KENNOX
TRUE VALUE INVESTORS

Investing at an inflection point

There has been a shift in the investment environment over the last few months. Having dominated Value for the best part of a decade until November 2021, Growth has since underperformed Value by 14%. This has been epitomised by the fortunes within market sectors: the two sectors that delivered the best returns in the prior decade (Technology and Consumer Discretionary) have delivered the lowest returns since November 2021, down 11 and 13% respectively[1].

Many investors, recognising the elevated levels of risk in global equity markets, are now considering Value as an alternative to Growth. That makes sense – long out of favour, the latent potential within Value is considerable. However, we would urge some caution. Not all Value is the same – not all will do well in the environment we face. Investors might wish to dig a little deeper into the Value they propose adding.

In this note we take a concise look at the new investment environment, its impact on equities overall, the many facets of Value and why we expect our risk focused quality Value approach to deliver strong performance (absolute and relative) from here.

- **A decade of momentum**
- **A certain sense of "déjà vu"**
- **What caused the recent shift**
- **Repositioning your portfolio – finding the balance**
- **How is Kennox positioned?**

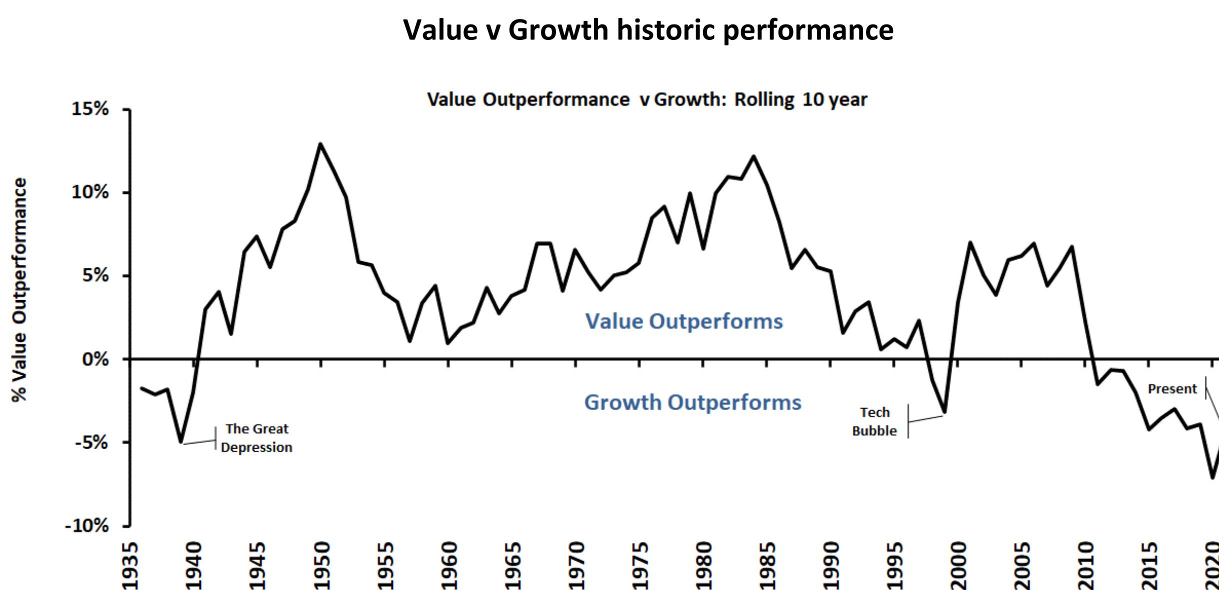
[1] Source: Bloomberg. Growth reflects performance of the MSCI World Growth index, and Value the performance of the MSCI World Value index. Both in sterling terms as at 28 February 2022.

A decade of momentum

The underperformance of Value stocks over the last decade has been as well-documented as it has been unprecedented. We contributed to the debate with our paper, "A decade of momentum" released in December 2020. In that paper, we discussed the rationale for Growth's outperformance (principally the roles of deflation, low interest rates/bond yields, market sentiment and the compounding impact of the Covid pandemic).

For those who need reminding, the graph below is a neat summary of the extent of Value's underperformance.

Value v Growth historic performance



Graphic I[2]

The lesson learned from history: although the relative Growth/Value performance over the last decade is the most extreme on record (including the Great Depression of the 1930s and the dot.com bubble of the 1990s), it isn't unheard of for Value to underperform over a decade. However, these periods of underperformance have always been followed by extended periods of Value outperformance, as stretched Growth valuations unwind.

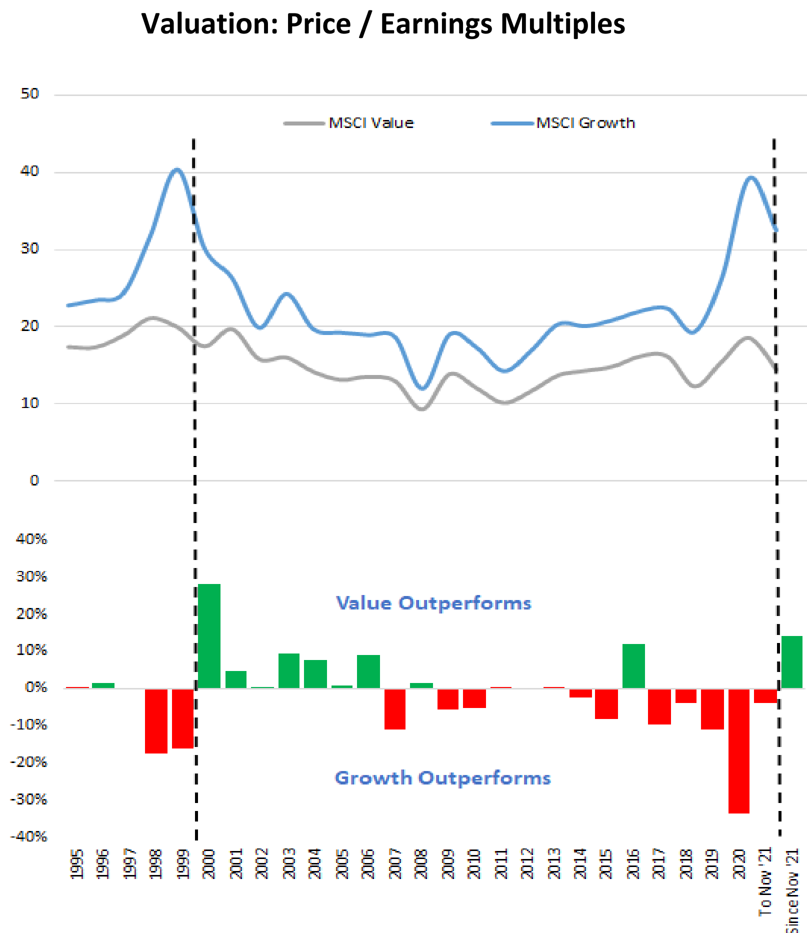
From here, the share prices of many fully valued investor favourites look challenged - those who follow GMO will have seen their recent 7-year real return forecasts in which they are predicting -5% p.a. for US large cap stocks[3]. Whilst we don't claim to be able to forecast stock market returns to a similar degree of accuracy, the sentiment echoes our concerns around the foreseeable upside (or lack thereof) for Growth.

[2] Rolling 10 year returns, Value vs Growth. Source: Fama/French research; Kennox. As at 28 February 2022. Depicts annualised out-performance of the cheapest stocks (lowest 3 deciles) versus that of the most expensive stocks (highest 3 deciles) based on P/B, P/E and P/Cash Flow ratios. Performance is calculated over rolling 10 year periods. Relative performance of MSCI Value vs Growth. Source: Bloomberg

[3] https://www.gmo.com/europe/research-library/gmo-7-year-asset-class-forecast-february-2022/

A certain sense of “déjà vu”

To get a good feel for current extremities, it’s worthwhile looking back at the last major underperformance of Value – the Dot.com bubble, when global stock markets were led to new highs by the euphoria around technology stocks. Sounds familiar, but the resemblance today goes beyond first glance (and doesn’t end well for Growth). The two charts below compare the relative performance and historic valuation multiples of the MSCI Value and MSCI Growth indices then and now:



Graphic II

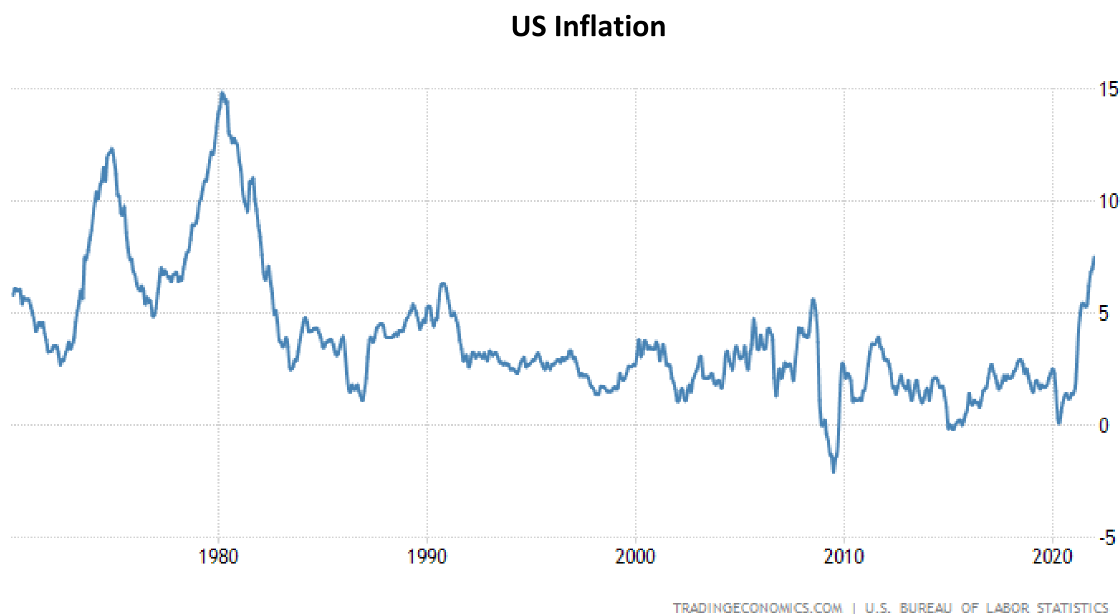
In both bubbles, Dot.com and now (we are currently in a bubble), valuation multiples in the World index spike to almost double while Value index valuations show little change. The result is significant Growth outperformance. However, this is brought to an end when investor euphoria rapidly recedes and more normal valuation multiples return, leading to a sustained period of Value outperformance. Following the Dot.com bubble the Value index outperformed Growth in each of the next seven years, and by a compound 59% (the Value index was up 32% in the seven years from 2000 to 2006, with the Growth index down 27%). History tends to repeat itself – should it at least rhyme with itself, the recent Value uptick could be the start of prolonged period of Value outperformance.

Looking at the aftermath of the Dot.com bubble, it’s not just the relative Growth/Value performance that catches the eye, but also the absolute performance of each (as mentioned above, over seven years Value was up 32% and Growth down 27%). This stands to reason – Value valuations didn’t expand nearly so much, nor did the potential Value returns contract. This is equally applicable to the fortunes of both today.

What is causing the current shift?

We'd say it stands to reason that the causes of the bubble are also likely to precipitate its correction.

We boldly announced in December 2020 that inflation was finally emerging. As tends to be the case, we were early. However, this opinion doesn't seem so speculative now, with US inflation[4] at its highest level since the early 1980s (and the UK highest since 1992).



Graphic III

Rising inflation is typically accompanied by rising interest rates and rising bond yields. Whilst we are seeing early signs of rises in both interest rates and bond yields, it is evident that the world is so awash with debt that central banks will struggle to raise interest rates far without crippling effects. As a result, the recent rise in inflation is unlikely to be transitory.

How does all this impact equities? For the last decade, with no inflation, rock bottom interest rates and falling bond yields, markets have been able to value stocks with a discount rate that is very close to zero. Growth stocks are much more sensitive to shifts in the discount rate as they have a higher weight of earnings that are further in the future. As we have seen in recent months, even a murmur of an increase in this discount rate can be truly traumatic for some of the most expensive stocks. Look at Netflix, whose share price is down by nearly 50% from highs in November, as valuations fell from over 60x earnings to around 30x earnings (still expensive, in our opinion).

The disruptive impact of inflation on equities overall should not be underestimated. On this we refer to our December 2020 discussion with Russell Napier, who sits on the Kennox Advisory Panel. With history as his guide, Russell discusses the reasons why Growth stocks tend to fare significantly worse during periods of inflation, and predicts that the incoming inflationary environment will see Value significantly outperform, not just in the short term, but for "a decade, possibly two".

[4] https://tradingeconomics.com/united-states/inflation-cpi

Repositioning your portfolio – finding the balance

Following a 10-year Growth led bull market, it is not surprising that most equity investors have a significantly overweight exposure to Growth. Now, as risks increase and future returns look to be challenged, many are considering (in most cases reluctantly) a move away from a strategy that has done them so well for so long. Some may be considering initiating or adding to a Value position.

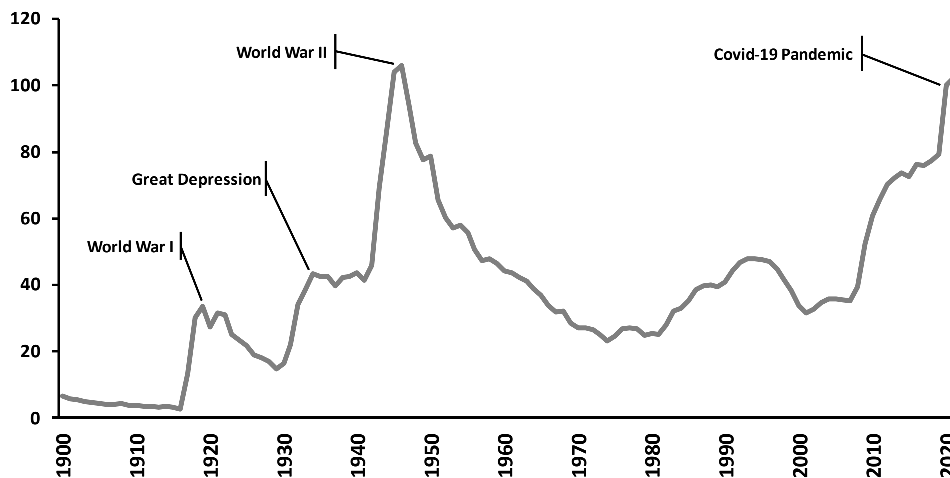
When deciding where to place funds we would suggest that all investors should be paying specific attention to the two key risks we mentioned earlier – the return of inflation and the spectre of rising interest rates. Looking at both problems:

Inflation. With Inflation rapidly emerging as the biggest cause of investor concern, we looked to find which areas of the equities market perform the most consistently (good and bad) in inflationary environments. It's a study fraught with difficulty, but we were comfortable drawing three conclusions (and recommendations):

- **Expensive stocks lag**: the increasing discount rate disproportionately impacts stocks where earnings are further in the future. So expensive consumer brands (think Amazon, Tesla), Tech and the US (very consensus/over-owned) should be avoided
- **Commodities boom:** specifically, the Energy and Materials sectors. Energy and Materials are widely underheld (a combined 8% MSCI World weighting) and much undervalued. Perhaps uncomfortable news for some, but these sectors are well equipped to deliver excellent returns in inflationary environments
- **Financials struggle:** This is not always the case in low inflationary environments, but typically holds when inflation cannot be contained by higher interest rates. Our recommendation would be to have reduced exposure here, in particular to banks (we have no banks).

Rising interest rates/excess leverage. Not unnaturally following a decade of easy money at historically low rates, global debt levels are at historic highs.

Debt – US Debt Held by the Public (%GDP)



Graphic IV Source: Congressional Budget Office[5]

[5] Federal Debt Held by the Public. https://www.cbo.gov/system/files/2021-03/56977-Data-Underlying-Figures.xlsx

High levels of debt boost returns in times of plain sailing, but also increase losses (and in the worst case bankruptcy) when the tide turns. This simple logic dictates that investors should now be looking to avoid the most highly leveraged companies, sectors, and geographies – in our opinion, this would include the US and banks.

A brief look into the eroding impact of inflation and interest rates shows it's time to reduce holdings in expensive, leveraged Growth. We would suggest at least a balance between Growth and Value managers. (Dare we even say that it may be time to be overweight Value?)

But what type of Value? So long out of favour, it had become expedient to dump all Value styles into one neglected Value bucket. Convenient when investors were not actively considering Value as a viable option, this oversimplification could be detrimental to those now looking to introduce or add to a Value weighting.

Not all Value is the same – a significant proportion of the Value menu on offer is not suited to the investment environment ahead. So, where to look within the Value space?

Perhaps easiest to start with the Value that we believe should be avoided:

Low quality Value carries higher risk, with potentially sizeable downside. In this category we would specifically include:

- Companies with fundamentally poor businesses/weak franchises. Superficially cheap, these companies are not sustainable businesses and tend to be found out in difficult market conditions
- Highly leveraged Value. Many companies in the Value space are operating at full leverage. As discussed above, rising interest rates will put considerable pressure on their ability to survive

Value ETFs should also be approached with caution. ETFs may appear like optimal vehicles for an efficient switch in to Value, but most come with an easily overlooked risk – they typically follow MSCI weightings and are therefore heavily exposed to the geographies and sectors that have done best (and underweight those with the most potential). This is shown clearly in the current MSCI World Value index exposures. In buying an ETF, investors would be taking on:

- 68% in the US, the most expensive and leveraged market
- 22% in Financials. Financials, both banks and insurance companies, have high levels of leverage, a significant risk in times of turbulence and asset price volatility

In contrast, the MSCI Value index is significantly underweight sectors and geographies that are well suited to outperform in the months/years ahead (areas where investors should be looking to increase exposure):

- 7% in Energy
- 6% in Materials
- 4% in Communications Services
- 5% in the UK, perhaps the most undervalued market

How is Kennox positioned?

Kennox has a track record of strong performance in difficult markets. Since 2007 portfolio inception we have outperformed in over 85% of significant down markets[6]. Notably in 2008, our portfolio returned +10% as global markets fell nearly 20%[7]. We have our current portfolio in similarly robust shape, a healthy balance of downside protection and realistically achievable upside potential – all with our consistent quality hallmarks:

28 sector leaders: Strong franchises with distinct competitive advantages. Run by conservative management teams who prioritise long-term performance over short-term growth. Each has a long-term track record – the proven capacity to survive in various market conditions and cycles.

Inflation-resilient: We hold none of the companies or sectors that typically suffer through inflation (including expensive stocks and banks). Instead, we have large weightings in areas capable of thriving in this environment, such as:

- Energy majors (a combined 21% position): including BP and Shell. Out of favour for years, these companies are set to deliver exceptional returns for years to come
- Gold miners (15%): including Newmont and Newcrest. In times of monetary and fiscal uncertainty having high quality, diversified exposure to gold is sensible
- Telcos: (15%) including China Mobile, Swisscom and Singapore Telecom. Producing a 4.5% yield, each holding a dominant position and owning the coveted 5G network in its domestic market. As essential service providers, these companies should be able to retain pricing power

Resilient to rising interest rates: Across the portfolio, all companies have low debt levels (over 30% of the portfolio is net cash, and nearly 90% has net debt / EBITDA of less than 3x). Our advantage over the market here is huge – the financial leverage in the Kennox portfolio (measured by total assets / equity) at 2.2x is around one third of that for the MSCI World (6.0x) and MSCI World Value (6.6x).

Exceptional valuations: In difficult times the market tends to attach more importance to valuations (which can, and have been, largely ignored by many during the good times). We take valuations seriously, seeing them as key indicators of the underlying health of our companies. Since inception our portfolio has had consistent exceptional valuations advantages over the market across key metrics. These are discussed in our paper "Kennox approach to Value investing". Again, the advantage over the market is enormous:

	MSCI World	MSCI Value	Kennox Portfolio
Price/Book Value	3.1x	2.1x	1.1x
Price/Cash Flow	12.3x	8.9x	5.3x
Dividend Yield	1.8%	2.7%	4.3%
Financial Leverage	6.0x	6.6x	2.2x
Price/Sustainable Earnings	>20x*	>15x*	12x

Graphic V. Source: MSCI, Kennox. Data accurate as at 28 February 2022.

[6] Significant drawdowns defined as periods where the MSCI World index has fallen by more than 5% in sterling terms

[7] Source Bloomberg: market return relates to MSCI World return in sterling terms

Uncorrelated to any index: Indices are naturally over-weight the areas of the market that have done best – a real risk. As active investors (Active Share: 99%) we are not influenced by consensus or benchmarks. As highlighted above in the section on Value ETFs, we are concerned that now is not the time to "own the market". Our differentiation is clear:

	MSCI World	MSCI Value	Kennox	
			Portfolio	Holdings
N. America	72%	72%	19%	Newmont; Yamana Gold; Exxon; Western Union
UK	4%	5%	14%	
Asia (ex Japan)	3%	3%	28%	
Financials	14%	22%	1%	Admiral
Tech	22%	9%	12%	Western Union; Quadient; Canon Marketing; Tradelink
Energy	4%	7%	21%	

Graphic VI Source: MSCI, Kennox. Data accurate as at 28 February 2022.

Clearly diversified from all indices (and other managers), our global equities solution is specifically suited for the potentially turbulent times ahead. If you'd like more information, please be in touch.

Kennox Strategic Value can be used as an **integral building block** in any well-balanced portfolio shaped to meet the demands of the uncertain markets ahead.

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Supporting materials

For further information, you may wish to look at:

Video: Our thoughts on the key drivers behind the unsettled market, what these mean to equity investors, and deeper insight into our portfolio positioning

"A decade of momentum": a paper we produced in 2020 on the reasons for Value underperformance and the possibility of Value outperformance

"The Kennox approach to value investing": which gives a comprehensive overview of our investment strategy

The Kennox Portfolio

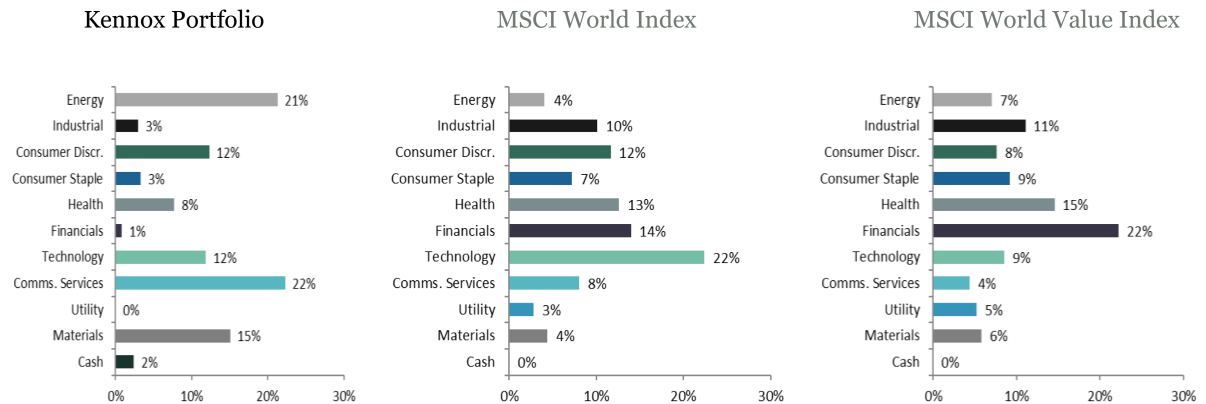
28 high conviction stocks. All with our hallmarks of quality, picked to give downside protection and deliver easily achievable upside, even in the toughest of markets

The Kennox Portfolio – Top holdings

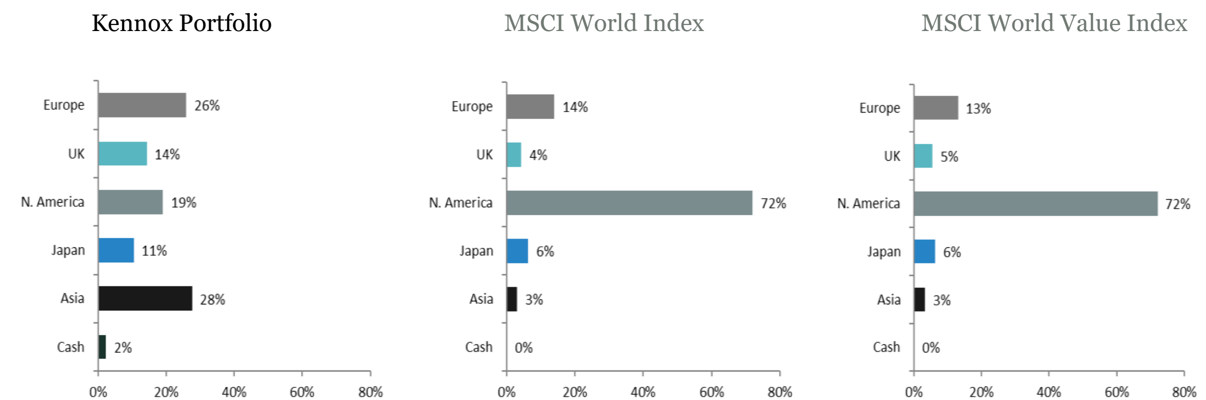
Company	Holding	Quality	Sustainable Earnings	Inflation	Leverage	Valuation Highlights	Region	Sector
NEWMONT	6.8%	The blue chip amongst the gold miners	🟢 14x SE	🟢	🟢	Up from just 6x SE	N. America	Materials
SHELL	6.3%	Integrated super-major; investments coming online	🟢 11x SE	🟢	🟡	Low break-even costs; resilient bussiness	Europe	Energy
EQUINOR	6.2%	Core Norwegian shelf reserves are a unique resource	🟡 17x SE	🟢	🟢	Low break-even costs; resilient business	Europe	Energy
BP	4.6%	Oil major with unparalleled deep-water engineering skills	🟢 10x SE	🟢	🟡	10xSE, undervalues core assets	UK	Energy
YAMANA GOLD	4.4%	Canadian and Latin American gold exposure	🟢 13x SE	🟢	🟢	Price undervalues optimized assets	N. America	Materials
EXXON	4.3%	Highest quality name; highest yield in 20 years	🟡 17x SE	🟢	🟢	Top quality energy and chemicals assets	N. America	Energy
SINGAPORE TEL	4.2%	Leading provider across six Asian countries	🟢 12x SE	🟡	🟢	Diverse and cash-generative operations	Asia	Communication Services
CHINA MOBILE	4.1%	Largest customer base in the world	🟢 9x SE	🟡	🟢	Under 3x EV/EBITDA; and $61bn in net cash	Asia	Communication Services
NEWCREST MINING	3.8%	Major gold miner with long reserve life and low production costs	🟢 14x SE	🟢	🟢	Strong cash generation, solid balance sheet	Asia	Materials
SKY NEW ZEALAND	3.7%	Only significant provider of premium sports content in NZ	🟢 9x SE	🟡	🟢	c. 9x conservative SE estimate	Asia	Communication Services
SWISSCOM	3.7%	The top communications provider in Switzerland	🟡 17x SE	🟡	🟢	4% yield in CHF	Europe	Communication Services
WESTERN UNION	3.5%	Largest global remittance co. (4x the size of next competitor)	🟢 10x SE	🟢	🟢	Low capex requirements, excellent FCF	N. America	Information Technology
KPN	3.4%	Strongest telco provider in Netherlands	🟡 19x SE	🟡	🟡	>10% FCF	Europe	Communication Services
TEXWINCA	3.3%	Leading provider of high-end textiles to global clothes brands	🟢 5x SE	🟡	🟢	11% yield	Asia	Consumer Discretionary
TESCO	3.3%	Strong market position affords sustainable cost advantages	🟡 16x SE	🟢	🟢	16xSE on conservative margin assumptions	UK	Consumer Staples
Total	65.5%							
Other holdings	32.1%							
Cash	2.4%							
Total	100.0%		Portfolio avg: 13x SE				Small Caps (<1bn) make up 20%	

Source: Kennox. Data accurate as at 28 February 2022.

Sector weights:



Region weights:



Source: MSCI, Kennox. Data accurate as at 28 February 2022

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