable earnings seems sensible, to us, in the face of these risks.

Stock of Interest: Taisho

Taisho is a Japanese pharmaceutical, call it a Japanese mini-GSK, a blend of pure pharmaceuticals alongside consumer healthcare. A company with a successful history over the last century, Taisho has a range of successful products including antibiotics and osteoporosis drugs, as well as hair treatment products and Lipovitan (an energy drink targeted at the lucrative Japanese middle-aged demographic). This brand has been an enormous success over its long history dating back to the 1960s and continues with a strong 40% market share and sales of about $600m.

Taisho's earnings in the last few years have been solid rather than spectacular. However, the expectations for Taisho's earnings have improved slightly in 2016 (reinforced by a small increase in the divided) and this has been enough to deliver a fillip to performance of the shares, up nearly 25% (in yen) in the first 6 months of 2016. We have owned Taisho since the launch of the fund in 2009 and it has delivered quiet but decent returns along the way. Whilst the annualised 5% it had returned until 2016 was reasonable, the recent step up has increased this to 7%. The strength of the yen vs sterling increases this annualised holding period return to over 8%.

Taking into account the substantial financial assets on the balance sheet (adding up to over 50% of the market cap of the company), the company's operations are trading at a substantial discount, and still look attractive even after the recent run up. Corporate Japan's moves towards efficiency and stewardship would be a further substantial boost for Taisho. Patience is paying off for us with Taisho, and it continues to look favourable.

Performance Commentary

The Fund was up 6.8% during the quarter (institutional share class), taking year to date performance to 31%. For reference, the MSCI world was up 7.4% taking year to date returns to 20%.

The performance has been broad-based, with no specific sectors or regions dominating. Sterling remains weak, which has been a small tailwind throughout our global portfolio.

It has been pleasing to see some of the most undervalued companies in the portfolio seeing the largest increases over the quarter. Three of the top 4 performers have been Delta Lloyd (up 37% in sterling terms); Fujikon (up 36%) and Neopost (up 25%).

Whilst Delta Lloyd suffered through its rights issue earlier this year, it remains at a price that represents only half of its book value (which matches an actuarial calculation of value). We would expect this to trade at closer to book value in the long term, so remains an incredibly attractive investment.

Fujikon (a high-end acoustic headset manufacturer) trades with 75% of its market capitalisation sitting in cash on the balance sheet and trading at just 7x its average earnings over the last 10 years. If you were minded to adjust for the excess cash, it is trading on a staggering 3x EV/EBITDA multiple. To our minds, this is an incredible price for a company possessing skills only shared by a handful of companies worldwide.

Neopost (a franking machine and parcel delivery service company) has one of the most attractive client bases that we can imagine (over 800,000 small and medium sized enterprises) and trades at 7x current earnings with a comfortably covered 7% dividend yield.

Whilst global equity prices are generally un-sustainably expensive in today's market, there remain some very interesting opportunities for the value-oriented.

The weakest stock in the portfolio was Yamana, one of our two gold miners, down 15% in sterling terms. Newmont also paused for breath in the quarter, up 3%. Against over 160% returns year to date for Yamana, this draw-back is acceptable. We retain our conviction that the returns this year merely unwind the excessive pessimism we saw in the sector in 2015 (recall that the price of gold miners fell by almost 90% in some instances, so a doubling or even tripling of those share prices from the bottom still leaves them trading significantly below recent highs. With a complete dearth of investment across the industry, this is an area where headwinds have turned firmly into tailwinds.

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

Period	Professional share class	Institutional share class	Class A share class
3 Months	6.8%	6.8%	6.8%
YTD	30.7%	31.0%	31.2%
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 – 30 September, 2016

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEWMONT MINING	N. America	Materials	20,800	6.7%
2	TAISHO	Japan	Health	9,300	4.2%
3	NEOPOST	Europe	Technology	1,000	4.1%
4	EXXON	N. America	Energy	361,900	4.0%
5	CANON MARKETING	Japan	Consumer Discr.	2,800	3.9%
6	BP	UK	Energy	111,500	3.8%
7	FUKUDA DENSHI	Japan	Health	1,300	3.8%
8	STATOIL	Europe	Energy	54,700	3.8%
9	WESTERN UNION	N. America	Technology	10,200	3.8%
10	DELTA LLOYD	Europe	Financials	2,100	3.7%
	Total Top 10				42.0%
	19 Other Holdings				44.1%
	Cash				14.0%

Unit Prices

As at 30 September 2016:

- Professional Share Class:
  - Income: 124.90 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 132.40 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 126.30 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 135.30 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 126.50 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 136.10 pence (unit price at inception, 29 April 2013: 104.3 pence)

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