QUARTERLY INVESTMENT REPORT

September 2017

It has been a busy three months for the portfolio, although headline return figures for the quarter (the Fund was up 0.8%) may give the appearance of a quiet period. Our two clothes retailers, Next and Gap, have a had good quarter; we've trimmed a few positions as they approach our upper valuation limit; and we have added a new stock to the portfolio – Sky NZ. We discuss highlights below.

Next and Gap were added to the portfolio in Q1 2017 after each had seen over 50% taken off its share value (as we said in our Q1 report, while we agree that there are legitimate concerns around both businesses - growth from here is likely to be harder to achieve than in the past – we considered the negative price movement to be excessive, the result of market overreaction).

The market continues to question the relevance of retailers with large physical store networks, which we understand. However, we believe strongly that clothes retailers are likely to be more robust than general merchandise retailers: people like to try on clothes before they buy them; and they like to be able to return clothes directly, and in person. Research shows that where clothes retailers close physical stores, they also lose the majority of their online sales as well – i.e. stores remain an asset, rather than a liability as they are often now portrayed.

Both are good businesses and making strong efforts to improve. Next already generates over 40% of its revenues online (over 50% of its profit). This comes from what they themselves describe as a "sub-standard" online sales platform that the company is investing heavily to improve. At Gap, the eponymous Gap brand is starting to recover after some very poor design choices in 2014 and 2015, but the value in Gap Inc is really delivered by two of its other brands: Athleta, its fast-growing athleisure brand; and Old Navy, which is actually its largest brand, generating nearly 45% of the business's revenue (10% more than the Gap brand) and healthy margins (c. 15%).

In the last month, both companies have reported results that would best be described as "reasonable", yet the share price of each is up strongly. Next is now 41% ahead of our purchase price in February, and Gap is up 24% (though the weakness of the dollar has impacted those returns in sterling terms). These are exactly the sort of opportunities that we look for: strong businesses, well established in their markets, where heavily negative market sentiment drives prices significantly below fair value. It is enormously satisfying to see such healthy investment returns delivered on only reasonable results and we are confident there is operational improvement still to be delivered. We remain comfortable with a 4-4.5% exposure to clothes retailing across the two positions, and have trimmed a little from our Next position to keep that exposure steady.

We trimmed a number of positions over the quarter as share prices rose. Deutsche Post has been very strong through 2017, supported by healthy Q2 results announced in early August (the share price is up 29% year to date, and almost 90% since early 2016 in sterling terms). It is approaching our peak holding valuation (20 times our view of long term Sustainable Earnings) and we sold 40% of our holding, reducing it to a 2% position. Fukuda Denshi (the Japanese med-tech) has also risen rapidly in 2017 (up 27% year to date), and while it remains at under 15x Sustainable Earnings, we trimmed it to a sub 4% position.

A couple of stocks that held back portfolio performance over the quarter were M1 and Neopost. Following a good first-half of 2017, M1 was down 17% in the quarter (and is down 5% YTD). The share price continues to reflect the threat of a new entrant in the Singaporean mobile phone market, but value is highlighted by a 6.3% yield (in SGD) and M1 remains on very attractive valuations at 10x Sustainable Earnings. Similarly, Neopost had a very strong first half, and has since retreated over the quarter. It remains up 20% for the year and is on 9x Sustainable Earnings – we remain comfortable holders.

New position – Sky NZ

We are happy to hold whilst companies experience operational improvement (often as industry-wide headwinds turn to tailwinds) and would like our largest holdings to be those that offer the most appealing valuations. As a result, it is common practice for us to trim our winners, and recycle this cash flow either into new ideas, or into stocks in the portfolio experiencing tougher times. In this context we've taken a new position in Sky NZ. Similar to the UK Sky business, Sky NZ focuses only on the delivery of television content. Closely affiliated with Vodafone in NZ (Sky NZ provides the TV service where Vodafone can bundle it for telephone and broadband customers), the Sky NZ share price fell 35% during 2017 when plans to merge the two businesses fell through. We think the market overreacted and agree with CEO John Fellet that the merger was not essential for Sky NZ, as the majority of synergies can be achieved through commercial arrangements.

Whilst the shadows of Netflix and Amazon Prime loom, we believe that Sky NZ offers a very different service to those video-on-demand providers. It is the only real provider of sports content, and provides access to premium third-party film and box-set content (as opposed to Netflix and Amazon who are focussing on in-house productions where global licensing is more easily achieved).

New Zealand as a market has a number of attractions: it is sport-mad; its population is disparate, making satellite delivery an essential alternative to those with no access to high speed broadband; and it is small, making it a less attractive target for global competitors. Using a very conservative estimate of the earnings potential of Sky NZ's business, it is now trading at under 10x our view of Sustainable Earnings, and close to 7x the average earnings of the last 5 years. It is happy to share cash flow with shareholders - currently yielding 10%, covered by a 15% trailing free cash flow (after capex). We initiated a small position in July and have since increased our holding significantly – Sky NZ is now a 3% position.

Looking Ahead…

The dynamics of global markets have changed substantially in the last 6 to 9 months. The rapid rise of markets appear to have slowed – after rising over 30% in the 12 months to March 2017, they have risen just 1% since. Simultaneously, the outperformance of Value over Growth seen in 2016 has reversed in the first 9 months of 2017. The combination of these two effects has increased the number of opportunities of interest to value investors, and we would not be surprised to see the cash levels in the Fund (currently c. 9.7%) reduce further as we home in on opportunities.

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

Period	Professional share class	Institutional share class	Class A share class
YTD	1.2%	1.5%	1.6%
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 September 2017

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEWMONT MINING	N. America	Materials	20,000	6.0%
2	NEOPOST	Europe	Technology	1,300	5.4%
3	TEXWINCA	Asia	Consumer Discr.	850	4.9%
4	ROYAL DUTCH SHELL B	UK	Energy	252,100	4.1%
5	BP	UK	Energy	126,800	4.1%
6	STATOIL ASA	Europe	Energy	66,000	4.0%
7	FUKUDA DENSHI	Japan	Health	1,400	3.9%
8	EXXON MOBIL	N. America	Energy	347,400	3.7%
9	CANON MARKETING	Japan	Consumer Discr.	3,600	3.7%
10	MUNICH REINSURANCE	Europe	Financials	33,000	3.7%
	Total Top 10				43.6%
	21 Other Holdings				46.7%
	Cash				9.7%

Unit Prices

As at 30 September 2017:

- Professional Share Class:
    - Income: 128.70 pence (unit price at inception, 30 April 2009: 70.08 pence)
    - Accumulation: 138.90 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
    - Income: 130.20 pence (unit price at inception, 12 May 2010: 85.46 pence)
    - Accumulation: 142.40 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
    - Income: 130.30 pence (unit price at inception, 29 April 2013: 104.3 pence)
    - Accumulation: 143.50 pence (unit price at inception, 29 April 2013: 104.3 pence)

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