investors CHRONICLE
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A UK fund on the bargain hunt

This active manager has a strong long-term record of sifting through an unloved market. **Dave Baxter** reports

Fidelity Special Values FSV 273p BUY
INVESTMENT TRUST

- Unconstrained and opportunistic approach
- Offers exposure to beaten up mid caps
- Good long-term returns
- Experienced team

Talk of an 'everything rally' has resurfaced with good reason this year. Tech stocks are flying, the US market is back on form and even Japanese and European indices have made big gains. But ample cause for frustration remains: the FTSE 100 is up this year but once again lags the S&P 500 in sterling terms.

Elsewhere, the UK's small- and mid-cap indices are sitting on only modest gains - not much of a reprieve from a savage 2022 that saw them sustain enormous losses.

Domestic shares have had a turbulent few years but this does bring its advantages: the UK market continues to look cheap relative to its peers, and the sheer unpopularity of the FTSE can mean a handful of outstanding companies stay overlooked, as our recent feature on the market's hidden stars illustrates. With the UK still seemingly due a recession and sentiment far from positive, the opportunities are there for contrarians who can do the research.

It's worth acknowledging, however, that not everyone will have the time, the resources, or even the risk appetite to back a selection of solid but unloved UK shares. That's where funds come in.

Patchy as the track record can be for professional stockpickers, they should be able to offer more value in an unloved market beset by structural problems. One name that continues to stand out here is **Fidelity Special Values (FSV)**.

FIDELITY SPECIAL VALUES HAS A BIG UNDERWEIGHT POSITION IN CONSUMER STAPLES ON VALUATION GROUNDS

Hail the contrarian stockpicker

Simply having faith in UK stocks has been akin to a contrarian stance in itself in recent years. Then again, the domestic market does not lack for companies that seem especially undervalued. That's the primary focus of FSV lead portfolio manager Alex Wright, who seeks out UK shares he thinks are undervalued or whose potential the market has failed to acknowledge.

Admittedly, Wright makes many of the usual noises we have come to associate both with value managers and UK equity investors. In a note published in July he argued that, even adjusting for outperformance from sectors such as energy and banks, the domestic market looked cheap, especially compared with its US counterparts. He has also argued that the current backdrop of sticky inflation, higher interest rates and economic volatility is "more representative of the longer-term pattern seen over the last 100 years". If the conditions that had benefited growth stocks are reversing, Wright contends, we may be reverting to a sustained positive backdrop for value stocks.

Such views aren't exactly new. Indeed, Wright and his value-minded, UK-focused peers have been making them for some time. However, FSV is distinct for plenty of other reasons: rather than simply buying shares that look cheap, Wright focuses on those undergoing positive change, then holding them "until their potential value is recognised by the wider market". He only buys companies where he believes he understands the downside risk, ideally backing names that have "exceptionally cheap valuations or some kind of asset that should prevent their share prices falling below a certain level". Examples of positive change include shifts in a company's competitors or market, new products, or an expansion into a new business area. This investment process - one that Wright has stuck to doggedly over the years - has steered the trust through thick and thin, and should help minimise the risk of falling into a value trap.

The portfolio

Investor pessimism towards the UK looks justified enough, suggesting that caution should be the watchword for even the most ardent contrarian. Wright, for one, has been a recent seller of certain "GDP-sensitive" stocks that fared especially well in the Covid-19 recovery of 2020 and 2021. The manager has by contrast favoured financials, which made up nearly a third of the portfolio at the end of May, with a particular liking for banks. His bull case for the sector focuses on banks' much improved capital positions, greater prospects for share buybacks and profit sharing, and a view that there exists a "general misunderstanding of how interest rates influence earnings".

He cites a "dramatic change in the earnings profile of interest rate sensitive banks such as [holdings] **AIB (AIBG)** and **NatWest (NWG)**" as evidence for staying overweight the sector.

Elsewhere, the FSV team has favoured what it sees as defensive stocks, including multinational healthcare business **Roche (CH:ROG)**, tobacco giant **Imperial Brands (IMB)** and outsourcer **Serco (SRP)**. "We also own **DCC (DCC)** and **Mitie (MTO)**, which have some defensive as well as cyclical businesses," notes Wright. "As such, the portfolio is diversified across sectors but also between defensive and more cyclical businesses."

As to the fund's omissions, it has a big underweight position in consumer staples on valuation grounds. Wright believes sector leaders **Diageo (DGE)** and **Unilever (ULVR)** are good companies, but that their valuations offer little potential for good returns. He also avoids mining, where the outlook for iron ore and thermal coal pricing has raised the "potential for earnings to fall meaningfully".

An unconstrained approach to stockpicking finds Wright hunting for bargains

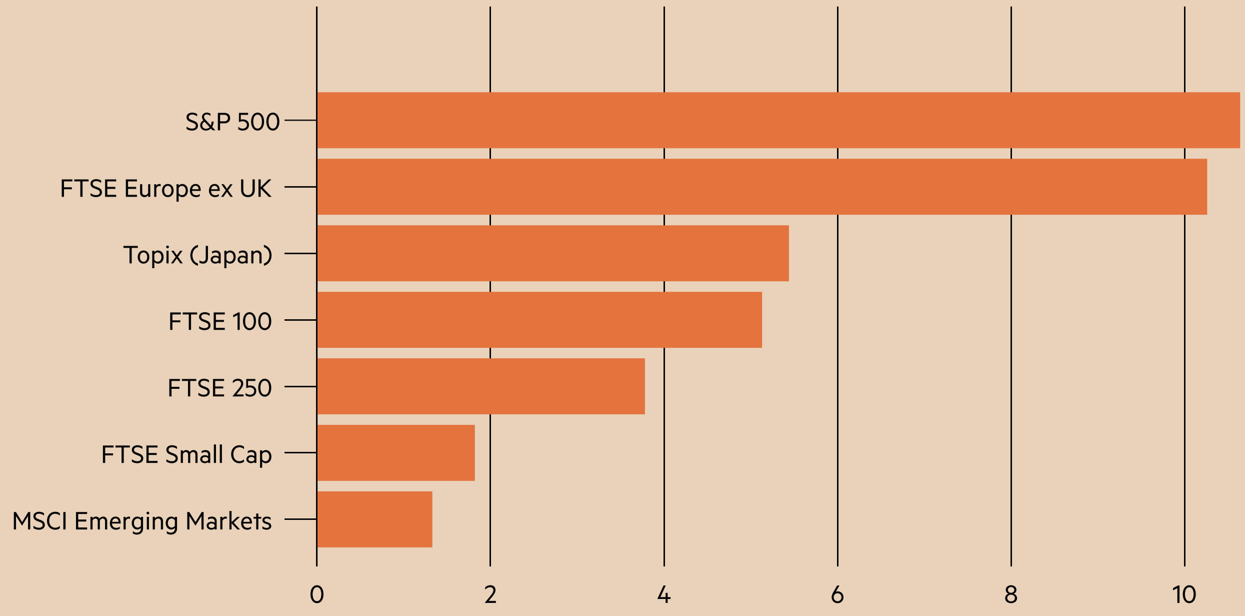
FSV'S TOP 10 HOLDINGS

Company	Weighting (%)
Roche	4.2
AIB	3.8
Phoenix Group	3.6
DCC	3.5
Aviva	3.4
Imperial Brands	3.3
NatWest	3.2
Barclays	3.2
Mitie	3
Ryanair	2.8

Source: Fidelity. As of end of May

UK STOCKS LAG MANY OF THEIR PEERS SO FAR THIS YEAR

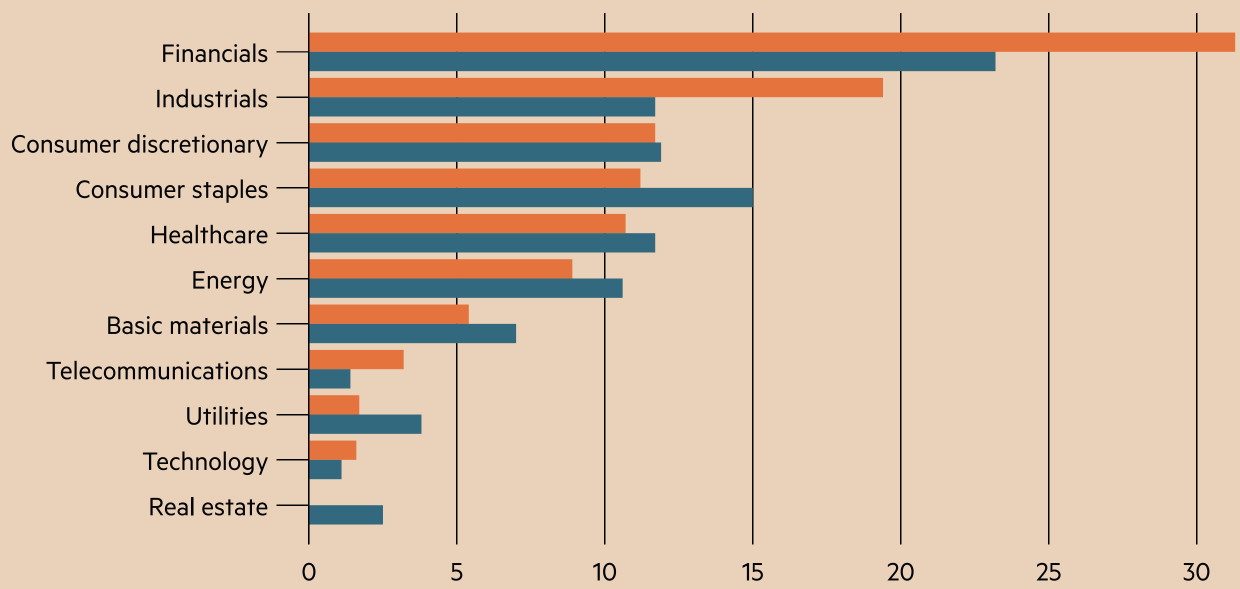
Sterling total return (%) for 2023 as of 21 July



Source: FE

THE FUND'S BIG SECTOR CALLS VERSUS THE FTSE ALL-SHARE

Fidelity Special Values FTSE All-Share Allocation (%), end of May



Source: Fidelity

FIDELITY SPECIAL VALUES (FSV)

Price: 273p	**Gearing:** 7%
AIC sector: UK All Companies	**Total assets:** £1.1bn
Fund type: Investment trust	**Share price discount to NAV:** -8.7%
Market cap: £884.8mn	**Ongoing charge:** 0.69
Launch date: 17/11/1994	**Share price dividend yield:** 2.8%

Source: AIC, as of 21/07/23

STERLING SHARE PRICE TOTAL RETURN (%)

Fund/index/sector	1-yr	3-yr	5-yr	10-yr
Fidelity Special Values	4.8	58.7	11.7	110.3
FTSE All-Share	8.0	33.7	18.4	70.4
AIC UK All Companies sector average	1.8	24.1	-2.5	50.2

Source: FE, as of 21/07/23

regardless of company size, with a decent weighting to small- and mid-cap stocks that should look especially cheap after a gruelling 2022. The fund had around 25 per cent of its equity holdings in the FTSE 100 at the end of May, with 34.2 per cent in the FTSE 250, 6.9 per cent in the FTSE Small Cap and a third in non-FTSE entities. As the presence of Zurich-listed top holding Roche demonstrates, the team make some use of overseas shares. While this muddies the UK value focus a little, it does give the team scope to fish in a bigger pond for undervalued companies.

Other considerations

This fund is unlikely to spike higher overnight. A lack of momentum in both mid-cap and value stocks helps explain the trust's underwhelming 2023 so far, which in turn has fed into a valuation that looks cheap, if not staggeringly so: FSV's shares traded at an 8.6 per cent discount to portfolio net asset value on 24 July, versus an average of 7.1 for the preceding 12 months. For context, the average peer group fund trades on a 10.5 per cent discount.

It's also worth noting that a preference for mid caps and unloved companies gives this fund a very different form of exposure to both UK equity trackers and rival active funds, such as the more growth and quality focused **Slater Growth (GB00B0706C66)** to **Henderson Smaller Companies (HSL)**, **SDL UK Buffettology (GB00BF0LDZ31)** and **Lindsell Train UK Equity (GB00B18B9X76)**.

Still, lest potential investors think that a value-led approach is likely to mean sharper volatility, there are a couple of reasons for encouragement. According to figures from Trustnet, FSV's top-quartile market outperformance over the past three years has been achieved without abnormal volatility. The fund's strong Sharpe and information ratios also suggest excess risks have been more than compensated for, and that management skill has helped to beat the benchmark. When it comes to actively managed funds, you can't ask for more than that. ●