QUARTERLY INVESTMENT REPORT

September 2020

Global equity markets were somewhat quieter over the third quarter. Having fallen rapidly in March and recovered almost as quickly in the second quarter following governments' unprecedented intervention, the MSCI World Index rose 3.6% in the third quarter. The US led the way with a rise of 4.4%. Given the uncertainty around how Covid-19 will continue to impact global economies, it is notable that the market remains in "risk-on" territory, with the bellwether defensive sectors such as Utilities and Health Care both underperforming the broader market. Straying too far down this risk-on path is at odds with Kennox' view that investors should retain no small degree of conservatism. When Covid-19 hit in early 2020, it was a massive shock to an already very leveraged financial system. Governments stepped in and increased debt further yet – for instance, the Fed printed more money in the three months following Covid-19 than in the five years following the global financial crisis of 2009. Now standing at approximately 350% of GDP, global debt has never been anything like this high, limiting options and potential responses to future shocks.

Further, it remains early for markets to declare the problems over. Crises evolve over time, with outcomes deferred by government actions and the normal buffers for consumers and companies (such as running down reserves, increasing debt). It is worth remembering the global financial crisis of 2008 – the first signs of a problem were felt as early as July 2007 (when BNP first shut two funds, reporting a "complete evaporation of liquidity in certain markets"), but Lehmans didn't collapse until September 2008, a full 15 months later. We may not know for some time how the world will look after Covid-19.

The global economy remains in unchartered territory – prudent investors should remain diversified, and wary of excess optimism.

The Fund fell 5.5% during the quarter with performance negatively impacted by our exposure to energy majors. Whilst oil prices have stabilised at c.$40 per barrel, negative sentiment towards the sector continues to weigh heavily on the share prices (the sector fell 19% during the quarter). In our view, this has led to a significant dislocation between the fundamental value of these businesses and their share prices. Seeking differentiated but robust returns, Kennox must be willing to make (and retain) investments where our views are at odds with those of the majority. After all, this is where the best returns can be made.

We share the belief that fossil fuels need to be replaced by renewable energies, but the global economy will need fossil fuels for the foreseeable future. As BP recently put it: "hydrocarbons are challenged but will remain part of the energy mix for decades". As the global energy mix shifts towards fuels with lower carbon emissions, so will the vast capex budgets of the energy majors. With a history of executing capital-intensive and complex energy projects, they are uniquely positioned to participate in the transition. Note that currently 85% of all global energy comes from fossil fuels, with around 6% coming from renewables. Under BP's most aggressive scenario, renewables will be just 20% by 2030, a full decade from now. Under their "rapid transition" scenario, renewables will only constitute about 45% of global production. That's by 2050. The companies we hold continue to be a significant part of the solution to both powering the world today and evolving energy production for the future. As the survivors, they exhibit the ability to

generate significant profits and cash flow, even in current markets. Whilst they continue to trade at depressed valuations, we will continue to be happy holding them.

Meanwhile, the discrepancy in performance of “Value” relative to “Growth” continues to widen. In the third quarter, value underperformed by a further 7%, making a cumulative underperformance for the year-to-date of a staggering 34%. This is coupled with a remarkable narrowing of the markets. By market capitalisation, the biggest 5 companies of the S&P 500 (Apple, Microsoft, Amazon, Alphabet and Facebook) now make up nearly 25% of the entire index (comparing to just 11% a decade ago). Of course, the performance of growth stocks is wider than just these 5 companies. Tesla (that has yet to make a full year profit) trades at 16x sales. Compare that to Toyota, the next biggest auto company by market capitalisation, that trades on a miserly 0.7x sales. Ocado (10x sales) is worth more than Tesco, despite Tesco having almost 35x Ocado’s revenue, and even EBITDA is almost three times bigger than all of Ocado’s revenue. Netflix trades at over 10x sales, and is valued at over $230bn, or 80x next year’s profit forecast. These valuations imply formidable future growth and profitability.

To illustrate the extent to which the recent rally has been fuelled by expanding multiples rather than improving fundamentals, over the last 12 months Apple’s market cap has doubled from $1tr to $2tr, a period during which its net earnings have produced a somewhat underwhelming increase from $55bn to $57bn (the consensus forecast for earnings to September 2020). Clearly, this cannot last forever. In the short-term, this can be justified by momentum – if investors continue to chase ever-decreasing list of companies, the share prices will increase regardless of valuation. But these gains often reverse when markets take stock of the miserly returns implied by the inflated valuations. As Benjamin Graham eloquently put it: “in the short term the market is a voting machine, in the long term it is a weighing machine”.

Whilst unusual, market distortions of this magnitude have been seen before. The last time Value experienced similar underperformance was in 1999, during the Dotcom bubble. Market commentary at the time was frighteningly similar: Value was proclaimed “dead”, and expensive tech stocks were expected to dominate for a generation. With the benefit of hindsight, we now know that in fact, the opposite transpired – from January 2000, Value outperformed Growth by 37% in 18 months, and by 8% p.a. for the next 7 years*.

We believe vehemently that it will always be sensible to invest in quality, sustainable companies trading at reasonable multiples of their long-term earnings potential. The portfolio as a whole trades at about 12x our view of sustainable earnings, valuations that imply solid future returns. Aside from the energy majors mentioned above, we have c. 20% in the conservatively managed gold miners (Newmont, Newcrest and Yamana) that should perform well in uncertain markets, 15% in telecoms (China Mobile, Swisscom, Singapore Telecom and KPN), that provide essential services in an increasingly digital world, and generate consistent cash flows that have been largely overlooked by the recent market recovery and a further 15% in small caps that are trading at exceptionally frugal valuations.

Whilst frustrated by the extended headwinds we’ve faced, we remain optimistic about the positioning and the valuations of our portfolio. We are content sitting tight until the market reverts to being a weighing machine – at which point our high-quality holdings trading at a sizable valuation discount to the market** will once again be a significant advantage.

* Source: Bloomberg. Data from MSCI World Value index vs MSCI World Growth index in GBP

** Price to book value at 1.0x vs 2.7x for the MSCI World; price to cash flow at 4.4x vs 10.4x for the MSCI World. Source: Kennox, Bloomberg

Fund Data – 30 September 2020

Performance (total return net of fees) in Pounds Sterling

Period	Professional share class	Institutional share class	Class A share class
YTD	-15.8%	-15.5%	-15.4%
2019	4.5%	4.8%	5.1%
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.

Top 10 Holdings

	Stock	Region	Sector	Market Cap (US$m)	Fund Weight
1	NEWMONT CORP	N. America	Materials	51,000	8.8%
2	NEWCREST MINING	Asia	Materials	18,000	5.6%
3	CHINA MOBILE	Asia	Communication Services	131,000	4.4%
4	SWISSCOM	Europe	Communication Services	28,000	4.2%
5	YAMANA GOLD	N. America	Materials	5,500	4.0%
6	TESCO	UK	Consumer Staples	27,000	4.0%
7	EQUINOR	Europe	Energy	46,000	4.0%
8	FUKUDA DENSHI	Japan	Health Care	1,300	4.0%
9	WESTERN UNION	N. America	Information Technology	9,000	3.8%
10	GLAXOSMITHKLINE	UK	Health Care	95,000	3.7%
	Total Top 10				46.5%
	17 Other Holdings				42.6%
	Cash				10.9%

Unit Prices

As at 30 September 2020:

- Professional Share Class:
  - Income: 104.10 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 120.30 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Institutional Share Class:
  - Income: 105.30 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 124.50 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 105.40 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 126.20 pence (unit price at inception, 29 April 2013: 104.3 pence)

Charles L. Heenan (Investment Director)

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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

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