Fidelity Special Values

Kepler INCOME & GROWTH RATING

FSV's wide discount doesn't reflect strong recent performance...

Update
15 May 2024

Overview

Fidelity Special Values (FSV) owns a portfolio of predominantly UK equities that manager Alex Wright, alongside co-manager Jonathan Winton, selects with a contrarian mindset. Alex takes a bottom-up approach, looking for companies from across the market-cap spectrum that are overlooked and therefore undervalued by the market. This leads to a **Portfolio** of around 80 to 120 holdings which has a bias toward smaller companies and a value style-tilt.

Alex has delivered significant outperformance of the benchmark over a number of time periods, with stock selection a significant contributor. Near-term **Performance** has been aided by the value style tailwinds, though the trust remains ahead over five years, which includes a period where there was a significant style headwind. Despite the recent outperformance, the trust's shares are currently trading at a wide **Discount** to NAV.

FSV pays a **Dividend** twice a year, as well as occasional special dividends. Whilst not a core focus for the manager, the ordinary dividend has been increased every year since 2009 and offers a historic yield of 3.1%.

Alex has reduced the level of **Gearing** in the trust over the past 18 months. This reflects a more cautious stance given the strong recent performance of risk assets and the higher cost of borrowing. The current effective level of net gearing is c. 3% which allows Alex to gain exposure to a number of stocks he believes are trading at cheap valuations whilst balancing the exposure to a potential slowdown in economic conditions.

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Analyst's View

We believe that FSV offers investors broad exposure to the UK market through a **Portfolio** that is one of the most diversified by market cap amongst its peers. Investors, therefore, can access an all-cap portfolio that is built through bottom-up stock selection that has historically delivered impressive alpha generation over a number of time periods (see **Performance**).

The trust's outlook is further supported by a style tailwind. Alex's contrarian approach means the portfolio usually has a value bias. This has been supportive of relative performance in the higher inflation and interest rate environment, and now the outlook is trending towards 'higher for longer', we believe this can continue to support future returns. The style also helps differentiate an investment in FSV from an investment in an index tracker, which it has handsomely outperformed over the long run.

The level of the current **Discount** could make for an attractive entry point for investors too, in our opinion. Not only is the level quite wide, currently at 9%, around one standard deviation wider than the trust's five-year history, but the discount level is a lot closer to the sector average than has historically been the case. We believe this stems from the good NAV performance not being acknowledged by the market and we think this could prove a good value opportunity for long-term investors.

BULL
Strong relative performance over several time periods, supported by stock selection
Currently trading at a wide discount that doesn't reflect good recent performance
Contrarian approach with a multi-cap portfolio offers significant differentiation to benchmark

BEAR
Value style could be a headwind should lower interest rate environment return
Smaller-cap tilt could lead to struggles in a weaker economic environment
A non-exclusionary approach may not suit investors who have strong ESG considerations

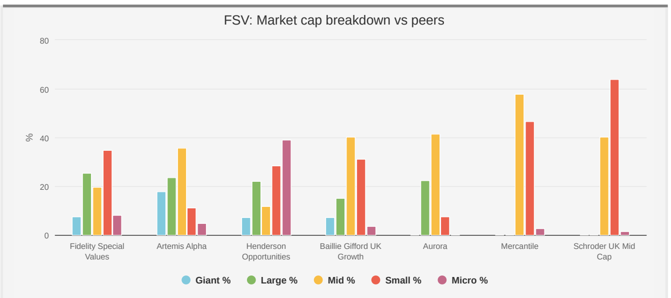
Portfolio

Fidelity Special Values (FSV) is managed by Alex Wright who takes a contrarian approach to identifying overlooked and undervalued companies from across the UK market-cap spectrum. As a result of this approach, the trust typically has a high active share that is typically in excess of 80%, as well as a value bias.

Alex, alongside co-manager Jonathan Winton, takes a bottom-up approach to building the portfolio. He uses the resources of the Fidelity research team to find unloved opportunities others may have missed, waiting for them to turn around over the next two or so years before selling them after their share prices have recovered. As such, turnover is usually within the 30% to 80% range. He has a total return mindset so will also consider the potential for a dividend to support returns. Alex can also hold up to 20% in overseas holdings. The current level is c. 23% though this includes c. 6.5% in companies based in Ireland that have a London listing and are not classified as overseas in investment trusts, which offers the advantage of greater flexibility over the open-ended equivalent fund that Alex and Jonathan also manage. Any currency risk involved in these investments is usually hedged by virtue of the fact that they use sterling-denominated Contract for Difference (CFDs) to achieve exposure to these securities.

The portfolio has a bias toward small- and mid-sized (SMID) companies due to the number of opportunities the manager finds among them. As such, the portfolio will be reasonably diversified at between 80 and 120 positions to allow for liquidity in the smaller-cap names, as we discussed in **our previous note**. This approach has led to FSV being the most diversified trust by market cap in the AIC UK All Companies sector, according to data from Morningstar, with the lowest maximum in any one market cap classification, as we have shown in the chart below.

Fig.1: Market Cap Breakdown



Source: Morningstar, as at 31/03/2024

Alex divides his portfolio into four super sectors to help analyse where he is taking exposure. These are financials, resources, other GDP-sensitive, and defensive. The financials super sector has typically been a substantial allocation in the portfolio, with the formal financial services sector at 27%, as of 29/02/2024, and overweight relative to the trust's benchmark, the FTSE All Share Index. Whilst financials remain a substantial allocation, the level has been steadily reduced over the past year though, partly as a result of Alex taking profits from good performers. One example of this is Bank of Georgia, which was one of the portfolio's best performers, though was sold in the first half of 2023.

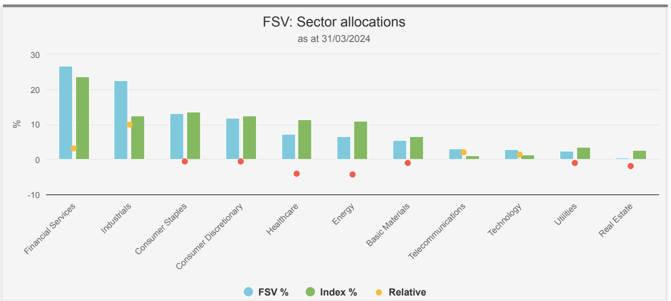
Alex's positioning within the financial sector is very varied. When the portfolio is further divided into subsectors, insurance is the largest overweight whereas capital markets is the largest underweight. This subsector also contains other investment trusts, which Alex is unlikely to have a large exposure to, contributing to the underweight. This has been partly influenced by recent activity, reflecting the sale of L&G and reduction in the Phoenix position, and a new holding in Direct Line and addition to the Just Group position last year. Furthermore, Alex reduced his holding in Barclays and added to Standard Chartered in the second half of 2023. This has led to an overweight in both life and non-life insurance and contributed to the insurance overweight.

Alex has also added to the defensive super sector. The number of opportunities in this sector is quite limited, though Alex has managed to identify a number of opportunities, primarily amongst the consumer health names, such as Reckitt Benckiser, Sanofi, and GSK. These firms have experienced share price volatility over fears of lawsuits relating to their drug businesses. However, from prior experience with the likes of Indivior (a prior ten-bagger for the trust), Alex believes markets have a tendency to overreact to such risks and overestimate any associated costs. He therefore added to these three names on weakness. He subsequently took profits on the Sanofi position when its shares bounced reflecting some success with its product pipeline. The stock was trimmed and then sold in Q2 and Q4 of 2023, with GSK and Reckitt added to in the second half of the year. We believe this activity is a good demonstration of Alex's contrarian approach, and the benefit of the sector expertise and depth of knowledge of the Fidelity research team, which means Alex is able to react to these market moves quickly as the information is available to him.

The allocation to other GDP-sensitive names has also increased, primarily through SMIDs. This includes additions to Victrex, as well as new positions in Dowlais and Ascential. Victrex and Dowlais are industrials companies, an industry that Alex likes the dynamics of because he believes the sector has gone through an economic cycle, having experienced a recession in 2023. However, he argues the sector is now through this and showing signs of a recovery, with earnings beginning to improve. The sector, which is very diverse and also includes support services firms, is the largest overweight relative to the benchmark, as we have shown in the chart below.

The commodities super sector remains an underweight. Alex has found some attractive valuations in smaller companies in these segments but remains underweight due to more expensive valuations among large-cap miners and large-cap oil companies which he does not hold. He believes the oil price will fall long term, and therefore the valuations of the oil majors are too high. New activity in commodities has been limited in the past year though, leaving both energy and basic materials as underweight sectors.

Fig.2: Sector Allocations



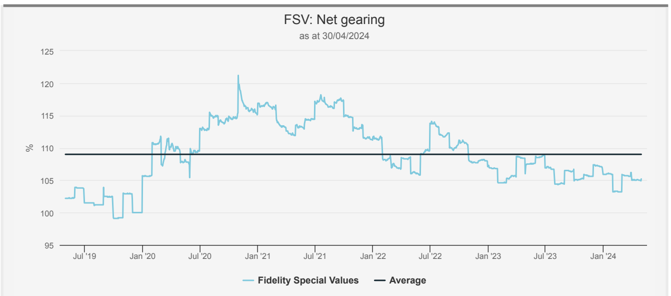
Source: Fidelity

Gearing

Whilst Alex believes valuations are attractive (see **Performance**), his gearing position has been relatively low over much of the past year. This reflects his relative caution given the strong recent performance of risk assets, as well as the higher cost of borrowing. As of 30/04/2024, the level of net gearing was 5.2%, despite being in double digits as recently as 2022.

The policy of FSV allows for a gearing level of up to 25% of net assets, with a maximum level of 40% allowed subject to board approval. Alex uses derivatives to take on gearing, rather than traditional borrowing facilities. Specifically, he uses CFDs. These are financial instruments that allow the manager to take more exposure than the amount invested. This also allows Alex to take additional exposure to specific stocks rather than broadly across the portfolio.

Fig.3: Gearing

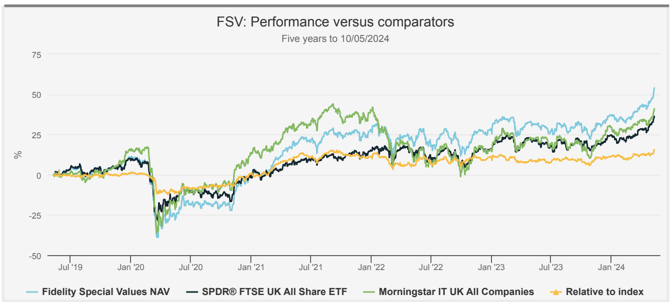


Source: Morningstar

Performance

Alex's contrarian approach has contributed to significant outperformance of the benchmark, the FTSE All Share Index, over the long term. The past five years have seen two distinct periods of market style. The initial phase significantly favoured growth investing as interest rates remained close to zero. Whilst this environment should have been a headwind, Alex only notably underperformed during the initial market fall of covid. However, when inflation and therefore interest rates rose, the value style came back into favour which has contributed to Alex delivering significant outperformance. This is shown by the yellow line in the chart below which represents cumulative performance relative to the benchmark. When the line falls, it indicates FSV is underperforming and vice versa. As a result of this resilient performance, FSV ended the five-year period nearly 16 percentage points ahead of the index, having returned 54.0% over the full period compared to 10/05/2024 versus 38.4% for the index. In the chart below, the index is represented by an ETF as a proxy.

Fig.4: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Aside from the style, the trust's SMID bias is likely to have an impact on long-term relative performance. Smaller companies typically underperform in periods of economic weakness but outperform in market recoveries. One example of this was in 2018 when a weak final quarter led to negative market returns for the calendar year of 9.5%. In this period, FSV underperformed by 4.7% over the course of the year, falling 14.2%. However, in the following year, the market rose 19.2% with FSV significantly outperforming by returning 24.4%. As such, we believe the SMID bias will be beneficial to performance over the long term.

The primary factor behind the relative performance is expected to be stock selection though. A good example of this generating alpha in the past year (to 31/03/2024) comes from Alex's financials holdings. Two of the top ten contributors over the year were AIB Bank and Kaspi.kz, an Irish bank and a Kazakhstan consumer finance marketplace firm respectively. Both are off-benchmark positions and have performed well, contributing 75.2bps and 54.7bps of alpha. Conversely, the lack of exposure to Prudential, a sizeable index constituent, contributed to relative returns. Prudential fell steadily over the course of 2023 and into 2024, ending the 12-month period to 31/03/2024 down over 30%. This also generated good alpha for FSV and is a good demonstration of the impact of stock selection on performance, in our opinion.

Further examples come from Alex's holdings in defensive companies. He is overweight in the defensive super sector (see **Portfolio**), though has underweight positions in Diageo and AstraZeneca on valuation grounds. Both have had challenging years, most notably with Diageo having a profit warning in late 2023. These underweights have been good contributors to relative performance over the year, contributing over 80bps of alpha each and therefore featuring in the top three contributors to performance in the 12 months to 31/03/2024.

Alex's holdings in support services companies have continued to be a positive for the trust. We discussed in **our previous note** the impact of these firms in the first half of 2023, with this continuing later in the year and into 2024. The best example of this is DCC which was the top contributor to performance over the six months to 31/03/2024. Similarly, Babcock International has been the top contributor over the full year, though Alex believes the firm can continue to perform well because of the backlog of work servicing the government's submarine fleet, in which Babcock specialises. We understand Alex has begun to take some profits in some of these companies following their good performance.

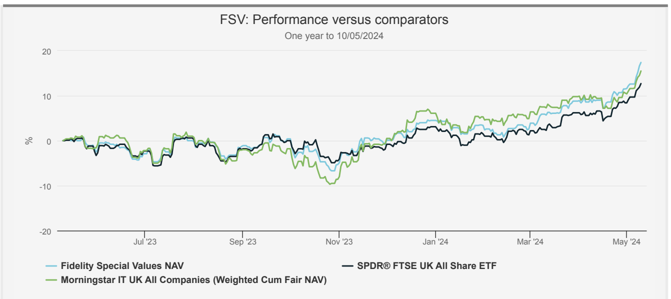
M&A has also continued to be a positive. Smart Metering Systems accepted a bid from private equity (PE) in December 2023, which as a 1.5% position contributed positively to performance. Alex notes that corporates have recently joined PE in bidding for other companies. He believes this is a sign of improved corporate confidence, however also cautioned that this behaviour is often typical at the top of the cycle, hence his caution with **Gearing**.

One sector that has detracted from performance has been healthcare. The sector has generally struggled, with the exception of Eli Lily and Novo Nordisk. Both of these firms are listed overseas, and whilst Alex can invest overseas, he does not hold these. Instead, he holds Roche as an off-benchmark position which has been weak and the largest detractor to performance over the year.

The underweight allocation to commodities has also been a detractor. This is primarily due to oil prices remaining higher than Alex and the team expected due to OPEC production discipline and geopolitical tensions. Alex believes Saudi supply capabilities mean this headwind will soon fade, although a significant underweight position in Shell was the second biggest detractor to performance in the year to 31/03/2024.

Despite these detractors, FSV has significantly outperformed the benchmark over the past year, having returned 17.4% to 10/05/2024 versus the index return of 13%. Alex's mid-cap bias has helped performance, having done particularly well in the past six months. We understand this is a result of a recovery in earnings, as well as improved optimism surrounding rate cuts which typically affects SMIDs more. This effect has contributed to strong performance from the weighted sector average too though as the largest trust in the sector, Mercantile, is focussed primarily on mid-caps.

Fig.5: One-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

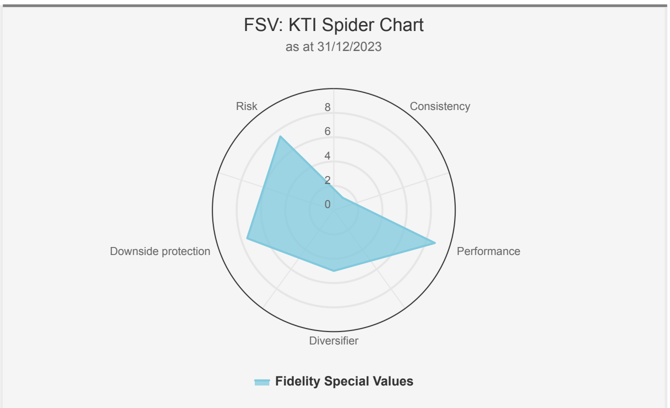
Alex's outlook reflects a combination of attractive valuations but also relative caution. He notes that investors have become quite bullish as a result of good corporate earnings, especially in the industrial sector. Alex believes earnings growth will be robust going forward, though is focussed on idiosyncratic turnaround stories which can grow faster than the market. However, he is cautious about earnings in the likes of oil and other commodities companies. As these firms make up a significant weight of the UK market, especially the FTSE 100, disappointments here could have an impact on broader market sentiment.

Furthermore, he points to the markets' strong run and that they are trading near all-time highs despite a lot of negative sentiment. Admittedly, inflation has eased offering central banks the capacity to cut interest rates but with growth remaining resilient, especially in the US, Alex argues this is not a certainty, hence is remaining relatively cautious. However, he points to valuations, especially in his own portfolio as being very attractive despite the recent run-up, which balances this somewhat. Ultimately, Alex still believes UK equities are significantly undervalued in a historical context, though macro and geopolitical headwinds could cause some short-term uncertainty.

Our proprietary KTI Spider Chart is shown below. This shows how FSV has performed versus a peer group of eight UK All Companies investment trusts over the past five years, in some key categories. Each category is scored out of ten and scores are normalised to the peer group, with a higher score indicating a superior characteristic.

FSV scores very highly for performance as a result of the significant alpha the trust has generated over the period. Scores for both downside protection and risk are also above average. This is due to a lower-than-average score for volatility than peers as well as better downside capture and worst five months score. FSV has a score that is in the middle of the peer group as a diversifier. The highlight within this is the low correlation score versus the bond index which is very low versus peers. Finally, the trust scores below average for consistency which we would attribute to the trust's style which has moved out of and then into favour.

Fig.6: KTI Spider Chart



Source: Morningstar

Past performance is not a reliable indicator of future results.

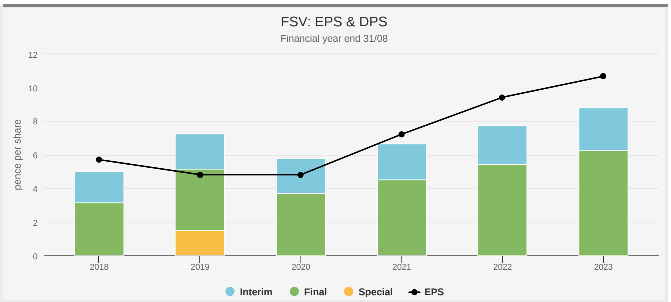
Dividend

The trust's policy is to pay out a considerable amount of the income generated by the portfolio, as the board appreciates the value of a dividend in challenging times. The trust pays semi-annually and has paid out occasional special dividends in the past, albeit the most recent one was in 2019.

Alex has a total return mindset when it comes to analysing stocks. This means he will incorporate the potential for the dividend when considering an investment, though we understand this will not be the core tenet of an investment. As such, there is scope for a modest dividend to be an ongoing feature of FSV though we would caution against relying on it.

In the most recent financial year, FSV paid a dividend of 8.8p per share, with the final dividend paid in January 2024. This represented a 13.6% rise on the previous year's amount and was the 14th consecutive year of growth, ex-specials. Based on the current share price, the trust offers a historic yield of 2.8%. The dividend was fully covered by revenue, which was 10.67p per share, and allowed reserves to grow to an amount equivalent to 1.5x of the most recent dividend. Reserves were last used in 2020 which enabled the dividend growth track record to be maintained. As such, we believe the dividend is well supported going forward and can continue to create an additional positive element of the investment case.

Fig.7: EPS & DPS



Source: Fidelity

Management

FSV has been managed by Alex Wright since September 2012. He has over 20 years' experience of investing in UK and European equities, having originally joined Fidelity in 2001 as a research analyst. In his time at the firm, he has rotated through a variety of sectors, including leisure, emerging European and African banks, alcoholic beverages, and UK small-cap stocks. He holds a first-class economics degree from the University of Warwick. Alex also manages the open-ended Fidelity Special Situations fund, which has around £2.8bn in assets, though is largely similar in approach to FSV. Alongside Alex is co-manager Jonathan Winton. They have worked closely together since 2013 in the UK equities team, before Jonathan formally became co-manager in February 2020.

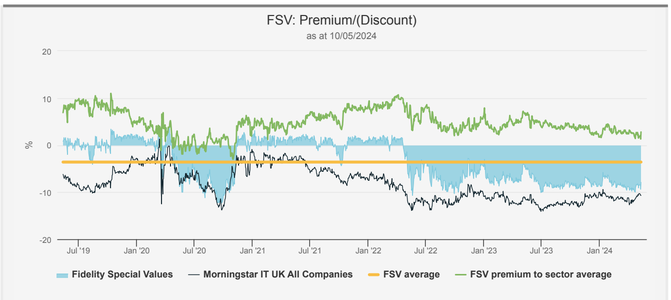
Alex and Jonathan have access to Fidelity's global equity research team, consisting of 174 equity analysts covering the US, Europe, Pan-Asia, and Emerging Markets. This team also has specialists in shorting and quant analysis, as well as a team of ESG specialists. Overall, Fidelity has over 250 professionals working within its global research platform, where collaboration is strong across regions. Fidelity has long-term incentive plans in place that reward analysts for successful stock picking.

Discount

The shares of FSV remain on a wide discount despite Alex having outperformed the benchmark over a number of years. We believe this is a result of negative sentiment towards the UK more generally rather than FSV-specific and therefore, could lead to narrowing should the UK market begin to recover. The current discount is 7.9%, over one standard deviation wider than the five-year average of 3.6% and only slightly narrower than the sector average of 10.7%.

The gap between FSV and the sector average has had a notable shift in the past year. For most of the past five years, as we have demonstrated with the green line in the chart below, FSV has traded at a premium to the sector, with an average over the full period of 4.8 percentage points. However, since July 2023, the gap between the discount of FSV and that of the sector average has been below average, with a current gap of just 1.3 percentage points. In this period, FSV has delivered significant NAV absolute returns of over 10%, which has significantly outperformed the index, albeit slightly behind the sector average. Regardless, we believe this narrowing gap demonstrates investors have been slow to respond to the improved performance of the UK more generally, and the rating of FSV's shares is not reflecting the recent pick up in NAV performance. As such, the current level could be seen as an attractive entry point in our opinion, as not only is the discount wide versus its own history but also much of FSV's premium rating versus the sector average has been eroded.

Fig.8: Discount



Source: Morningstar

The board has stated they intend to use share buybacks to ensure the discount remains within single digits in normal market conditions. Whilst the discount has traded close to double digits, it has not traded wider than that for a sustained period and therefore, no buybacks have been undertaken for over two years.

Charges

FSV has a straightforward, single-tier management fee of 0.6% which has been in place since January 2021 and is based on net assets. There is no performance fee.

As one of the largest trusts in its peer group, FSV benefits from the economies of scale this brings. We also believe that the management fee is very competitive which has contributed to charges looking favourable versus the peer group. The most recently published OCF for FSV is 0.7% as of 31/08/2023. This compares to the simple average of the UK All Companies sector of 0.77%, according to figures by JPMorgan Cazenove as of 15/04/2024.

The trust has a KID RIY of 0.88%, which compares to 1.24% as the simple average of the peer group although we would caution that valuation methodologies can vary.

ESG

There are no formal ESG restrictions for Alex to consider when he is constructing his portfolio, though he remains cognisant of the risks each element may bring. He does believe that the consideration of governance factors is very important though, and this has always been a key part of the approach. The process looks to identify companies which can execute a turnaround and part of this requires strong management teams which are capable of delivering on the recovery strategies.

For assessing the environmental and social factors of a firm, Alex analyses how a firm's business operations are exposed to government policy goals. Where a firm's activities are likely to conflict with these, Alex and the team will engage with their holdings to find a solution that won't lead to friction, rather than using this as a way of excluding companies. Alex notes that companies are unlikely to operate in a way that actively goes against regulation, but using this approach is a good guide for identifying potential risks, as was the case with previous holdings in the gambling sector. The manager noted a clear increase in problem gambling and, as such, expected an increase in regulatory pressure. Alex reduced his allocation to the sector accordingly, although consolidation in the industry was also a driver of this reallocation.

Despite not taking an exclusionary approach, the ESG characteristics of the trust are not that far from that of the index. Morningstar scores the trust below average compared to the peer group, though, scoring two out of five globes. However, a contributor towards this is the number of small and mid-cap companies in the portfolio, which are not covered by the external ratings systems and will have impacted the score.

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