Review of investment trust range | Investment trusts

2 February 2017

Fidelity Closed-End Funds

This is a regular publication looking at Fidelity and recent developments in three of its investment trusts – Fidelity Asian Values, Fidelity Japanese Values and Fidelity Special Values.

In this issue:

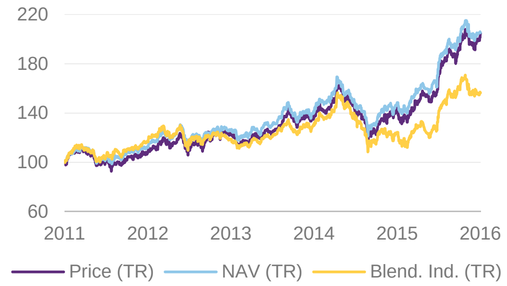
- The appointment of Nitin Bajaj as manager of Fidelity Asian Values (FAS) has been a very successful move for the trust. It has recently made a bonus issue of subscription shares allowing existing holders the opportunity to further participate in this success.
- Fidelity Japanese Values' (FJV's) performance has been turning a corner, aided by weak sterling. Corporate earnings are weak but its manager thinks these are close to a nadir and, with the Japanese government working hard to increase real wages, he has increased exposure to consumer discretionary spending as he expects this to get a boost.
- The manager of Fidelity Special Values (FSV) approaches the fifth anniversary of his appointment. Alex's strategy has been transformative for the trust and we take a look at this in more detail.

Special feature: Fidelity Special Values

Alex Wright took over the management of Fidelity Special Values (FSV) in September 2012. He manages the portfolio using a value/contrarian style, which has proved to be very successful for the trust, affording it peer-group-beating performance. Reflecting this, the trust has experienced a marked improvement in demand for its shares. Its discount has narrowed from 15.4% when Alex took over, to 1.6% today. In our special feature, we take a look at FSV's strategy, the investment process, Alex's outlook and some key themes currently being used in the management of the portfolio.

Fidelity Asian Values perf.

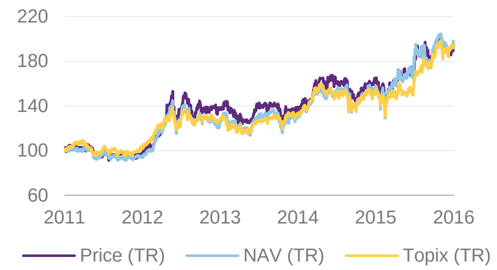
Time period 31/12/2011 to 31/12/2016



Source: Source: Bloomberg, Morningstar, Marten & Co.

Fidelity Japanese Values perf.

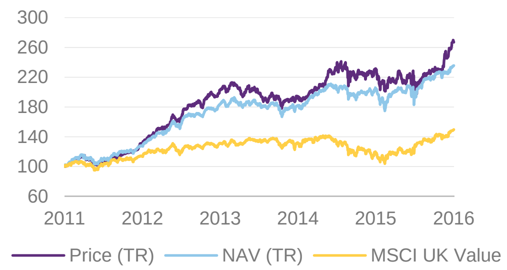
Time period 31/12/2011 to 31/12/2016



Source: Source: Bloomberg, Morningstar, Marten & Co.

Fidelity Special Values perf.

Time period 31/12/2011 to 31/12/2016



Source: Source: Bloomberg, Morningstar, Marten & Co.

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Recent developments at Fidelity

Fidelity has been celebrating its second year as *Money Observer's* Premier Group (an award which is based on the average net asset value (NAV) total returns achieved by each of the group's trusts) and has now been running investment trusts for over 25 years. Fidelity has plans to expand its successful investment trust business and, following approval by shareholders, Fidelity Asian Values has recently made a bonus issue of subscription shares.

Fidelity International

Fidelity Internatioal has US $279.1bn of assets under management. It has a significant presence in London, Hong Kong, Tokyo, Singapore and Sydney.

Fidelity International is a global investment manager that has substantial expertise in equity and fixed income investments, as well as other asset classes. It had US $279.bn (£223.7bn) of assets under management, as at 31 December 2016, and offers an impressive range of funds to both private and institutional investors. Fidelity maintains a global network of fund managers, but has a significant presence in London, Hong Kong, Tokyo, Singapore and Sydney. Managers are supported by an extensive analytical team that also has a global footprint (Fidelity has a network of circa 350 investment professionals located in over 13 countries) and Fidelity is renowned for both its bottom-up stock-picking investment process as well as a focus on long-term performance.

Fundamental investment process

Portfolio managers are incentivised based on their long-term performance.

Fidelity's managers, whilst having access to extensive macroeconomic analysis and market-cycle information, do not have top-down macro views imposed upon them. Instead, asset allocation decisions reside with portfolio managers whose incentive schemes are primarily based on the longer-term performance of the funds that they manage. Managers and analysts will typically form opinions taking a three-to-five-year view. They maintain projections over this time frame and are not encouraged to follow fads or chase trends. The core to Fidelity's approach is that, irrespective of the strategy (growth, value, etc.), each investment opportunity is researched in depth, from the bottom up, with a view to ensuring that every holding is a sustainable longer-term investment. Following this approach, consistently, has been a pillar of Fidelity's success during the last 40 years.

Special feature: Fidelity Special Values

Fidelity Special Values (FSV) aims to achieve long-term capital growth by investing primarily in UK-listed special situations. The trust has an all-cap strategy, but there is an inherent bias towards small-and mid-cap companies. Alex Wright has been managing FSV since September 2012. His value/contrarian style has proved to be very successful for the trust providing it with performance markedly ahead of the peer-group average.

Alex seeks to identify stocks that have experienced some difficulties but may, in his view, have scope for a recovery that is not reflected in the valuation of the company. He also invests in stocks that he believes have growth potential that is not recognised by the market.

FSV's portfolio bears little resemblance to the composition of the UK benchmark indices.

When investing, Alex is looking for a margin of safety such that downside risk is limited. For investee companies, Alex typically expects to see both a recovery in profitability and an improvement in sentiment that leads the market to place a higher multiple on the company's earnings. The nature of this stock-picking strategy means that the portfolio bears little resemblance to the make-up of UK benchmark indices.

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Fidelity Asian Values

Sticking to the Nitin!

The second anniversary of Nitin Bajaj becoming manager of Fidelity Asian Values (FAS) is approaching and, if he continues in the same vein, his appointment will have been a very successful change of strategy for the trust. FAS has recently made a bonus issue of subscription shares allowing existing investors to further participate in this success.

Long-term growth from small-cap Asia ex Japan

FAS aims to achieve long-term capital growth by investing in a portfolio of companies that are listed on the stock markets of the Asia ex Japan region. Nitin Bajaj, the portfolio manager, takes a value-orientated stock-picking approach, based on fundamental research that is coupled with an absolute return mindset. The portfolio is overwhelmingly focused on smaller-cap companies as this is where he sees the greatest opportunity to find valuation anomalies given that this section of the market is less well-researched.

Nitin seeks to identify investments that he believes can return 50% over a three-year period, while looking to avoid sharp capital losses. In addition to valuation, the research process places considerable emphasis on a company's financial strength, ability to generate cash-flows, competitive advantages, business prospects and earnings potential. Nitin is able to draw on Fidelity's proprietary research resources in this regard.

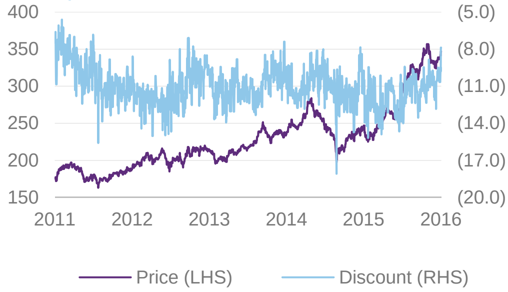
Year ended	Share price TR. (%)	NAV TR. (%)	Peer group avg. NAV TR. (%)	Blended b'mark Index TR. (%)*	MSCI World TR. (%)
31/12/12	8.7	12.1	23.1	16.7	10.7
31/12/13	13.2	13.1	1.5	1.8	24.3
31/12/14	11.8	11.4	12.2	9.6	11.5
31/12/15	4.6	5.1	(3.7)	(4.4)	4.9
31/12/16	42.3	38.1	26.7	25.8	28.2

Source: Fidelity Asian Values, Bloomberg, Morningstar, Marten & Co. *Note: The blended benchmark index comprises the MSCI AC Far East Ex Japan Index until 31 July 2015 and the MSCI AC Asia Ex-Japan Index thereafter.

Sector	Asia Pacific Ex Jap
Ticker	FAS LN
Base currency	GBP
Price	364.75p
NAV	382.18p
Premium/(discount)	(4.6%)
Yield	1.2%

Share price and discount

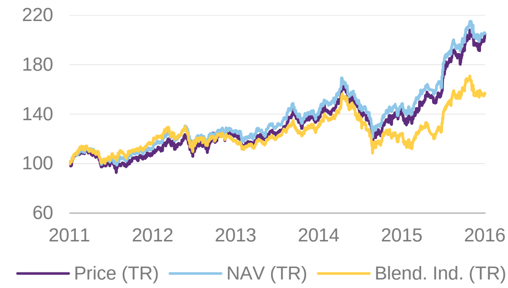
Time period 31/12/2011 to 31/12/2016



Source: Source: Morningstar, Marten & Co.

Performance over five years

Time period 31/12/2011 to 31/12/2016



Source: Source: Bloomberg, Morningstar, Marten & Co.

Domicile	United Kingdom
Inception date	13 June 1996
Manager	Nitin Bajaj
Market cap (GBP)	246.2m
Shares outstanding	67.5m
Daily vol. (1-yr. avg.)	121.9k shares
Net cash	1.6%

One for five bonus issue of subscription shares

There has been a notable change to the capital structure of the company recently. In December 2016, FAS made a bonus issue of subscription shares to existing shareholders on the basis of one subscription share for every five ordinary shares held. Each of the 13,497,222 subscription shares gives holders the right to buy an ordinary share at a fixed price on fixed days in the future as follows:

- On the last business day in November 2017, the subscription price will be 370.75 pence per share (a 1% premium to the NAV on 2 December 2016);
- On the last business day in November 2018, the subscription price will be 381.75 pence per share (a 4% premium to the NAV on 2 December 2016); and
- On the last business day in November 2019, the subscription price will be 392.75 pence per share (a 7% premium to the NAV on 2 December 2016).

The subscription shares can be bought and sold separately from the ordinary shares. The ticker code is FASS. Marten & Co's sister company, QuotedData, publishes information on warrants and subscription shares each month which can be accessed here.

Portfolio

Figure 1 shows the 10 largest overweight positions relative to the benchmark as at the end of November 2016. We have compared the end of November top 10 overweights with the positions at the end of March 2016 (the data we used in our last update on the fund). There has been little change to the top 10, which reflects Nitin's investment style. Religare Health Trust has changed its name to RHT Health Trust.

Figure 1: Top 10 overweight positions as at 30 November 2016

Holding	Sector	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31 Mar 2016 (%)	Percentage point change
Power Grid Corp India	Utilities	3.9	0.0	3.9	3.6	0.3
TISCO Financial	Financials	3.1	0.0	3.1	2.6	0.5
Cognizant Tech Sols.	Information tech.	2.6	0.0	2.6	2.0	0.6
WPG Holdings	Information tech.	2.4	0.1	2.4	2.3	0.1
RHT Health Trust	Healthcare	2.2	0.0	2.2	2.9	(0.7)
Ascendas India Trust	Real estate	2.0	0.0	2.0	2.0	0.0
Intl. Housewares	Cons. discretionary	1.9	0.0	1.9	1.2	0.7
LT Group	Industrials	1.9	0.0	1.9	1.9	0.0
WT Microelectronics	Information tech.	1.6	0.0	1.6	1.7	(0.1)
G8 Education	Cons. discretionary	1.6	0.0	1.6	2.0	(0.4)

Source: Fidelity Asian Values (monthly factsheets as at 30 November 2016 and 31 March 2016)

We discussed many of the top 10 overweight positions in our last note (see page 7 of that note).

The manager has been adding to the position in Cognizant Technology Solutions, the largely Indian IT services provider listed in the United States. The shares have been weak recently due to fears that a Trump administration will cut the number of visas available for IT professionals travelling to the US for work while penalising companies that outsource jobs to other countries. The stock has been targeted recently by Elliott Advisers, which has sent management an action plan for unlocking value from the company.

Nitin has taken profits on the holding in New Oriental Education.

Figure 2: Sectoral allocations, as at 30 November 2016

	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31 March 2016 (%)	Percentage point change
Consumer discretionary	23.7	9.7	14.1	23.9	(0.2)
Information technology	19.1	27.3	(8.2)	18.4	0.7
Consumer staples	11.0	5.0	6.0	8.5	2.5
Industrials	9.4	7.9	1.5	10.4	(1.0)
Financials	9.1	24.3	(15.2)	17.7	(8.6)*
Health care	7.4	2.4	5.0	6.5	0.9
Real estate	6.2	5.8	0.4	n/a	n/a
Utilities	5.0	3.6	1.5	5.8	(0.8)
Materials	2.9	4.4	(1.5)	4.2	(1.3)
Energy	1.8	4.2	(2.4)	0.7	1.1
Telecoms	0.4	5.5	(5.1)	0.8	(0.4)
Other	(2.3)	0.0	(2.3)	0.0	(2.3)
Net cash	6.3	0.0	6.3	3.0	3.3
Total	100.0	100.0	0.0	100.0	0.0

Source: Fidelity Asian Values (monthly factsheets as at 30 November 2016 and 31 March 2016). *Note: Financials previously included Real Estate, which has since been split out as a separate item.

Figure 3: Country allocations, as at 30 November 2016

	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31 March 2016 (%)	Percentage point change
India	19.7	9.5	10.2	17.4	2.3
Taiwan	11.0	14.5	(3.5)	13.0	(2.0)
Hong Kong	9.2	12.1	(2.9)	8.4	0.8
China	8.7	32.1	(23.4)	14.3	(5.6)
Australia	7.9	0.0	7.9	7.4	0.5
South Korea	7.0	17.0	(10.0)	7.3	(0.3)
Singapore	6.6	5.0	1.6	7.4	(0.8)
Thailand	5.8	2.6	3.2	5.7	0.1
Philippines	4.8	1.4	3.4	4.0	0.8
Indonesia	4.0	2.9	1.1	3.9	0.1
Other	9.0	2.9	6.1	8.2	0.8
Net cash	6.3	0.0	6.3	3.0	3.3
Total	100.0	100.0	0.0	100.0	0.0

Source: Fidelity Asian Values (monthly factsheets as at 30 November 2016 and 31 March 2016)

Fidelity say that, at the end of October 2016, the portfolio had an average p/e ratio of 12.8x which compares to 13.8x for the MSCI Asia ex Japan Index. If we strip out Chinese financial stocks, an area that FAS has no exposure to and one which has been under pressure given the prevalence of non-performing loans in the sector, from the MSCI Index, the Index is trading on an average p/e of 15.4x.

The portfolio remains heavily skewed towards companies with a market cap of less than $1bn: these accounted for 56.6% of the portfolio at the end of November 2016 as compared to 0.3% of the MSCI Index.

Performance

Figure 4 shows how FAS has performed (based on NAV) relative to the average of a peer group that comprises Aberdeen Asian Income; Aberdeen Asian Smaller Companies; Aberdeen New Dawn; Edinburgh Dragon; Henderson Far East Income; Invesco Asia; JPMorgan Asian; Martin Currie Asia Unconstrained; Pacific Assets; Pacific Horizon Schroder Asia Pacific; Schroder Oriental Income and Scottish Oriental Smaller Companies. As is clear from the graph, Nitin has delivered pretty consistent outperformance of the average of that peer group and FAS is in fact the top-performing fund, in NAV terms, over most time periods.

Figure 4: NAV performance relative to peer-group average since manager appointed (rebased to 100)

Source: Morningstar, Marten & Co

Figure 5 shows how FAS has performed relative to both its benchmark and the average of its peers over a range of time periods. FAS has returned more than twice as much as the peer-group average since Nitin's appointment.

Figure 5: Total return performance to 31 December 2016 (Performance figures in excess of 1 year are annualised)

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 01/04/2015* (%)
NAV	0.7	3.6	13.2	38.1	61.8	105.1	29.8
Share price	4.3	7.0	20.7	42.3	66.4	104.8	34.9
Blended benchmark	(1.0)	(1.5)	11.6	25.8	31.7	56.5	9.2
Peer group avg. NAV	0.2	(0.7)	11.0	26.7	37.0	71.2	13.0
Peer group avg. price	1.6	0.2	14.1	28.2	34.0	69.1	11.7

Source: Fidelity Asian Values, Bloomberg, Morningstar, Marten & Co. *Note: Nitin Bajaj was appointed to manage Fidelity Asian Values from 1 April 2015. Fidelity Asian Values' blended benchmark index comprises the MSCI AC Far East Ex Japan Index until 31 July 2015 and the MSCI AC Asia Ex Japan Index thereafter.

Fidelity has supplied us with performance attribution data for the 12 months ended 31 October 2016. The top contributors to and detractors from performance are shown below:

Figure 6a: Contributors 12 months to 31 October 2016

Stock	Country	Average active weight (%)	Total relative contribution (bps)
New Oriental Education	China	1.6	197.6
Power Grid Corp. of India	India	3.8	128.6
Luen Thai Holdings	Hong Kong	0.6	128.1
TISCO Financial	Thailand	2.8	123.7
Clinuvel Pharmaceuticals	Australia	0.63	110.8

Source: Fidelity Asian Values

Figure 6b: Detractors 12 months to 31 October 2016

Stock	Country	Average active weight (%)	Total relative contribution (bps)
Tencent Holdings	China	(3.8)	(143.5)
Cognizant Technology	United States	1.8	(72.6)
Samsung Electronics	Korea	(4.6)	(68.3)
Yowie Group	Australia	0.7	(68.1)
Taiwan Semi.	Taiwan	0.1	(54.1)

Source: Fidelity Asian Values

Top contributors to performance

New Oriental Education's share price rose by 45% over the period from 31 March 2016 (the data we used in our last note on FAS) and 30 November 2016. It now trades on a historic p/e ratio of 29.5x, having fallen by 13% in December after an accusation that it helped students falsify documents used to gain entrance to US universities. Nitin had been taking profits on the stock and it is no longer held in the fund.

Power Grid Corporation of India's shares rose by 38% over the eight months to the end of November. Its regulated earnings and forecast growth helped isolate it from the market turmoil in India that has followed the withdrawal from circulation of a substantial portion of India's bank notes. It posted a 32% jump in profit for Q3 2016, but Nitin believes the as yet, unmet demand for power in India should stand it in good stead for years to come. He points out that it trades on a low double-digit p/e, but thinks it can achieve mid-teens digit growth.

Clothing and accessories manufacturer, Luen Thai Holdings, had already been a strong performer over 2016 before its share price soared at the end of October on the back of a takeover bid from Shangtex Holding.

Nitin likes TISCO Financial for its high yield and strong cash flow. The Thai provider of auto loans plans to expand into digital banking. It is seeing a substantial reduction in its year-on-year provisions for bad debts and this is boosting its profitability.

Clinuvel Pharmaceuticals, which focuses on treatments for skin disorders, has done well on the back of a fast-track designation from the FDA for its new drug, Scenesse, which is a therapy for photosensitive skin disorders.

The list of detractors from relative performance is dominated more by stocks that FAS does not hold than stocks in the portfolio. Not holding Tencent had the largest impact on relative performance. Cognizant is discussed on pages 7 and 8. Taiwan Semiconductor's position in the table of detractors is unfortunate as it is a big position in the fund, but FAS has been underweight relative to the benchmark at times when the stock has been doing well. It remains one of the fund's largest absolute holdings (2.6% of the portfolio at the end of October 2016), however.

MARTEN & CO

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Fidelity Japanese Values

Turning a corner

Fidelity Japanese Values (FJV) has shown a notable improvement in performance relative to its peer group in recent months. Over the course of 2016, weak sterling has boosted returns to UK investors while yen-denominated returns have been lacklustre. However, FJV's manager thinks Japanese corporate earnings are close to their nadir. His portfolio is tilted towards consumer discretionary stocks. The Japanese government is trying hard to drive real wages higher which would help consumption and boost this sector.

Long-term growth from Japanese-listed equities

The investment objective of the company is to achieve long-term capital growth from an actively managed portfolio of securities, primarily of small- and medium-sized Japanese companies listed or traded on Japanese stock markets.

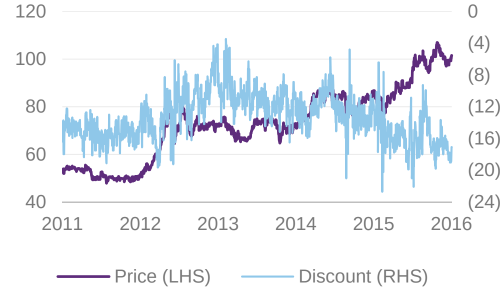
Year ended	Share price total return (%)	NAV total return (%)	Peer group average TR (%)	TOPIX Index TR (%)	MSCI World Index TR (%)
31/12/12	(1.7)	(5.7)	16.3	2.8	10.7
31/12/13	39.5	33.5	37.6	24.7	24.3
31/12/14	0.0	3.1	0.4	2.7	11.5
31/12/15	20.5	21.6	30.3	18.2	4.9
31/12/16	17.0	23.6	11.9	23.4	28.2

Source: Bloomberg, Morningstar, Marten & Co.

Sector	Japan Small Co.s
Ticker	FJV LN
Base currency	GBP
Price	105.12p
NAV	126.54p
Premium/(discount)	(16.9%)
Yield	Nil

Share price and discount

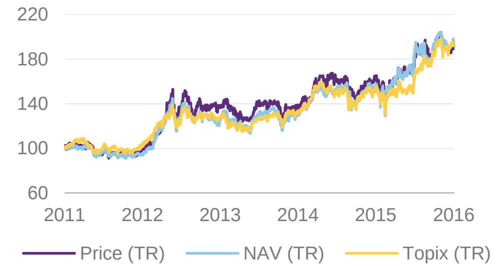
Time period 31/12/2011 to 31/12/2016



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/12/2011 to 31/12/2016



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	15 March 1994
Manager	Nicholas Price
Market cap (GBP)	142.9m
Shares outstanding	136.0m
Daily vol. (1 yr avg.)	131.0k shares
Net gearing	24.3%

One year into new investment approach

It is just over a year since Nicholas Price (Nicholas or the manager) took on responsibility for FJV on 1 September 2015. Nicholas adopts a 'growth at a reasonable price' (GARP) approach to managing money. He aims to identify companies that are growing, but whose growth is not reflected in their valuation. Often these companies will be misunderstood by investors because they are not well-researched. He targets companies where he feels investor sentiment is at odds with the fundamentals of the business. These companies could also be in a state of flux where new products and markets are being accessed, or their end market is changing in their favour and the market has not appreciated this.

Nicholas believes in the importance of maintaining a strong sell discipline: taking profits in positions that have done well and recycling into new names to maintain performance, selling when valuation targets are reached and cutting positions when the fundamentals of the underlying business deteriorate.

Market backdrop

Nicholas acknowledges that it has been a difficult period for the Japanese market. To a large extent this has been driven by dramatic shifts in the value of the yen. Overseas investors have been reducing exposure to Japan and this has also weighed on the market. Nicholas says that, more recently, the external environment has been more benign. There has been a modest pick-up in exports and industrial production is improving as indicated by a rise in the PMI.

The manager thinks we are close to the bottom for corporate earnings, especially as the effects of yen appreciation fall away, implying we should start to see earnings improvements and upgrades from here. This should help cyclical stocks. Nicholas thinks valuations look attractive. The MSCI Japan Smaller Companies Index is trading on a forward p/e of 14.6x. Moreover, the trend towards increasing distributions by companies is continuing as corporate governance reforms take hold.

The Bank of Japan (BoJ) is trying to hold down rates across the yield curve while the government is keen is boost real wage growth and inflation. There is a large excess of vacancies to workers available to fill these jobs which ought to help. Efforts to increase female participation in the workforce are also increasing household incomes.

It is possible that worries about EU politics may trigger another rush to safe havens (including the yen) but, for now, we are seeing sustained depreciation of the yen which is aiding exporters. On the export front, Trump scrapping the Trans-Pacific Partnership (TPP) is a negative, although the manager believes the market was not pricing in much benefit from this trade deal.

Portfolio

At the end of November 2016 there were 90 holdings in the portfolio. Relative to its benchmark, the fund had an overweight exposure to smaller companies (those with a market cap below $1bn). Over the past few months, Nicholas has been reducing exposure to domestically focused companies and stable growth companies, and increasing positions in more cyclical stocks.

There have been few changes to the largest overweight positions (relative to the fund's index benchmark) over the past few months. A notable new entrant to the list in Figure 7 is Yamaha Motor. Yamaha is probably best known in the UK for its motorcycle business but, for Nicholas, the main attraction is its outboard motor business in the US. This has a strong market presence and is bought by relatively affluent consumers, making it less susceptible to unpredictable US economic growth.

Another new entry into this list is Nitori Holdings. This company owns a range of home furnishing stores across Japan. It is building its business in other countries in Asia, including Taiwan and mainland China, and is also expanding in the US.

Nicholas has also been buying Nintendo in anticipation of the launch of its games on mobile devices in mid-December. He thinks it increases the value of a game's intellectual property and kick-starts a whole new cycle for the company.

He has added to the fund's holding in Yonex, the world's largest manufacturer of badminton equipment, which we highlighted as a new holding when we last wrote about the fund.

Figure 7: Top 10 overweight positions at 30 November 2016

Holding	Sector	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31 March 2016 (%)	Percentage point change
Yamaha Motor	Consumer discretionary	7.3	0.4	6.9	0.7	6.6
Nissan Chemical Ind.s	Chemicals	6.0	0.2	5.8	6.5	(0.5)
Nippon Shinyaku	Pharmaceuticals	5.2	0.1	5.1	3.1	2.1
Mitsubishi UFJ Fin	Financials	4.2	0.0	4.2	0.0	4.2
Yonex	Services	3.7	0.0	3.7	2.0	1.7
Kubota	Machinery	3.5	0.0	3.5	6.0	(2.5)
SoftBank	Information technology	3.4	0.0	3.4	4.1	(0.7)
Nitori Holdings	Consumer discretionary	3.9	0.5	3.4	1.3	2.6
M3 Inc	Chemicals	3.4	0.2	3.2	2.6	1.2
Zojirushi Thermos	Electrical appliances	3.0	0.0	3.0	3.4	(0.4)

Source: Fidelity Japanese Values (monthly factsheets as at 30 November 2016 and 31 March 2016)

Nicholas has taken some profit in Nissan Chemical Industries, whose shares rose by more than 35% between the end of March 2016 and the end of November. Likewise, he has trimmed the positions in Nippon Shinyaku which was up over 25% during the same period and Kubota (up 21%).

Aeon Financial Services has been a disappointment. Although Nicholas still likes the business, the company raised money through a dilutive share issue and this triggered a sell-off in the shares (down 24%). Nicholas cut the position, but retains a reasonably large holding as he believes it is attractively valued and can deliver double-digit earnings growth as credit card penetration increases.

The portfolio's bias to consumer discretionary stocks is evident in Figure 8. The portfolio percentages are of net assets and so are inflated by FJV's net gearing of 23% at the end of November 2016.

Figure 8: Sectoral allocations, as at 30 November 2016

	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31 March 2016 (%)	Percentage point change
Consumer discretionary	43.8	19.1	24.8	31.8	(7.1)
Industrials	19.5	23.6	(4.0)	19.6	(0.1)
Health care	15.1	6.8	8.3	13.6	1.5
Information technology	13.8	12.3	1.5	14.0	(0.2)
Materials	10.9	10.6	0.3	9.7	1.2
Financials	8.4	10.4	(2.1)	11.5	(3.1)
Consumer staples	4.6	9.4	(4.8)	9.4	(4.8)
Real etate	3.6	2.1	1.5	3.4	0.2
Telecoms	3.4	0.0	3.4	5.5	(2.1)
Energy	0.0	1.8	(1.8)	0.0	0.0
Utilities	0.0	3.8	(3.8)	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Net cash	(23.2)	0.0	(23.2)	(18.6)	(4.6)
Total	100.0	100.0	0.0	100.0	0.0

Source: Fidelity Japanese Values (monthly factsheets as at 30 November 2016 and 31 March 2016)

Performance

Figure 9: NAV performance relative to peer-group average since manager appointed

Source: Morningstar, Marten & Co

FJV sits within an AIC-defined peer group that comprises Atlantis Japan, Baillie Gifford Shin Nippon, JPMorgan Japan Smaller Companies and Prospect Japan. Figure 9 shows FJV's performance relative to the average of its peer group over the period since Nicholas took up the management of the portfolio on 1 September 2015. While FJV's relative performance has been on an improving trend for most of 2016, the pace of its outperformance of the peer group has accelerated over the last few months as the small and mid-caps have seen an improvement in relative performance, having lagged during the middle of the year.

Figure 10 shows how the cumulative performance of the fund over various time periods stacks up against the Topix Index and the average of the peer group.

FJV is ahead of the peer group average over most time periods in the short term. Since Nicholas started managing the fund the NAV performance has lagged a little, but he has outperformed in recent months.

Figure 10: Total return performance to 31 December 2016

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 01/09/15 (%)
NAV	2.9	2.2	4.7	23.6	54.9	95.0	29.2
Share price	1.1	2.3	6.8	17.0	41.0	93.3	24.7
Topix	2.2	4.9	17.2	23.4	49.7	91.9	31.8
Peer group average NAV	0.8	(2.9)	1.0	15.6	51.7	129.4	29.8
Peer group average Price	(0.8)	(2.4)	1.2	11.9	46.4	134.2	28.5

Source: Morningstar, Marten & Co, *date of manager's appointment

Fidelity tells us that the positive performance over the past six months can, largely, be attributed to stock selection.

Positive contributions to recent performance

Nissan Chemical Industries results came in ahead of analysts' estimates and the company's own guidance. Forecasts were revised upwards. The company is reporting strong sales of its flea and tick treatments for cats and dogs. These have the advantage of being three-month rather than one-month treatments.

Ono Pharmaceutical has done well on the back of its Opdivo immunotherapy cancer treatment. The stock price increased during June and July and the manager sold out of the stock ahead of weakness later in the period. Nippon Shinyaku and Kubota were discussed on page 13. Defensive stocks were generally weak in late summer.

Having an underweight exposure to banks also helped the fund's relative performance. The BoJ's negative interest-rate policy is making life tough for banks.

Detractors from recent performance

Aeon Financial Services, which was discussed on page 13, was the main detractor from performance. The July/August period proved difficult for FJV as the market focus seemed to rotate from growth to value and cyclicals on anticipation that interest rates were as low as they would go.

Fidelity Special Values

Tilting away from the cyclicals

As discussed in our previous notes, Fidelity Special Values (FSV) is a fund that thrives on volatility and uncertainty. It seeks to exploit mispricing created by swings in investor sentiment – moving into 'unloved' stocks when they are cheap and then selling them once they have recovered. The manager took advantage of depressed markets earlier this year to add to more cyclical areas, which was bolstered by expanding gearing in the trust. This has served FSV well as the market has rebounded post Brexit and the manager has recently been reducing this cyclical exposure, now that these stocks are more fully valued, in favour of cheaper stocks. Amongst other stocks, FSV's manager continues to see value in banks, energy and construction.

UK-focused special situations

FSV aims to achieve long-term capital growth by investing in special situations. The portfolio is primarily focused on UK-listed equities and whilst it is an all-cap strategy, there is an inherent bias towards small- and mid-cap companies. The manager has adopted a value/contrarian style.

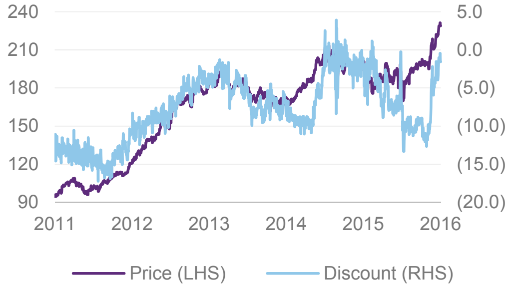
Year ended	Share price total return (%)	NAV total return (%)	Peer group average TR (%)	MSCI UK Value Index TR (%)	MSCI World Index TR (%)
30/11/12	31.0	27.2	19.7	13.3	10.7
30/11/13	55.3	44.8	28.8	16.0	24.3
30/11/14	(4.6)	(1.2)	0.3	(0.4)	11.5
30/11/15	18.6	12.3	7.9	(9.5)	4.9
30/11/16	16.0	15.4	9.3	26.4	28.2

Source: Morningstar, Marten & Co.

Sector	UK All Companies
Ticker	FSV LN
Base currency	GBP
Price	229.25p
NAV	232.88p
Premium/(discount)	(1.6%)
Yield	1.6%

Share price and discount

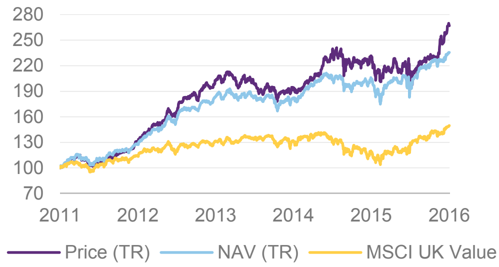
Time period 31/12/2011 to 31/12/2016



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/12/2011 to 31/12/2016



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	17 Nov 1994
Manager	Alex Wright
Market cap (GBP)	606.5m
Shares outstanding	264.5m
Daily vol. (1 yr. avg.)	312.5k shares
Net gearing	9.9%

Reasons to celebrate the manager's approaching fifth anniversary

The manager has a value/contrarian style, capturing sentiment changes and earnings recovery, and identifying unrecognised growth potential

September 2017 will be the fifth anniversary of Alex Wright taking over as manager of FSV's portfolio. Further discussion of Alex's value/contrarian style is included in the special feature on pages 20 to 27 of this note but, assuming Alex's strategy continues to perform as it has done since his appointment, FSV will be able to celebrate this anniversary with performance markedly above its peer-group average (see pages 19, 21 and 22). Alex's contrarian style leads him to go against consensus, reaching into unloved areas in search of value. The trust has recently benefitted from the recent rally as Alex had added to FSV's cyclical exposure when it was out of favour and looked cheap. He has recently been reducing FSV's cyclical exposure, now that it looks more expensive, in favour of other areas that look cheap and unloved.

Portfolio

Figure 11: Top 10 overweight positions at 30 November 2016

Holding	Sector	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31 March 16 (%)	Percentage point change
Citigroup	Financials	6.0	0.0	6.0	5.4	0.6
CRH	Industrials	5.6	1.0	4.6	4.3	1.3
Ultra Electronics	Industrials	4.3	0.1	4.3	3.2	1.1
Royal Mail	Industrials	3.4	0.2	3.2	5.9	(2.5)
Ladbrokes Coral	Consumer services	3.2	0.1	3.1	2.2	1.0
HomeServe	Industrials	3.0	0.1	3.0	3.3	(0.3)
Hewlett Packard Ent.	Technology	2.9	0.0	2.9	2.7	0.2
Phoenix	Financials	3.0	0.1	2.8	2.5	0.5
BT	Telecoms	4.1	1.4	2.7	1.4	2.7
HP	Technology	2.4	0.0	2.4	2.7	(0.3)

Source: Fidelity Special Values (monthly factsheets as at 30 November 2016 and 31 March 2016)

As discussed on page 26, Alex continues to maintain a high-conviction position in banks, which contributes to making financials FSV's largest sector exposure. Citigroup is FSV's third-largest holding, and its largest overweight position, although Lloyds, previously a top-five holding, has moved out of the top 10 altogether as Alex has halved the position. Barclays, another bank holding, has been sold in its entirety although FSV continues to hold positions in Bank of Ireland (Alex expects that, like Lloyds, Bank of Ireland will soon return to dividend payment), and Paragon.

Banks are economically sensitive and benefit from rising interest rates, and they have benefitted from the post-Brexit rally, allowing Alex to reduce some holdings he felt to be more fully valued (he has generally been trimming more cyclical positions). Furthermore, it would appear that the prospects for a rise in UK interest rates have been pushed back, following the Brexit result and, while there has been the recent bonanza following sterling's depreciation, there are real concerns that Brexit will act as headwind to economic growth.

The largest position in the portfolio continues to be Royal Dutch Shell; it retains a modest underweight position relative to the index (6.7% versus 7.7%). The position was expanded earlier this year when the stock was under pressure as investors became concerned that, following the oil price collapse, it might be forced to cut its dividend. The market reaction was severe and the stock has since recovered strongly. However, as discussed on pages 26 and 27, Alex continues to see strong potential. Oil companies were quick to cut back on capex, which leads to a dwindling of output. Alex believes that falling supply will allow returns to improve, which should also lead to a further rerating of these and FSV's other oil-related positions (for example Faroe, SOCO and Amerisur Resources).

In terms of recent activity, the manager has added positions in Balfour Beatty and Scandinavian Tobacco as well as the Paragon position mentioned above. The rationale behind FSV's banking positions, including Paragon, is covered above and on page 26, although, in the case of Paragon, Alex considers this to be a less cyclical financials exposure. As a result, this also plays into the recent theme of reducing the cyclical exposure in FSV's portfolio following the post-Brexit rally. In the case of Balfour Beatty, its addition reflects Alex's view on the construction industry and the exposure it offers to infrastructure spending.

Alex has also increased the positions in BT, LivaNova and Sports Direct. BT has been under pressure following the emergence of problems in its Italian business, but Alex considers that it has a very strong franchise and customer base and that, after a multi-year period of strong downward pricing pressure, there is evidence that prices have been firming in the UK domestic broadband market. He anticipates that capex requirements will not be unduly onerous in the next few years and expects to see improvements in profitability going forward.

Medical devices manufacturer, LivaNova, specialises in devices for cardiac surgery, neuromodulation and cardiac rhythm management. With ageing populations in the developed world, and emerging middle classes in emerging markets, companies such as LivaNova are benefitting from increasing demand for their medical devices. However, Livanova is also facing challenges from pricing pressures and the growing cost of launching new products. The company had a challenging year during 2016, which culminated with the FDA issuing it with a warning letter in relation to mycobacterium chimaera infections associated with its Stöckert 3T heater-cooler system. The stock has suffered heavily as a result. However, Alex thinks that the market's reaction has been overdone and that management is getting to grips with the problems. In his view, there is unmet demand for LivaNova's products and he sees strong recovery potential.

The position in Sports Direct has been increased following recent difficulties. The company's problems have been well-publicised, but Alex considers that management now understands the need for changes and has made further progress in addressing the company's problems. Inevitably there will be costs, which puts downward pressure on profitability, but management is well-versed in controlling costs and, with the reduction in the share price, it offered an attractive risk-reward ratio.

In terms of portfolio disposals, Staffline, Headlam, Volution and Dalata have been sold out in their entirety, whilst Countrywide has been reduced dramatically. These are more cyclical stocks that have had a good run and Alex saw the potential for pressure on profitability, so used the recent rally to exit.

Figure 12: Sectoral allocations at 30 November 2016

Heading	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31 Mar 16 (%)	Percentage point change
Financials	37.7	25.7	12.0	41.5	(3.8)
Industrials	28.4	10.9	17.5	31.5	(3.1)
Consumer services	10.0	11.7	(1.6)	16.5	(6.5)
Oil & gas	9.6	12.5	(2.9)	8.7	0.9
Technology	7.5	0.8	6.6	7.0	0.5
Health care	6.0	9.1	(3.1)	5.3	0.7
Consumer goods	5.2	14.5	(9.2)	5.2	0.0
Telecommunications	4.5	4.1	0.4	2.2	2.3
Basic materials	3.7	7.1	(3.4)	3.9	(0.2)
Utilities	0.0	3.6	(3.6)	0.0	0.0
Other*	(7.7)	0.0	(7.7)	(7.7)	0.0
Net cash	(5.0)	0.0	(5.0)	(14.1)	9.1
Total	100.0	100.0	0.0	100.0	0.0

Source: Fidelity Special Values (monthly factsheets as at 30 November 2016 and 31 March 2016). * Note: Other includes FSV''s FTSE 250 short position.

Performance

Figure 13: Total return performance to 31 December 2016

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 01/09/12* (%)
NAV	4.4	7.4	18.8	15.4	28.0	135.7	104.2
Share price	7.9	16.7	27.2	16.0	31.3	167.0	139.1
MSCI UK Value	6.5	8.6	16.8	26.4	13.9	49.7	40.3
Peer group average NAV	4.8	3.7	14.7	9.3	18.2	82.3	64.8
Peer group average Price	4.4	3.2	15.6	3.6	11.9	87.2	72.3

Source: Morningstar, Marten & Co, *date of manager's appointment

Over the year to the end of December 2016, FSV's NAV total return has beaten the peer-group average by a difference of 6.1 percentage points. The gap between FSV and the peer-group average for share-price total return is even wider with FSV beating this by 12.4 percentage points, which reflects a tightening in FSV's discount over the period.

The lack of exposure to large-cap mining stocks has helped performance for much of the past few years, but has been a headwind more recently as these stocks performed well during 2016. The bias to small-cap stocks has continued to be beneficial as these have outperformed larger companies over the medium term, although suffering more heavily in the immediate aftermath of Brexit. Fidelity says that the largest contribution to FSV's performance continues to be stock selection.

Stocks that the manager has identified as making a positive contribution to performance in recent months include Hewlett Packard Enterprise, HomeServe, Burford Capital and Citigroup. Bank of Ireland, Countrywide, Regus and HSBC were the largest detractors.

Special feature: Fidelity Special Values

Long-term capital growth from special situations using a value/contrarian style

Fidelity Special Values (FSV) is an investment trust that aims to achieve long-term capital growth by investing in special situations. It has been managed since September 2012 by Alex Wright in a value/contrarian style and its portfolio is primarily focused on UK-listed equities, although up to 20% of the portfolio can be invested in companies listed on overseas exchanges.

FSV's portfolio bears little resemblance to the composition of the UK benchmark indices.

Alex seeks to identify stocks that have experienced some difficulties but may, in his view, have scope for a recovery that is not reflected in the valuation of the company. Successful investments will not only experience a recovery in profitability, but also benefit from improved sentiment that puts a higher multiple on these earnings. Alex will also invest in stocks that he believes have growth potential that is not recognised by the market. The nature of this stock-picking strategy means that the portfolio bears little resemblance to the make-up of UK benchmark indices.

When Alex selects investments for the portfolio, he is looking for stocks whose downside is limited because they are already trading at excessively low market multiples or have assets that support the valuation.

FSV's portfolio is biased towards the small-and mid-caps.

FSV has an all-cap strategy, but there is an inherent bias towards small- and mid-cap companies. This reflects the fact that change is often easier within smaller companies and that, as these companies tend to be less well-researched, there is a greater likelihood of being able to gain an informational advantage from conducting extensive due diligence.

Ability to use derivatives

Gearing is provided by long CFD positions.

Alex is permitted to use derivative instruments in manging FSV's portfolio. The primary use of derivatives is long contract for difference (CFD) positions which are used, at times, to provide gearing to the portfolio as an alternative to bank loans or bonds.

Derivatives can also be used to hedge equity market risks. This could occur where the manager believes that suitable protection can be purchased to limit the downside from a falling market at a reasonable cost. FSV currently has a small FTSE 250 hedge in place. Derivatives can also be used to hedge currency risks on non-UK positions.

Short positions are used very sparingly. The manager must be able to see a clear catalyst for a derating.

FSV's investment policy permits Alex to take short positions in stocks that he considers to be overvalued. In practice, this authority is used very sparingly – short positions currently account for around 3% of FSV's net assets. It is not enough for Alex to consider that a stock is overvalued. He must also be able to identify a clear catalyst to generate a derating of the stock.

Peer-group-beating performance

FSV is a member of the AIC's All Companies sector. From 1 September 2012, when Alex took over management of the portfolio, to 31 December 2016, FSV has provided a NAV total return of 104.2% and a share-price total return of 139.1%. As also discussed on page 19, these are significantly ahead of the peer-group averages of 64.8% for NAV and 72.3% for price. FSV's discount has also narrowed significantly during this time (from 15.4% to 1.6%), which we think reflects the success of Alex's strategy and the resultant strong performance.

Please click here to visit QuotedData.com for up to date data for FSV's UK All Companies peer group.

Figures 14 to 16 provide a peer-group comparison for the UK All Companies sector. This peer group currently has 18 members although the style in which FSV is managed is distinctly different to the majority of its peers. This means that its performance is likely to deviate, at times, from that of the general performance of the peer group and care must be taken when making 'broad-brush' comparisons. Nonetheless, all of these funds are investing in a similar space and so are credible alternatives to one another. However, given these considerations, we believe that longer-term performance comparisons are the most relevant against which to assess the success of FSV's strategy.

Figure 14: Peer group NAV total return performance to 31 December 2016 (annualised for periods over one year)

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 1/9/12 (%)*
Fidelity Special Values	4.4	7.4	18.8	15.4	8.6	18.7	17.9
Aberdeen UK Tracker	5.0	3.9	11.9	16.6	5.8	9.7	9.6
Artemis Alpha	3.8	4.3	14.1	4.8	0.4	5.1	2.2
Aurora	2.9	5.7	16.7	6.5	(1.9)	0.8	1.8
Crystal Amber	12.2	9.2	45.7	46.3	14.1	21.4	20.2
Damille Investments II	5.8	11.1	23.5	27.7	6.3	6.0	6.4
Henderson Opps.	7.6	4.2	20.0	11.1	5.9	18.4	16.8
Invesco Perp. Select UK	5.5	5.2	8.9	9.3	9.9	16.4	16.3
JPMorgan Mid Cap	1.9	1.6	14.7	(2.8)	9.5	20.5	20.1
Jupiter UK Growth	6.3	4.9	17.5	2.1	2.8	10.4	9.2
Keystone	4.0	(0.2)	3.3	1.5	5.5	12.5	12.3
Manchester & London	4.4	0.3	11.6	19.7	7.5	3.4	4.4
Mercantile	2.3	1.5	13.0	(3.2)	5.6	16.6	14.5
Sanditon	0.3	(1.2)	(1.9)	5.1			
Schroder UK Growth	5.7	4.8	12.8	13.7	2.3	12.0	11.4
Schroder UK Mid Cap	4.4	1.8	14.2	2.5	4.4	16.6	15.0
Threadneedle UK Select	5.4	2.7	9.5	11.9	7.0	10.6	11.9
Woodford Patient Cap'l	0.9	(2.2)	8.0	(3.5)			
FSV rank	10	3	4	5	4	3	3
Sector arithmetic avg.	4.6	3.6	14.6	10.3	5.8	12.4	11.9

Source: Morningstar, Marten & Co. *Note: Alex Wright took over the management of FSV's portfolio with effect from 1 September 2012.

Figure 14, which provides a comparison across the UK All Companies Peer Group for NAV total return over various time periods, illustrates that with the exception of the very short-term one-month time frame, FSV has consistently provided top-quartile performance versus its peers. We think this that is a reflection of the strength of Alex Wright's strategy over the long term.

Figure 14 also illustrates that, since Alex took over the management of the portfolio in September 2012, FSV ranks third out of 16, for NAV total return performance. It is only surpassed modestly by two funds, JPMorgan Mid Cap and Crystal Amber, both of which are markedly smaller than FSV; FSV's market cap is over twice the sector average of £292.3m, whilst JPMorgan Mid Cap and Crystal Amber are less than the sector average. Of these two, JPMorgan Mid Cap's strategy is the most comparable to FSV's although its returns appear to be more volatile. Crystal Amber has a considerably more concentrated portfolio than either FSV or JPMorgan Mid Cap; its top four holdings account for just over 50% of its portfolio.

Figure 15: Peer group share-price total return performance to 31 December 2016 (annualised for periods over one year)

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 1/9/12 (%)*
Fidelity Special Values	7.9	16.7	27.2	16.0	9.5	21.7	22.3
Aberdeen UK Tracker	2.1	3.1	14.1	12.7	5.4	9.9	9.6
Artemis Alpha	6.4	3.5	17.5	1.7	(4.3)	1.4	(1.9)
Aurora	(0.6)	5.8	12.7	11.9	3.0	4.8	5.8
Crystal Amber	12.4	6.3	40.3	34.5	11.9	21.9	25.6
Damille Investments II	3.8	6.4	25.6	25.6	4.4	1.1	6.0
Henderson Opps.	5.7	2.5	12.1	(5.6)	1.5	19.9	18.3
Invesco Perp. Select UK	3.6	1.6	10.0	3.6	9.9	17.9	16.3
JPMorgan Mid Cap	2.6	0.0	15.1	(11.3)	9.2	23.4	24.6
Jupiter UK Growth	5.7	3.8	16.3	3.1	3.2	12.4	10.9
Keystone	3.3	(2.5)	4.4	(5.2)	1.8	11.4	10.3
Manchester & London	(0.1)	(2.5)	13.4	15.3	4.5	1.5	3.1
Mercantile	4.4	3.5	17.3	(3.7)	6.3	18.3	16.6
Sanditon	0.0	(1.0)	(0.8)	(1.8)			
Schroder UK Growth	5.2	3.4	13.6	10.5	(1.9)	10.9	10.0
Schroder UK Mid Cap	5.0	2.2	14.4	(8.2)	(2.2)	17.2	15.7
Threadneedle UK Select	3.7	3.7	17.2	12.3	3.3	11.7	12.6
Woodford Patient Cap'l	(0.3)	(2.5)	8.2	(9.7)			
FSV rank	2	1	2	3	3	3	3
Sector arithmetic avg.	3.9	3.0	15.5	5.6	4.1	12.8	12.9

Source: Morningstar, Marten & Co. *Note: Alex Wright took over the management of FSV's portfolio with effect from 1 September 2012.

Looking at Figure 15, which provides a comparison across the UK All Companies Peer Group for share-price total return over various time periods, it can be seen that FSV has consistently provided top-quartile performance versus its peers. The one-month share-price performance is stronger than that of the NAV performance, which is arguably a reflection of the discount tightening seen during the period, which we think is itself a reflection of FSV's recent strong performance.

During the period since Alex Wright took over the management of FSV's portfolio, FSV ranks third out of 16 for share-price total return. As with its NAV performance, it is only surpassed by that of JPMorgan Mid Cap and Crystal Amber. As discussed above, both of these funds are markedly smaller and we would expect to see less liquidity in their shares. We would also expect that Crystal Amber could be prone to exhibit higher volatility in its returns due to the concentrated nature of its portfolio.

As illustrated in Figure 16, FSV's ongoing charges are one of the highest in its peer group although, unlike many of its peers, this is an all-in cost as FSV's management contract does not include a performance fee element. FSV has one of the tightest discounts in the peer group, which we think reflects the demand for its strategy and recent performance. FSV's dividend yield is low relative to peers, but it is primarily focused on capital gains and we think that this is where investors should expect to see the vast majority of their returns. FSV's gearing varies according to the strength of opportunities available to the manager although it tends to be above the peer-group average and towards the top end of the peer- group range.

Figure 16: Peer group comparison – size, fees, discount, yield, gearing

	Market cap (£m)	Ongoing charges (%)	Performance fee	Discount (%)	Dividend yield (%)	Gross gearing	Net gearing
Fidelity Special Values	607.3	1.10	No	(3.4)	1.6	117	110
Aberdeen UK Tracker	344.4	0.29	No	(6.9)	3.2	100	100
Artemis Alpha	137.2	0.90	Yes	(17.2)	0.8	107	104
Aurora	52.5	2.25	Yes*	2.4	0.6	100	100
Crystal Amber	214.8	0.00	Yes	(7.6)	3.4	100	100
Damille Investments II	45.4	0.00	Yes	(15.7)	0.0	100	100
Henderson Opps.	87.4	1.02	Yes	(21.4)	1.8	113	113
Invesco Perp. Select UK	69.2	0.96	Yes	(1.0)	3.7	114	113
JPMorgan Mid Cap	243.0	0.91	No	(11.3)	2.5	105	102
Jupiter UK Growth	43.2	0.00	Yes	(1.4)	1.8	122	120
Keystone	253.5	0.69	Yes	(10.5)	3.1	113	107
Manchester & London	78.4	0.85	No	(21.3)	2.9	111	110
Mercantile	1,716.0	0.48	No	(9.5)	2.2	111	100
Sanditon	51.4	1.27	Yes	1.4	1.1	100	100
Schroder UK Growth	294.6	0.32	No	(12.6)	2.7	100	100
Schroder UK Mid Cap	193.7	0.95	No	(19.9)	2.1	102	103
Threadneedle UK Select	45.9	1.40	Yes	(10.4)	2.2	106	103
Woodford Patient Cap'l	782.9	0.10	Yes*	(3.1)	0.2	100	100
FSV rank	3	15	N/A	6	13	17	14
Sector arithmetic avg.	292.3	0.75	N/A	(9.4)	2.0	106.7	104.7

Source: Morningstar, Marten & Co. *Note: Aurora and Woodford Patient Capital only charge a performance fee; neither charges a base management fee.

Investment process - seeking 'unloved' stocks with the potential for change

Understanding the downside

In assessing potential candidates for FSV's portfolio, the manager begins by making an assessment of the downside risk for an investment idea. His analysis focuses on: assessment of business risk (the potential for further negative impacts on earnings), financial risk (an assessment of balance sheet strength) and valuation risk (how a company's valuation compares in absolute and relative terms). Alex is not only looking for an end to negative news flow but is also looking for a margin of safety that should underpin the valuation.

Identifying the potential for change

The next step in assessing portfolio candidates is to identify the potential for change. Alex believes that the market is often slow to recognise change in unloved companies. Change can come from a variety of sources. It can be internal change (self-help) that is driven by management. It can also be driven by external changes at the industry level. Alex says that analyst due diligence is vital in building conviction that change is underway.

Leveraging the resources of Fidelity International

In managing FSV, Alex is able to draw on the resources of Fidelity International's team. This includes one roving UK analyst, five pan-European small-cap analysts and40 pan-European mid/large-cap analysts as well as six other UK portfolio managers.

The three-stage investment cycle – from unloved to recovery

Stage 1 – out of favour companies

These are generally disliked by the market and are being valued as ex-growth. This stage can last for quite some time, allowing FSV's manager to conduct analysis and take his time to build a position. Alex rarely initiates a position following a first profit warning, although this can be a signal to start following a company more closely. He will usually wait for further news flow and will start to purchase stock once he considers that the further downside is limited. As Alex is able to take time to build a position, he says that liquidity issues are limited. Around a third of FSV's portfolio is invested in companies at this stage.

Stage 2 – start of perception/operational change

As the changes start to come through relative outperformance begins as a result. FSV's manager can continue to build a position as the market frequently takes time to acknowledge change. Value adding change can also occur in a number of waves, which means that the market can fail to keep pace for some time. The portfolio typically has between 50% and 60% invested in companies at this stage.

Stage 3 – change coming through

Operational change has come through, as has the perception by the market that change is occurring. Companies have benefitted from earnings improvement and will have also likely seen a rating improvement to reflect their increased quality. These companies are sell candidates and FSV's manager will be reducing the positions as valuations become more full and liquidity allows. The manager will take time to exit a position so as to not adversely affect the price. The portfolio typically has 10-15% invested in companies at this stage.

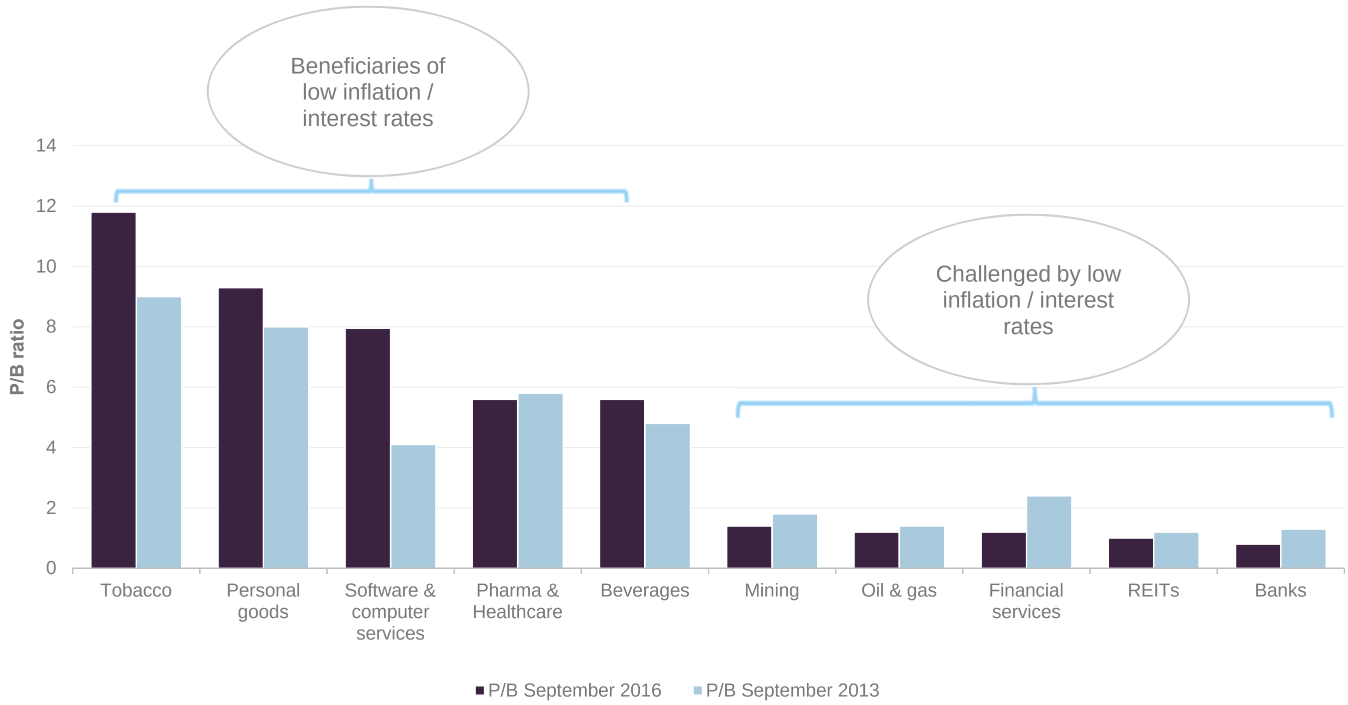
Manager's Outlook

Bifurcated markets – a headwind for the value investor

Historically, value/contrarian investors have been able to benefit from a tendency towards mean reversion in markets. If the investor can avoid value traps, excess returns can be earned by purchasing stocks when they are out of favour, and consequently cheap, and waiting for them to be rerated by the market. These can then be sold down, at higher valuations, with the proceeds then reinvested in cheaper stocks with the view that these will once again rerate.

Alex believes, and we agree, that the high levels of liquidity pumped into financial markets in the post-financial crisis era has had many distorting effects. In his view, it has led to a bifurcation of markets with companies that are beneficiaries of the low inflation/low interest-rate environment becoming increasingly expensive while conversely, those that are challenged by this environment have continued to become cheaper. This is illustrated in Figure 17 below, which compares the P/B ratio for various segments at September 2016 and September 2013.

Figure 17: P/B ratios September 2016 versus September 2016 for sectors that are beneficiaries of/challenged by low inflation and interest rates



Source: Fidelity International

In reality, there are a number of influences at work. For example, uncertainty has driven some investors towards safe income producing stocks, such as tobacco, beverages, personal goods and similar. Similarly, low interest rates have drawn traditional bond investors who have been struggling to earn returns to the safer income producing equity stocks, often referred to as 'bond like equities'. These effects have given rise to the 'expensive defensives', whilst at the same time areas such as the banks, financials services and REITS, which benefit from higher interest/inflation rates have not been in demand and have become cheaper. Alex says that this unusual market environment, with its lack of mean reversion, has made it difficult for the traditional value/contrarian investor. However, the strong bottom-up value approach employed to manage FSV has meant that it has continued to perform well, taking advantage of the mispricing created by swings in investor sentiment.

As illustrated on page 19, FSV's portfolio has significant exposures to banks, energy and construction. Some commentary on the rationales underlying these themes is provided below.

Banks

Approximately 10% of FSV's portfolio, as at 30 November 2016, was invested in banks (the overall financials allocation, including the banks, was approximately 30%). Banks have recently been trading at close to the 'trough valuations' they were trading at in the post-financial crisis era. Alex acknowledges that there are clear headwinds to banks' growth, such as current low interest rates and the regulatory environments, but he considers that these are being overly discounted in banks' share prices. Banks have changed significantly during the last eight years, rebuilding their capital buffers, strengthening their balance sheets, reducing risk and improving their return on equity (ROE). They also operate in a less competitive landscape.

Lloyds Bank, for example, has seen its ROE improve to around 13% and it has returned to paying a dividend. Alex considers that this is inconsistent with the single digit P/E it continues to trade on. He also believes, and we agree, that in ordinary market conditions the merger between Lloyds and HBOS would not have been permitted on competition grounds. This gives Lloyds a significant scale advantage in UK retail banking while, at the same time, today's challenger banks are much smaller; they do not have the scale of the likes of Northern Rock and HBOS.

Other banks, such as the Bank of Ireland, are also improving their profitability. Banks are economically sensitive and Bank of Ireland has benefitted from GDP growth in both Ireland and the UK (these account for circa 70% and 30% of its business respectively). The UK is Ireland's biggest trading partner and so it could be more challenged if the UK economy suffers significantly as a result of Brexit. However, Alex considers that the Bank of Ireland has done much to improve its operations and profitability. He expects that, like Lloyds, it will shortly return to paying a dividend.

In terms of the current market outlook, the advent of Brexit seems to have paved the way for interest rates to remain lower for longer, which is a negative for banks' near-term profit growth. However, earnings have recovered, underwriting standards are now higher and banks are much less geared themselves. This should allow for more robust profitability during challenging periods, which in time, should allow for a rerating of the sector. Bank holdings include Lloyds Bank, Bank of Ireland, Citigroup and Paragon.

Energy

Oil and gas, and related services, have been somewhat out of favour with investors following the oil price collapse. The oil price has since recovered (Fidelity analysis of the supply-side suggests that the oil price should be stable within the $50 - $70 range) and while the share prices of some companies have seen marked improvements, Alex believes that there is further room for improvements in profitability and rating.

The falling oil price and falling profitability saw capital expenditure reduced, which ultimately leads to falls in production. Data from Fidelity International suggests that non-OPEC production peaked towards the end of 2014 and has been on a declining trend since. Alex believes that this falling supply will allow supply and demand to get back into balance at a higher oil price than we have today. As the profitability of the oil majors improves, they will look to expand capex once again, which should then give a boost to oil services companies. Portfolio holdings include Royal Dutch Shell, Amerisur Resources, Soco and Faroe.

Construction

Companies exposed to construction represent circa 10% of FSV's portfolio. Construction offers exposure to infrastructure spending, which is a theme that Alex really likes. Reflecting austerity measures in the post-financial crisis era, infrastructure spending in the UK and US has been low. As a consequence, the average age of infrastructure has been on a rising trend; analysis from Goldman Sachs shows that the average ages of US highways, sewerage and water infrastructure is over 25 years and the average age of US air transport infrastructure is over 20 years.

Alex's view is that a lot of US infrastructure needs replacing and expects to see a rise in infrastructure spending both in the US and the UK. Despite significant austerity measures, growth has been relatively muted and the current low interest-rate environment makes such spending relatively easy to finance.

This appears to be a view shared by the new Trump administration, which has been making noises about a one trillion dollar infrastructure programme, likely to be financed through debt. In the UK, Theresa May's government has also moved away from austerity and is also talking about boosting infrastructure spending as a way of stimulating growth. Portfolio companies include CRH, Wolseley, SIG, Speedy and Balfour Beatty.

Reducing pro-cyclical exposure post Brexit

Alex had previously taken the opportunity to increase exposure to more cyclical stocks when the market was in a more 'risk-off' mindset and this exposure was cheap. However, this overweight exposure has been reduced post-Brexit. Although the initial reaction was negative, the market subsequently experienced a strong rally, which Alex has sold down into.

MARTEN & CO

Authorised and regulated by the Financial Conduct Authority
123a Kings Road, London SW3 4PL
0203 691 9430

www.martenandco.com

Registered in England & Wales number 07981621,
135a Munster Road, London SW6 6DD

Investment company sales:

Edward Marten
(em@martenandco.com)

Christopher Bunstead
(cb@martenandco.com)

Investment company research:

James Carthew
(jc@martenandco.com)

Matthew Read
(mr@martenandco.com)

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