KENNOX
TRUE VALUE INVESTORS

QUARTERLY INVESTMENT REPORT

December 2017

During the 4th quarter of 2017, we continued to slowly rotate the Fund – trimming or exiting those positions that have moved closer to our upper valuation limit, and replenishing the portfolio with new stocks that offer more attractive long term returns. In a market that has rewarded and encouraged ever increasing levels of leverage (through persistent low interest rates), we have continued to find exceptional opportunities with either very low levels of debt, or preferably with cash on the balance sheet. Whilst this means we will not benefit from the super-heated returns that leveraged companies can generate, it significantly reduces the operational risk our companies are exposed to. This low-risk approach is coupled with a focus on valuations that should produce very attractive returns in the longer term: our portfolio trades at a 12.5% cashflow yield where the MSCI World index delivers just 8.1%. While this doesn't guarantee capital appreciation in the short term (the MSCI technology index delivers a 6% cashflow yield, but returned an eyewatering 25% to investors in 2017), it certainly puts the odds in our favour. The Fund was up 1.0% in the quarter.

We mentioned in the 3rd quarter commentary that we had sold 40% of our position in Deutsche Post. In the 4th quarter, we continued to sell, and exited completely in November at around €40. As recently as September 2011, the shares traded at under €10 as the market questioned the future of a mail delivery company in the face of increasing electronic communication. The exceptional brand strength of the express (parcel delivery service) segment was overlooked as its logistics segment struggled to find the critical mass required to generate even reasonable returns, and the domestic mail business suffered falling volumes and margins. The business traded at a miserly 10x PE, despite a healthy 5% dividend. Rolling the clock forward 6 years, the logistics business continues to struggle but is showing signs of finally coming good, the express business goes from strength to strength and the mail business has stabilised. In 2016 Deutsche Post generated record profits, with analysts expecting similar performance in 2017, and more to come in 2018. The shares now trade on 18x peak earnings, but over 20x our more conservative view of what is sustainable. Including the healthy dividend, the stock has delivered a more than 500% return since we launched the Fund in the UK in 2009.

The extreme negative sentiment that Deutsche Post faced in 2011, and the more recent transition of that business, bares more than a passing resemblance to another of our stocks: Neopost - another company that produces excellent (but falling) cash flows from a dominant post-related core business. In Neopost's case, it sells (or more often rents) franking machines to small and medium sized enterprises globally. Similarly to Deutsche Post, it is leveraging existing relationships to transition from its core business into the growth areas of electronic communication and logistics for e-commerce. Through organic growth and sensible small-scale acquisitions, it has developed market leading solutions in both areas. Neopost shares have fallen c. 25% during 2017, giving back some of the 65% gains in 2016. This seems an exaggerated reaction to weaker trading results for 3Q 2017. We spoke at length with management after the results announcement, and are confident that the company is taking the right steps to stabilise the business as it enters new sectors for its market-leading logistics solutions. The shares are likely to remain volatile through the transitional period, and we will continue to take advantage of this volatility to add to our holding. We have been buying through recent weakness at under 7x earnings, into a 7% dividend yield and an over 15% free cash flow yield. It is a 4.3% position.

We have added a new stock to the portfolio (Welling; see below), and also added to Sky Network Television ("Sky New Zealand") as the shares bottomed in November. It has recovered c. 17% in December, but still remains well positioned as the pre-eminent provider of premium sports content in New Zealand. The shares trade at a 10x PE and even higher free cash flow yield (as it has recently completed a roll-out of internet-enabled set-top boxes). Sky New Zealand is a 3.4% position.

Returning to the selling side of our rotation, Canon Marketing Japan and Fukuda Denshi (also in Japan) have both had stellar years in 2017. Canon Marketing up nearly 50% and Fukuda Denshi up around 25%. We have trimmed, and both finish the year as c. 3% positions. We have also reduced our exposure to Gap by about a third as the shares rose almost 50% from mid-year lows. We remain excited by the prospects of the business – it continues to demonstrate its ability to shift assets and investment between its different brands, capitalising on shifts in consumer trends and tastes. Whilst the Gap brand itself is currently weaker, Old Navy (its largest segment) and Athleta (the fast-growing athleisure brand) are performing admirably. However, the shares were more enticing at around 11x Sustainable Earnings as they were before the share price move, than the current 16x. It is now a 2.2% position.

We are genuinely excited in our outlook for the Fund as these moves leave the portfolio well positioned in terms of high quality and attractive valuations, with businesses that have already been through headwinds. This combination offers attractive risk to return characteristics irrespective of whether 2018 turns out to be a year of smooth sailing, or of less benign temperament.

New position – Welling Holdings Ltd

Welling Holdings is a HK-listed manufacturer of small motors for air-conditioning units and white-goods. It has leading market shares (globally) in both air-conditioning motors and washing machine motors, due in part to its relationship with Chinese white-goods manufacturer Midea (who own 66% of the shares) to whom it makes over 50% of its sales. It has generated remarkably solid profits for the last 8 or 9 years (averaging about $600m) equating to about an 7x PE, and 8x our estimate of Sustainable Earnings at $500m (the low end of the range of results over that period). Adding to the appeal, it is very conservatively financed, with around 75% of the Market Cap represented by cash at the time of purchase. It is a robust business, and operates in a growth market. As affluence increases across Asia, demand for its products continues to increase. It is likely to face margin pressure as wage increases bite, but it can absorb these increases, and as a provider of low cost, but essential parts (each motor sells for just $5), Welling is likely to be able to pass these costs on over time.

Having first bought in September/October, Midea have since made an offer to take the company private, some 47% above our entry price. A rapid realisation of value wasn't our expectation, but clearly Midea agree with us – the shares are markedly undervalued. We are holding on to the shares for now (even the recent share price represents a discount to where we feel it should be), in the expectation of an improved offer. While Welling is exactly the type of business that we would be happy to hold for the long term, it is likely that the shares will not be a feature of the portfolio for long.

Performance (total return net of fees) in Pounds Sterling to 31 December 2017

Period	Professional share class	Institutional share class	Class A share class
2017	2.1%	2.5%	2.6%
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 – 31 December 2017

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEWMONT MINING	N. America	Materials	20,000	5.9%
2	TEXWINCA	Asia	Consumer Discr.	800	4.4%
3	ROYAL DUTCH SHELL	UK	Energy	280,000	4.4%
4	BP	UK	Energy	140,000	4.4%
5	NEOPOST	Europe	Technology	1,000	4.3%
6	STATOIL	Europe	Energy	71,000	4.2%
7	EXXON	N. America	Energy	356,000	3.8%
8	MUNICH REINSURANCE	Europe	Financials	33,700	3.7%
9	M1	Asia	Telecoms	1,200	3.6%
10	WESTERN UNION	N. America	Technology	8,800	3.5%
	Total Top 10				42.3%
	20 Other Holdings				44.8%
	Cash				12.9%

Unit Prices

As at 31 December 2017:

- Professional Share Class:
  - Income: 127.50 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 140.10 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 128.90 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 143.80 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 129.00 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 144.90 pence (unit price at inception, 29 April 2013: 104.3 pence)

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