QUARTERLY INVESTMENT REPORT

June 2017

The Fed lifted interest rates in June, marking a concrete milestone in a world of speculation on the direction of monetary policy. What next? The inkling of renewed rate rising has caused a bit of choppiness in the markets, and, perhaps surprisingly, it came in the form of a few uncomfortable days for technology shares, rare events in the last few years. Tech companies have no borrowings, why would they be affected by an increase in rates? And how does a rise in interest rates affect the outlook for value investing, and for Kennox? We have no crystal ball providing definite answers, but we were intrigued by the discussion during our most recent Advisory Panel Meeting. We discussed how painful a rise in interest rates can be for highly-rated, high-growth companies – as the bulk of their earnings is farthest in the future, they are most at risk from a rising discount rate. In other words, current valuations for expensive growth companies can be defended only if the growth continues and interest/discount rates stay low. If either of these assumptions prove to be false, a fall (potentially substantial) in growth share prices will unquestionably follow. This is a fundamental part of the rationale as to why rising interest rates are good for value stocks, particularly relative to growth.

But if rising rates aren't going to be great for highly-rated growth companies, highly-leveraged companies don't feel especially comfortable either, as large debt loads look particularly unappealing with a headwind of rising interest costs. This again reinforces, for us, the advantages of an investment style with an explicit bias against leverage – on average, the Kennox portfolio has just 8% leverage to Market Capitalisation – as well as a focus on other aspects of what we consider quality. Remember that at Kennox we are focused on buying the highest quality businesses but only when we find them at exceptional prices. How is that possible? We search far and wide, we are patient, and importantly, we are willing to buy when the short-term outlook is that of headwinds – typically the only time when high quality companies are available at great prices. We don't buy many stocks as it is rare we find the right combination between quality and price, along with the conviction that the headwinds are likely to be temporary and turn to tailwinds in our holding period. These are exceptional investments, and the basis for our philosophy and portfolio. (For those of you who are interested, please refer to the case study on our newly updated website.)

There are reasons for optimism throughout the global economy – the outlook for growth seems to be improving, and Europe is doing especially well. But there are risks. The risk that most concerns us is debt levels – across the system, from Chinese corporate to US student to government debt across the globe, debts have risen to above pre-crisis levels. As a result, the global economy has come to a bit of an uncomfortable impasse. If rates were to continue to rise, it is hard to see how this would not cause real pain, whether from high interest costs and/or huge write offs. A world of eternally-low interest rates is not eminently desirable either, certainly not according to Hyman Minsky, who believed that stability leads to increased risk-taking, therefore instability. Neither path looks especially appealing. This is to be ignored at one's own peril.

As always, there are reasons for optimism and for pessimism. In this uncertainty, we feel the portfolio is well positioned, able to deliver good returns in rising markets but should hold up well if the environment turns more challenging. Why? The stocks in the portfolio are all available at attractive valuations and are moving form short-term headwinds towards tailwinds, making the performance drivers of the portfolio differentiated from market cycles. And there is true diversification between the underlying profit drivers of our companies – just consider the top three stocks: Neopost, with both post and parcel solutions; Newmont, where the gold mining industry continues to see declining supply (a tailwind for the survivors); and Texwinca, with its niche position within the fabric industry and its exceptional valuations. There is no one bullet that will affect the profits of all three of these companies simultaneously.

In these times, we are attracted to the combination of sound businesses at inexpensive valuations which are fundamentally diversified, from each other and from the market. Our money continues to be invested in the Fund alongside our clients, and this is exactly the investment profile that we seek.

Stock of Interest: M1 Limited

M1 (formerly MobileOne) is a Singaporean mobile phone company. There are currently just three major operators (the other two being Starhub and Singtel), though a fourth has been granted a license to enter the market. The share price has suffered as news of the fourth operator has filtered into the market and it now trades on a 6% covered dividend yield – this is a very cash generative business, that is willing to share its fortunes with investors when the cash is available (for example, it returned the entire IPO share price in dividends within 6 years). Whilst the new licensee is likely to make inroads into the market when they launch in 2018, M1 has also been bolstering its offering. M1 remains popular with the key under 30s demographic, and are growing fixed line (broadband) services quickly. M1 is an intelligent operator, and we are confident in its long-term prospects despite this added challenge.

M1 has been an interesting case study as to how we size positions within the portfolio. In 2009/2010, M1 traded at under 10x our view of the company's sustainable earnings, and was one of the largest positions in the Fund at a 5.0% position. The price rose steadily until the end of 2014, at which point (including dividends), the return on those shares was around 200% (in sterling terms). Against that run in the share price, we trimmed the position down to 2.5%, reflecting the reduction in the margin of safety the increase price represented. With the recent retraction, the share price has returned to very attractive levels (at around 13x our view of sustainable earnings). In 1Q 2017, we have almost doubled our position, and it is currently the 4th largest position in the Fund at 4.4%. Through active management of position sizes, we strive to ensure that the Fund retains the largest exposures to the best opportunities where margins of safety are highest.

Performance Commentary

The Fund was down 0.9% during the quarter (institutional share class). Global markets also had a quieter month, with some of the heat taken out of the tech rally after a strong first quarter. The MSCI World index was up 0.5%.

Fukuda Denshi (a Japanese med-tech company specialising in patient monitoring and diagnostic equipment) has had a very good quarter. It posted strong results in mid-May, and the share price has risen over 25% in yen (22% in sterling terms) to reflect the rise in profits. Despite recent gains, the stock still trades at just 13x our view of sustainable earnings, with a very healthy balance sheet (with 20% of the market capitalisation sitting in cash). We remain happy holders at a 4.2% position in the Fund. Neopost has also had a very strong period, up 16% in the quarter and now up over 100% since lows in the first half of 2016. They continue to deliver on the transition between the traditional franking machine business (which remains highly cash generative during its steady decline) and the rapidly growing parcel and logistics business. They remain a trusted advisor to over 800,000 SME clients, many whom are developing online sales businesses reliant upon Neopost's services. The company was so heavily out of favour a year ago that it still trades at exceptionally frugal valuations with the business now looking strong. It remains the biggest position in the Fund.

Elsewhere, Texwinca has had a tough quarter, announcing an (expected) profit warning in May. The size of the expected reduction in earnings reflects exceptionals last year as well as softer operating performance in the current period. Despite the near-term nature of these issues, the market knocked 15% of the value of the company. The news has not impacted our assessment of the business – it is a leading provider of textiles to high end clothing manufacturers and retailers, and its capabilities become more attractive as retailers bolster their ESG profiles and reduce supply chain timelines. We added to our position on the profit warning, and the share price has since started to recover. Texwinca is the third largest position in the Fund.

Performance (total return net of fees) in Pounds Sterling to 30 June 2017

Period	Professional share class	Institutional share class	Class A share class
6 Months	0.4%	0.6%	0.7%
2016	35.4%	35.8%	36.2%
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 June 2017

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEOPOST	Europe	Technology	1,600	6.6%
2	NEWMONT MINING	N. America	Materials	17,300	5.2%
3	TEXWINCA	Asia	Consumer Discr.	850	4.9%
4	M1	Asia	Telecoms	1,500	4.4%
5	FUKUDA DENSHI	Japan	Health	1,400	4.2%
6	BP	UK	Energy	115,100	3.8%
7	EXXON	N. America	Energy	342,100	3.7%
8	ROYAL DUTCH SHELL	UK	Energy	222,300	3.7%
9	CANON MARKETING	Japan	Consumer Discr.	3,400	3.5%
10	MUNICH REINSURANCE	Europe	Financials	31,400	3.5%
	Total Top 10				43.4%
	19 Other Holdings				42.9%
	Cash				13.7%

Unit Prices

As at 30 June 2017:

- Professional Share Class:
  - Income: 127.70 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 137.80 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 129.10 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 141.20 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 129.20 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 142.20 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. Our website is www.kennox.co.uk