KENNOX
TRUE VALUE INVESTORS

QUARTERLY INVESTMENT REPORT

December 2022

If anyone was hoping for a quieter year after the mayhem wreaked on the markets by Covid-19 in 2020 and 2021, they certainly didn't get it. We are a long way from returning to markets that could be described as "normal".

Let's have a refresh very quickly on the year gone. Covid-19 is starting to feel like a less significant disruption at home, but it is still very much a factor in global markets. China continues to yo-yo between lockdowns and releases and global logistics suffer as a result. 2022 saw deaths in the UK surpass 200,000 and restrictions were only finally lifted towards the end of February 2022. On the same day that restrictions were lifted in England (the 24th of February), Russia invaded Ukraine and most western countries rallied in support of Ukraine. The ramifications are far-reaching, but the most obvious is a renewed emphasis on national energy security as the world has been very quickly weaned off cheap and plentiful (relatively speaking) Russian oil and gas. One should never be surprised by the short-sightedness of politicians, but the UK has responded with a windfall tax on energy producers that has left EDF questioning the viability of its nuclear power stations in the UK (that provide 15% of the UK's electricity and more on days when the wind doesn't blow), all energy companies questioning investments in North Sea projects and the government approving a new coal mine for the first time in 30 years.

If this leaves you questioning the effectiveness of a 5-year political cycle, the alternative doesn't look very much more appetising. In China, Xi Jinping was re-elected for a third term in October. He has effectively made himself the second "president for life" after the communist party founder Chairman Mao Zedong. Uncertainty over the level of state control and for the global supply chain more generally remain high.

All of this, together with government and central bank actions since the global financial crisis, has led to inflation not seen since the 1980's and interest rates rising, climbing over 1% for the first time since 2009. We have written about the impact of inflation and rising interest rates several times (most notably in our March paper "Investing at an inflection point[1]"), but in short, this change has been positive for value investors. As Russell Napier recently pointed out in an excellent webinar, during times of inflation, expensive stocks don't protect investors[2].

Recent outperformance of value feels like the tip of an iceberg. Having underperformed growth by a combined 94 percentage points between the end of 2016 and end of 2021, value outperformed growth by 26 percentage points in 2022[3]. As we highlighted in that paper, the last time markets reversed from a period of sustained growth outperformance (leading up to the Dot.com bubble in 2000) value outperformed for 7 consecutive years, and by a compound 59% (the MSCI World Value index was up 32% with the MSCI World Growth index down 27% between 2000 and 2006).

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[1] https://kennox.co.uk/wp-content/uploads/2022/03/Investing-at-an-inflection-point.pdf
[2] In the period between 1966 and 1982 interest rates rose in response to inflation and PE multiples collapsed over 16 years.
Watch "Asset allocation in financial repression: governments decide who's naughty and nice" available on the ERIC website: www.eri-c.com
[3] Comparing performance of the MSCI World Growth and Value indices in pounds sterling

A recent study by GMO[4] assesses the valuation gap between the cheapest and most expensive halves of various global markets, and shows that in the US, the valuation gap was at an 11th percentile level at the end of the 3rd quarter 2022 (all-be-it, up from a 4th percentile level a year previously). In Europe, the valuation gap is still at the 4th percentile level. In other words, despite the recent run, the cheaper half of the market remains highly undervalued.

In these unusual markets, it is worth a quick reminder of how Kennox looks at stocks to assess opportunities. We remain cautious (looking to protect capital before growing it). We value (free) cash flow as much as, if not more than reported earnings. We favour companies with solid balance sheets (particularly prescient in the face of rising costs of borrowing), and those that have a healthy respect for external shareholders. This is seen often in ownership structures (we like companies with significant management ownership) and in shareholder returns (we like companies that share when they are doing well, ideally in dividends). And we like conservative management, which sometimes means cutting dividends when times are tough. Whilst there is nothing new here, this is starkly different to most of the market that still favours growth above all, and certainly at the expense of valuation. Nothing about the current market turmoil makes us think that the Kennox approach needs to change.

As you might imagine, 2022 was a very good year for Kennox, with the Fund rising 13%[5]. In a year where global markets were down 8%, 15 of 29 names in the Kennox portfolio posted positive returns, and 20 beat the market.

Several themes within the portfolio performed well. Our energy names posted returns of over 65%, our communication services companies posted returns of 12% and our gold miners returns of 10%. It is notable that excluding any one of these exposures, the Fund would still have posted positive returns in 2022. [6]

We remain comfortable in all three positions. **Energy companies** because they are integral to society (as we are reminded daily), and they remain extremely unpopular and therefore inexpensively valued. **Telecoms** because they are another of life's essentials that had been spurned by investors drawn to the more enticing handset manufacturers (Apple was down 18% in 2022 and Samsung down 24% both in GBP). **Gold miners** have yet to reflect a world slowly reducing dependence on the US dollar – the third quarter of 2022 alone saw central banks buying close to 400 tonnes of gold. Gold markets haven't seen this level of central bank activity since the late 1960s, yet gold remains at around $1,800 per troy ounce, a price breached back in 2020. History would lead us to believe that energy and telecoms are sound investments in difficult economic times, and gold holds its value as well as anything in times of inflation.

Elsewhere, our portfolio of Japanese stocks also performed well (all four were up in the year, and up 14% on average against the broader Nikkei index that was down 9%). There is little that connects our Japanese holdings beyond the location of their listing. **Canon Marketing** (up 32%) is the Japanese marketing and distribution arm for parent Canon, **Taisho** (up 9%) is a prescription and self-medication (or over the counter) pharmaceutical, **Fukuda Denshi** (up 9%) is a medical equipment manufacturer and **Star Micronics** (up 7%) is a machine tool manufacturer for the production of precision parts. Perhaps what ties them together is valuation. They each trade at or below tangible book value, they pay reasonable dividends (around 3% on average across the four) and have cash on the balance sheet equating to almost 40% of the combined market capitalisation.

Our two UK retailers have been the most chastening exposure for us. **Tesco** was down 19% whilst **Currys** was down c. 50%. The economic outlook for the UK looks challenging to say the least and consumer confidence is at close to an all-time low. Perhaps unsurprising as disposable income comes under pressure from the rising cost of living without commensurate pay rises. We remain comfortable that

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[4] https://www.gmo.com/americas/research-library/3q-2022-gmo-quarterly-letter/

[5] 12-month performance to 30 December 2022: IA Global Index, -11.3% [source: Morningstar]; MSCI World Index, -7.9% [source: Bloomberg]; MSCI World Value Index, +5.4% [source: Bloomberg]

[6] Period returns for Kennox portfolio include part-year performance for China Mobile that was sold mid-year

both will weather this storm. Tesco is the very definition of a consumer staple and has an unrivalled scale advantage. Currys is the largest provider of white goods and consumer electronics and couples its market leading position in the UK with similar dominance in the Nordics through their brand Elkjøp. It is not without its challenges, but we remain convinced that omnichannel (offering people the opportunity to see products before purchasing) has an enduring position in high-ticket retail where their scale allows them to price match even online-only competitors.

A quick word on ESG, as it continues to dominate conversation and as Sustainability Disclosure Requirements (SDR) approach in the UK. We will not label or define ourselves as a sustainability or ESG fund and the requirement to label ourselves (or not to) will do nothing to impact our approach to investing. That is not to say that we don't take ESG seriously – companies that do not take their corporate responsibilities seriously (to the environment (E), to society more broadly (S) and to its shareholders (G)) are not sustainable businesses, and therefore offer limited "value" for shareholders who intend to hold for extended periods of time (as we do). In other words, ESG considerations are an important contributor to our decision making, but no more important than many other quality or value factors. For those familiar with the EU's Sustainable Finance Disclosure Regulation (SFDR), this is akin to being classified as an Article 6 fund. This stance has not always been comfortable in recent times (as money has flowed towards explicitly labelled ESG funds), but we believe it is a rational and consistent approach, and we will stick with it.

Finally, an update on a few themes that we have driven the bull market for the best part of a decade, but look to be reaching a time of reckoning: rising levels of speculation; and ever-increasing leverage. Rising speculation (or the greater fool theory) has come unstuck all over the market. SPACs have unwound, crypto assets have crashed and Tesla's market cap has fallen by c. 75% (before you ask, it's still expensive). Indebtedness is no longer a fringe concern, and as businesses start to have to roll over their debts, that is spreading from the balance sheet to the P&L. Watch this space.

But even in these uncertain times, a portfolio can flourish – if it is built around a sensible investment philosophy and aware of the risks of the moment. Thus armed, Kennox is cautious about markets and the economic backdrop but remains firmly optimistic about the portfolio.

Fund Data – 30 December 2022

Performance (total return net of fees) in Pounds Sterling

PERIOD	SHARE CLASS		
	CLASS P	CLASS I	CLASS A
2022	12.3%	12.6%	12.9%
2021	9.6%	10.1%	10.5%
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: Class P on 30 April 2009; Class I on 12 May 2010; and Class A on 29 April 2013.

Top 10 Holdings

STOCK	REGION	SECTOR	MARKET CAP (US$M)	WEIGHT (%)
EQUINOR	Europe	Energy	113,500	7.2
SHELL	UK	Energy	202,000	6.8
EXXON	N. America	Energy	454,000	6.2
NEWMONT CORP	N. America	Materials	37,500	5.9
BP	UK	Energy	107,000	5.7
YAMANA GOLD	N. America	Materials	5,500	5.3
SINGAPORE TELECOM	Asia	Communication Services	31,500	4.7
CANON MARKETING	Japan	Information Technology	3,000	4.2
SWISSCOM	Europe	Communication Services	28,500	4.0
FUKUDA DENSHI	Japan	Health Care	1,500	3.8
TOTAL TOP 10				**53.7**
18 OTHER HOLDINGS				45.0
CASH				1.3

Unit Prices

As at 30 December 2022:

- Class P Share Class:
  - Income: 126.30 pence (unit price at inception, 30 April 2009: 70.08 pence)
  - Accumulation: 156.00 pence (unit price at inception, 29 April 2013: 103.1 pence)
- Class I Share Class:
  - Income: 127.60 pence (unit price at inception, 12 May 2010: 85.46 pence)
  - Accumulation: 162.50 pence (unit price at inception, 29 April 2013: 104.3 pence)
- Class A Share Class:
  - Income: 127.70 pence (unit price at inception, 29 April 2013: 104.3 pence)
  - Accumulation: 165.90 pence (unit price at inception, 29 April 2013: 104.3 pence)

Charles L. Heenan

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If you have any questions on Kennox or the Kennox Strategic Value Fund, please contact us on +44 (0) 131 563 5440 or email him at clients@kennox.co.uk. Our website is www.kennox.co.uk

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