QUARTERLY INVESTMENT REPORT

September 2021

In a quarterly report we wrote back in 2008, we referenced the ancient Chinese curse: "May you live in interesting times". It is the first of three curses of increasing severity, the other two being: "May you come to the attention of those in authority" and "May you find what you are looking for." Well, we certainly live in interesting times.

In the years since the great financial crisis (GFC) of 2008 (and re-fuelled by the pandemic), the world has become increasingly distorted from long-term norms. Extremes are being tested on many metrics, and clear signs of strain indicate the likelihood of near-term reversal in certain areas:

Leverage. The world has never been more indebted than it is today - since the GFC, debt has increased by a third. That is staggering when you consider that the GFC was a debt-induced crisis. The increase in debt has been provided at record-low prices and has therefore benefitted highly leveraged businesses. Leverage is finally coming into focus with stories like Evergrande in China and may well soon be considered a threat rather than an opportunity.

Inflation. We have also lived in a world where deflationary forces have dominated. This has allowed record low interest rates to go unchallenged. Low inflationary environments have typically benefitted financials and high growth companies (as a low discount rate over-weights earnings further in the future). We are now talking about inflation. It is here, and with the increase in money supply over the last decade, it is here to stay. Inflationary environments have typically benefitted energy companies (we've started to see these move already), materials companies (though not until inflation exceeds likely interest rate rises) and companies on low multiples.

Valuation. Growth indices have outperformed by record amounts for a decade (and by a further 34% in 2020 alone) as has the US (the world's most expensive market). This won't last – the greater fool theory (price doesn't matter as long as someone else is willing to pay more) has never been a good long-term strategy.

All of these macro trends have been stiff headwinds for Kennox and have impacted our performance. Our long-term biases have led us away from areas of the market that have been beneficiaries: we hold no heavily-leveraged companies (approximately half of the portfolio has next to no debt or is actually net cash); we hold no banks; and we hold no companies whose valuations can only be justified by unchartered growth assumptions (in fact our portfolio valuations are on as big a discount to the market as we have ever seen).

However, as these trends start to unwind, what we do own looks particularly well positioned:

We have 20% of the portfolio in **energy majors**. These companies have started performing (share prices up 12% on average in the third quarter) but are still seriously undervalued. We are very likely to see a shortage of supply in the next 3-5 years as there has been chronic underinvestment in traditional energy (oil and gas), which will support energy prices. In the first half of 2021 alone, **Royal Dutch Shell** produced c. $16bn in free cash flow (i.e. a 20% free cash flow yield). That's backward-looking, so before recent gas price surges from $3 to $5 (/MBtu). Our energy majors have almost no correlation to global markets and look very well positioned to benefit as the economy emerges from the pandemic.

We have 12% of the portfolio in **gold miners**. Another area of the market that is emerging from a bear market (gold prices peaked in 2011, with capex peaking in 2012). To give an example of the opportunity, **Newmont** (our largest position) is now producing high single digit free cash flow returns backed up by a 4% dividend yield. As inflation bites, and confidence in fiat currencies is further undermined by central banker activity, these companies could produce very much better returns than those high single digit free cash flows imply.

A further 15% of the portfolio is in **traditional telecom** companies. In the past, we have described these companies as “ballast”. Companies that have utility-like returns as the service they provide has become a staple for society. As these have been overlooked by the market in favour of the hot tech stocks (i.e. handset manufacturers Apple and Samsung). We feel that 5G technology shifts that balance of power towards the owners of the network. Development of these networks has been a headwind for the telecoms companies for some time (due to the cost of roll-out), but will soon be a tailwind as it becomes a point of differentiation. Valuations are incredible. **Singtel** is a good example. It owns c. 32% of subsidiary Bharti Airtel (the second largest player in India). That is a liquid position, and if you remove it (and associated cash flows) from the valuation of Singtel, the remainder of the business is trading on c. 17% free cash flow yield.

Elsewhere, we continue to hold idiosyncratic businesses with key attributes in common: leading market positions in the niches in which they operate; little or no financial leverage; operations that have largely recovered since the pandemic; and trading at high single digit or low double digit free cash flow yields, again often backed up by significant dividend yields. Needless to say, these are exactly where we feel the right balance of risk and return can be found.

Jeremy Grantham (of GMO) also clearly believes that we live in interesting times. In their current 7-year forecasts, GMO predict -8% returns per annum for a decade for US equities, such is the extent of the current over-valuation*. So our thoughts return to 2008 when we last invoked the Chinese curse. As it did in 2008 (our portfolio provided returns of +10% even as global markets fell nearly 20%), today's potential looks similar, with a potent balance of likely downside protection and ample upside potential.

* https://www.gmo.com/europe/research-library/gmo-7-year-asset-class-forecast-august-2021/

Fund Data – 30 September 2021

Performance (total return net of fees) in Pounds Sterling

Period	Class P share class	Class I share class	Class A share class
YTD	10.1%	10.5%	10.6%
2020	-11.3%	-11.1%	-10.9%
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	43,500	6.0%
2	ROYAL DUTCH SHELL	UK	Energy	171,500	5.9%
3	EQUINOR	Europe	Energy	83,000	5.8%
4	QUADIENT	Europe	Information Technology	800	5.0%
5	BP	UK	Energy	90,500	4.9%
6	SINGAPORE TELECOM	Asia	Communication Services	30,000	4.1%
7	CHINA MOBILE	Asia	Communication Services	123,500	3.8%
8	SWISSCOM	Europe	Communication Services	30,000	3.7%
9	TEXWINCA	Asia	Consumer Discretionary	300	3.6%
10	FUKUDA DENSHI	Japan	Health Care	2,000	3.5%
	Total Top 10				46.3%
	18 Other Holdings				51.8%
	Cash				1.9%

Unit Prices

As at 30 September 2021:

- Class P Share Class:
  - Income: 118.40 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 139.50 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Class I Share Class:
  - Income: 119.80 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 144.80 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 119.90 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 147.10 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