QUARTERLY INVESTMENT REPORT

September 2019

The Fund returned 1.6% in the third quarter, bringing year to date returns to 5.3%. The Fund displayed much less volatility than the market over the quarter and held up well through the larger market drawdown seen in late July and August.

Over the quarter Western Union was the Fund’s top performer, with the shares up 21% (all performance is quoted in sterling terms). The investment case is typical for a Kennox holding. The company has distinct but often overlooked competitive advantages – it remains the market leader in global money transfer services; it has a huge network of agents worldwide that would be impossible to replicate in anything but the longest of time frames; and its competitors face a very high barrier to entry, created by increasingly tight anti-money laundering regulation. Looking at the big picture, the demise of cash and mobile transfers as dominant factors in the money transfer industry seem unlikely as these services fulfil a basic social need for a large demographic. Western Union remains lowly valued, at 11x our view of Sustainable Earnings. The company generates strong cash flow (8% free cash flow yield), pays a decent dividend (a yield of 4%) and has a low amount of debt on the balance sheet.

With the rise of the underlying gold price our gold miners, Newmont Goldcorp and Yamana, also had a strong quarter (Yamana notably up 30%). Nothing has changed our view of these positions in the portfolio. Firstly, the industry benefits from constrained new supply due to cut backs post peak gold price eight years ago. An added benefit is the gold miners’ role as a store of value, attractive in a world of negative interest rates and also in any return to inflation. It is worth noting that the two companies had their strongest performance when the market was down in August. Strategically, Yamana’s management is simplifying the business and focusing on its core and strongest assets. Newmont looks very well positioned having significantly improved its cost efficiency. It is the largest gold miner in the world with a low level of debt (even post the Goldcorp transaction) and reasonable cash flow generation that we expect will increase. We remain happy holders of both.

Texwinca, the HK listed fabric producer, was the weakest portfolio performer in Q3 with its shares down 17%. Sentiment is clearly being hampered by US-China trade concerns and uncertainty regarding the retail environment globally. It is almost impossible to predict when the clouds over the retail industry will abate or what will be the outcome of the trade dispute but, as mentioned last quarter, we believe the extent to which the company is effected by the trade war is misunderstood – the fact is that only 10% of Texwinca’s revenue come from direct trade between China and the US. In the face of these uncertainties, we note that the underlying operations of the company are showing progress. Performance in the core fabric business remains resilient with recent results even showing growth in sales and improving profit margins. It is one of only 3 significant players in its industry and has a list of global high quality customers. The valuations continue to price in extreme pessimism, trading at just 5x our view of Sustainable Earnings, dividend and free cash flow yields in the double digits, and with a strong balance sheet trading at 0.5x book (representing a significant discount to a proxy of break-up value). We have systematically reviewed our holding as the share price has fallen – at these valuations, buying an operation built to survive, and thrive, in the long term is the type of opportunity that can be extraordinarily profitable to investors who can hold their nerve.

This quarter, with concerns over slowing global growth, our energy names were negative contributors to performance, with our four holdings down on average 3%. This should be taken in the context of a strong start to the year (on average they are still up 6%), and that they will not be immune to short termism, both in the form of market sentiment and of volatility in commodity prices. A longer term view should focus on their strong positioning within the industry, including their vertical integration, offsetting some of the commodity exposure, and especially overlooked in our opinion is the capital cycle. Investments made over the years are now coming on stream and this is exceptionally powerful, improving their cash flow with limited reliance on short-term commodity prices. With these large historic investments now coming online as high margin major projects, cash flow looks robust for years to come. For instance, we met with Shell management in the quarter and they reiterated their commitment to return to shareholders $25bn a year for five years from 2021, equating to half the current market cap (currently around $250bn). Thereafter they assure that returns should be even higher.

Due to the gas price weakness, Equinor was the one energy major we owned that had been weak through 2019 (down by about a third from peaks late last year, falling back to 12x our view of Sustainable Earnings). We viewed this as an opportunity and added to our position at attractive prices. It remains on track for production increases next year with the ramp up of new sites. At the same time, it reported lower capital expenditures, showing the potential for growing free cash flows. As a signal of the confidence in the outlook for the company, management have reinstated its buy-back programme.

As the global market continue its 10 year rise it’s worth spending a moment to reflect the market’s performance over the quarter. The MSCI World ended the period up 4%, but simply focusing on the final performance number misses the underlying skittishness of investor sentiment. In August we saw markets fall 5.5% (peak to trough) as investor focus shifted to slowing global growth and political uncertainties. Thereafter, arguably, not much changed for the long-term outlook with the Fed deliberating over future monetary policy, trade tensions ever present (especially around US and China), and political issues such as the unrest in Hong Kong and Brexit in the UK remaining unresolved. Yet the market rebounded strongly (up 5% from trough to peak) as investors again chose to focus on the positives.

The point to note is that market sentiment (and thus stock prices) can and does change, both positively and negatively, often without a clear change in the market narrative.

We set the Fund to thrive in all market conditions, without predicting these swings in market sentiment or fashions. We are not reliant on bull or bear markets, nor on continuing economic growth or fearing a swing to an economic contraction.

- Over the market cycle we would expect to deliver high single digit absolute returns that are commensurate with the risk taken and in line with the long term returns from equities. (We have delivered an annualised 8% after fees in the period since portfolio inception in 2007.)
- In extended bull markets with a large amount of optimism built in we would expect to lag (which we have this year).
- In volatile markets, we would expect to hold up significantly better than the market. (Since 2007 we have outperformed in over 75% of larger market drawdowns. Our worst calendar year has been -4%.)

For thematic or aggressive investors, there are many products in the market that might suit better. For cautious and risk-aware investors, those who can think patiently for the long term, this is a style for all seasons, come what may with those market swings in sentiment.

Performance (total return net of fees) in Pounds Sterling to 30 September 2019

Period	Professional share class	Institutional share class	Class A share class
YTD	5.1%	5.3%	5.5%
2018	-2.5%	-2.2%	-2.0%
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 – 30 September 2019

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEWMONT GOLDCORP	N. America	Materials	31,000	7.5%
2	WESTERN UNION	N. America	Information Technology	10,000	4.7%
3	EQUINOR	Europe	Energy	64,000	4.6%
4	BP	UK	Energy	129,000	4.6%
5	ROYAL DUTCH SHELL	UK	Energy	234,000	4.4%
6	QUADIENT	Europe	Information Technology	717	4.3%
7	CHINA MOBILE	Asia	Communication Services	169,000	4.2%
8	MUNICH REINSURANCE	Europe	Financials	37,000	4.0%
9	GLAXOSMITHKLINE	UK	Health Care	106,000	4.0%
10	TESCO	UK	Consumer Staples	29,000	3.7%
	Total Top 10				46.0%
	18 Other Holdings				41.4%
	Cash				12.6%

Unit Prices

As at 30 September 2019:

- Professional Share Class:
  - Income: 127.10 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 143.50 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 128.60 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 148.00 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 128.70 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 149.80 pence (unit price at inception, 29 April 2013: 104.3 pence)

Charles L. Heenan

(Investment Director)

Geoff Legg

(Investment Director)

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