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:

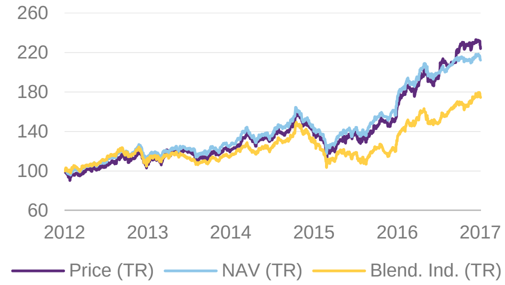
- It is now over two years since Nitin Bajaj was appointed as manager of Fidelity Asian Values in April 2015. Nitin's appointment has been good for the trust – it has markedly outperformed its peer group and benchmark since Nitin took up the reins. Year-to-date, the trust has faced a headwind as large-cap stocks (in which the trust has an underweight position) have outperformed, but its absolute returns (the trust's prime focus) have nonetheless been very strong. Nitin expects that in time this headwind will reverse and the trust will benefit.
- Fidelity Japanese Values has performed strongly this year as investors have switched their focus back towards growth stocks. When we last wrote, the trust's manager, Nicholas Price, felt that weak Japanese earnings were close to their nadir; these have also recovered strongly. Despite these improvements, Nicholas thinks that shareholder returns (also at a high) still have room to grow.
- With market valuations close to all-time highs, Fidelity Special Values' manager, Alex Wright, is sounding a note of caution and has moved the UK-focused trust to a circa 3% net cash position (a more natural level is 10% net borrowings). However, with his contrarian style, Alex is currently overweight more cyclical stocks as this is where he sees value. He is underweight 'expensive defensives', which he believes will suffer as interest rates rise.

Special feature: Fidelity Asian Values

In this special feature, we provide a recap of Nitin's investment approach, an update on his market outlook and two case studies of stocks he has added to the trust's portfolio: Power Grid Corporation of India and TISCO Financial Group.

Fidelity Asian Values perf.

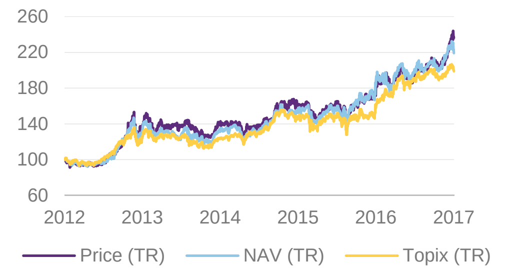
Time period 30/06/2012 to 30/06/2017



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

Fidelity Japanese Values perf.

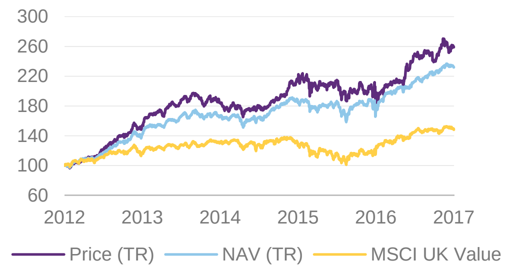
Time period 30/06/2012 to 30/06/2017



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

Fidelity Special Values perf.

Time period 30/06/2012 to 30/06/2017



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

Contents

3	**Recent developments at Fidelity**
3	**Fidelity International**
3	**Fundamental investment process**
4	**Previous research publications**
5	**Fidelity Asian Values**
5	Two years on and all is well
5	Long-term growth from small-cap Asia ex Japan
6	**Asset allocation**
7	**Performance**
9	**Fidelity Japanese Values**
9	Reasons to be cheerful
9	Long-term growth from Japanese-listed equities
10	**Despite challenges, Japanese corporates continue to prosper**
10	**Asset allocation**
11	**Performance**
13	**Fidelity Special Values**
13	Sounding a note of caution
13	UK-focused special situations
14	**Bifurcated markets are a headwind for the value investor**
14	The Trump reflation trade has reversed this year
14	The Current environment remains challenging for the value investor
14	**Asset allocation**
16	**Performance**
17	**Special feature: Fidelity Asian Values**
17	Nitin Bajaj
17	Investment approach – smaller companies with a value bias
18	**Manager's outlook**
19	**Power Grid Corporation – a case study**
20	**TISCO Financial Group – a case study**

Recent developments at Fidelity

Fidelity International has been celebrating being highly commended in the 2017 Money Observer Investment Trust Premier Group Awards. With Fidelity European Values celebrating its 25th anniversary in November 2016, Fidelity has now been running investments trusts for over 25 years. Fidelity European Values' portfolio manager, Sam Morse, also celebrated his fifth anniversary, of manging the trust, at the end of last year, while Alex Wright, is due to celebrate his fifth anniversary of managing Fidelity Special Values later this year. Fidelity is committed to Investment Trusts over the long term and to having the right managers who can continue this success.

Fidelity International

Fidelity International 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$303.3bn (£233.4bn) of assets under management, as at 30 June 2017, 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 around 390 investment professionals located in 12 countries) and Fidelity is renowned for both its bottom-up stock-picking investment process and its focus on long-term performance.

Fundamental investment process

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

Fidelity's managers, while 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. 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.

Previous research publications

Additional information is available at the fund manager's website, https://www.fidelity.co.uk/investor/investment-trusts.page

Readers interested in further information about Fidelity Asian Values, Fidelity Japanese Values and Fidelity Special Values may wish to read our previous reviews of Fidelity's closed-end funds range, as detailed in Figure 1. You can read the notes by clicking on them in Figure 1 or by visiting our website.

Figure 1: Marten & Co. previously published research on Fidelity's investment trusts

Date	Company profiles	Special feature
15 October 2015	FAS, FJV, FSV	FAS
20 May 2016	FAS, FJV, FSV	FJV
2 February 2017	FAS, FJV, FSV	FSV

Source: Marten & Co.

MARTEN & CO

Company profile | Investment companies

27 July 2017

Fidelity Asian Values

Two years on and all is well

Since Nitin Bajaj's appointment in April 2015, Fidelity Asian Values (FAS) has markedly outperformed its peer group and benchmark. This is despite relative performance suffering this year, as large-cap stocks (where it is underweight) have outperformed smaller companies (FAS' absolute returns have nonetheless been very strong). Over the long term, Nitin expects that this will reverse and the trust will benefit.

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: 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 to five-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 draws on Fidelity's proprietary research resources in this regard.

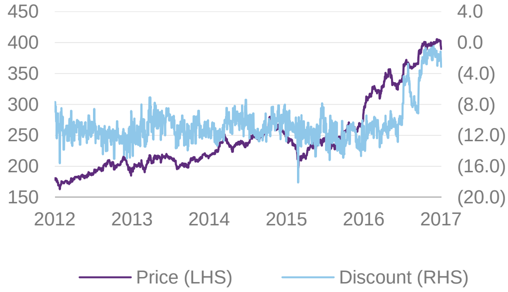
Year ended	Share price TR. (%)	NAV TR. (%)	Peer group avg. NAV TR. (%)	Blended b'mark Index TR. (%)*	MSCI World TR. (%)
30/06/13	9.7	14.4	19.4	12.8	22.6
30/06/14	10.4	10.4	0.3	2.4	10.0
30/06/15	14.3	12.2	9.1	12.9	10.3
30/06/16	19.3	24.1	8.6	2.6	14.4
30/06/17	35.6	20.7	28.2	30.4	21.6

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	377.00p
NAV	410.84p
Premium/(discount)	(8.2%)
Yield	1.2%

Share price and discount

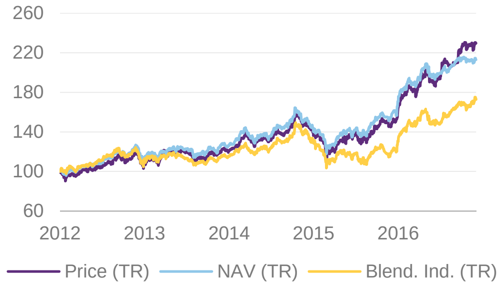
Time period 30/06/2012 to 30/06/2017



Source: Source: Morningstar, Marten & Co.

Performance over five years

Time period 30/06/2012 to 30/06/2017



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

Domicile	United Kingdom
Inception date	13 June 1996
Manager	Nitin Bajaj
Market cap.	254.4m
Shares outstanding	67.5m
Daily vol. (1-yr. avg.)	191.9k shares
Net cash	12.9%

Asset allocation

Although the manager comments that asset allocation is a result of stock selection, looking at the portfolio from an aggregate perspective, the most significant move has been the increase in the cash weighting in the portfolio, as Nitin has become more cautious of markets and stocks have hit his price targets.

Nitin has been adding to the fund's exposure to Korea, favouring Korean property and casualty insurance companies (not life insurance companies as these are hard to analyse effectively) and healthcare stocks. The non-life insurance sector offers companies on P/E ratios in the region of 6x to 8x, and about 85% of the market is shared between five companies. Within the Korean healthcare sector, there are companies making branded, generic drugs that generate 15%/20% ROIC and trade on 12x/14x earnings.

Notable reductions have been made to the allocations to India and the 'Other' category, which includes countries such as the US, Sri Lanka and Japan.

Figure 2: Country allocations, as at 31 May 2017

	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 30/11/16 (%)	Percentage point change
India	16.4	10.1	6.3	19.7	(3.3)
Taiwan	12.2	14.1	(1.9)	11.0	1.2
South Korea	10.4	18.0	(7.6)	7.0	3.4
China	7.8	31.8	(23.9)	8.7	(0.9)
Australia	7.5	0.0	7.5	7.9	(0.4)
Hong Kong	6.6	11.7	(5.1)	9.2	(2.6)
Singapore	6.2	4.8	1.4	6.6	(0.4)
Philippines	6.1	1.4	4.7	4.8	1.3
Indonesia	5.6	2.9	2.7	4.0	1.6
Thailand	2.9	2.5	0.4	5.8	(2.9)
Other	5.5	2.8	2.7	9.0	(3.5)
Net cash	12.9	0.0	12.9	6.3	6.6
Total	100.0	100.0	0.0	100.0	0.0

Source: Fidelity Asian Values (monthly factsheets)

Figure 3 shows how the portfolio's sectoral breakdown has changed over the past six months. The big moves have been reductions in the consumer discretionary and technology exposures, on the back of strong performances from those sectors, and the increase in the cash weighting that we noted above. Exposure to industrials has increased but, within this sector, Nitin has cut positions in Chinese industrial stocks on valuation concerns.

There has been a number of changes to the list of the 10 largest holdings over the past six months. Nitin has trimmed the weighting in Power Grid Corp of India, but it retains its position as the largest holding in the portfolio. He points out that Power Grid has a near monopoly in power transmission in India and says that there is no pressure for a review of its regulation in the near term. Nitin describes Australian childcare business, G8 Education, as 'recession proof' and he is happy to retain the holding despite recent underperformance.

Figure 3: Sectoral allocations, as at 31 May 2017

	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 30/11/17 (%)	Percentage point change
Consumer discretionary	18.1	9.9	8.2	23.7	(5.6)
Information technology	15.7	29.3	(13.6)	19.1	(3.4)
Consumer staples	12.5	4.7	7.7	11.0	1.5
Industrials	11.3	7.8	3.5	9.4	1.9
Financials	9.8	23.5	(13.7)	9.1	0.7
Health care	6.6	2.1	4.5	7.4	(0.8)
Real estate	4.3	6.0	(1.7)	6.2	(1.9)
Utilities	5.2	3.2	2.0	5.0	0.2
Materials	2.9	4.5	(1.6)	2.9	0.0
Energy	1.8	4.1	(2.3)	1.8	0.0
Telecoms	0.6	5.0	(4.4)	0.4	0.2
Other	(1.7)	0.0	(1.7)	(2.3)	0.6
Net cash	12.9	0.0	12.9	6.3	6.6
Total	100.0	100.0	0.0	100.0	0.0

Source: Fidelity Asian Values (monthly factsheets)

Figure 4: Top 10 positions as at 31 May 2017

Holding	Country	Sector	Portfolio weight (%)	Portfolio weight 30/11/16 (%)	Percentage point change
Power Grid Corp India	India	Utilities	3.0	3.9	(0.9)
Taiwan Semiconductor	Taiwan	Information technology	2.6	2.5	0.1
WPG Holdings	Taiwan	Information technology	2.5	2.4	0.1
Housing Dev Finance	India	Financials	2.5	2.1	0.4
LT Group	Philippines	Industrials	2.4	1.9	0.5
Redington India	India	Information technology	2.0	0.8	1.2
Infosys	India	Information technology	1.7	1.1	0.6
Ascendas India Trust	India	Real estate	1.7	2.0	(0.3)
G8 Education	Australia	Consumer discretionary	1.6	1.6	0.0
HDFC Bank	India	Financials	1.5	1.0	0.5

Source: Fidelity Asian Values (monthly factsheets)

Nitin has been adding to the portfolio's exposure to the Indian mortgage market, buying Housing Development Finance Corporation on a p/e of 13x and making 20% ROCE. One other recent addition to the portfolio has been Fast Food Indonesia, which owns that country's KFC franchise. He says that the company is making below normal margins due to rapid minimum wage increases of last few years but that, as this normalises, margins should recover as should the valuations.

Performance

Markets have been moving higher and Nitin believes this has been fuelled, in part, by liquidity flowing from China and also by a resurgence in the technology sector on the back of some decent results. Some stocks are looking expensive, in his opinion. Nitin says there have been no 'blow ups' in the portfolio, but recent underperformance relative to the peer group (evident in Figure 5) is down to large-cap stocks outperforming small-cap stocks significantly.

Figure 5: NAV performance relative to peer-group average since manager appointed (rebased to 100)

Source: Morningstar, Marten & Co

In terms of positive contributors to recent performance, Nitin highlights chip maker, SK Hynix. This was a result of cyclicality of memory chip prices and as Demand Supply came back into balance, all memory related stocks benefited.

Luen Thai is a Hong Kong listed apparel and accessories manufacturer, which Nitin says benefited from a takeover offer from state owned Shangtex. Luen Thai's decision to dispose its non-core businesses and factory properties was also well received by investors. V-Mart is a department store in India, one of very few consumer plays that is taking advantage of a shift to organised retailing in that country.

On the downside, Yowie, a maker of chocolates similar to Kinder, has suffered a couple of quarters of disappointing earnings growth. Nitin is holding on to the position, anticipating a recovery.

Figure 6: Total return performance to 30 June 2017

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 01/04/2015* (%)
NAV	(0.3)	(0.5)	6.6	20.7	68.2	112.4	38.4
Share price	(2.5)	(1.1)	12.3	35.6	84.9	124.0	51.5
Blended benchmark	1.0	4.3	16.8	30.4	51.2	74.5	27.5
Peer group average NAV	1.6	3.9	15.6	28.2	51.9	82.0	30.6
Peer group average price	1.6	5.6	16.7	33.2	49.8	82.0	30.4

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.

One notable feature of the past year has been a narrowing of FAS' discount, resulting in strong returns to shareholders.

27 July 2017

Fidelity Japanese Values

Reasons to be cheerful

Fidelity Japanese Values (FJV) has recovered strongly this year as investors have refocused their attention on growth stocks. Japanese corporate earnings have recovered sharply from their nadir and while yen strengthening, on the back of geopolitical events, is a potential challenge, FJV's manager says that an uptick in the global cycle has helped Japan to expand beyond its potential growth rate. The trust's manager, Nicholas Price, observes that the trend of improving corporate governance continues and he believes that this is driving shareholder returns to a record high. Nonetheless, with companies holding considerable cash, he believes returns still have room to grow from here and, in a climate of heightened concerns over valuations, Japan compares favourably with other developed markets. FJV's 12.4% discount also offers some comfort.

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.

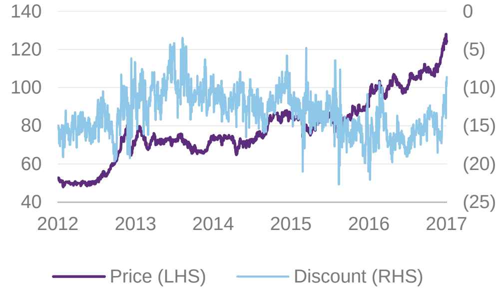
Year ended	Share price total return (%)	NAV total return (%)	Peer group average TR (%)	TOPIX Index TR (%)	MSCI World Index TR (%)
30/06/13	37.6	31.8	36.0	25.1	22.6
30/06/14	3.1	0.9	7.6	(1.2)	10.0
30/06/15	12.8	16.1	12.4	18.4	10.3
30/06/16	13.1	22.3	26.6	9.5	14.4
30/06/17	30.5	16.0	24.9	24.2	21.6

Source: Bloomberg, Morningstar, Marten & Co.

Sector	Japan Small Co.s
Ticker	FJV LN
Base currency	GBP
Price	122.00p
NAV	139.32p
Premium/(discount)	(12.4%)
Yield	Nil

Share price and discount

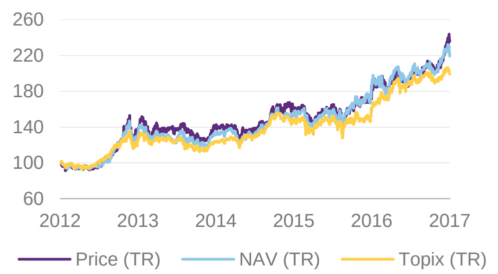
Time period 30/06/2012 to 30/06/2017



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/06/2012 to 30/06/2017



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	15 March 1994
Manager	Nicholas Price
Market cap.	165.4m
Shares outstanding	135.6m
Daily vol. (1 yr avg.)	97.6k shares
Net gearing	22.2%

Despite challenges, Japanese corporates continue to prosper

Readers interested in more information on FJV should see our previous Fidelity Closed Funds Reviews and, in particular, the special feature on FJV in the May 2016 edition (see page 4 of this note for further details).

FJV's manager, Nicholas Price, acknowledges that the Japanese economy faces some well-publicised challenges, not least an ageing population, difficult politics, near-zero inflation and shifts in the value of the yen. However, he believes that the trend is one of gradual improvement. Japan is a major exporter and as the global economic outlook improves, so do the prospects for Japan's exporters. Within Asia, a key destination for Japanese goods, an export-led cyclical recovery has helped Japan's export prospects across the region. In common with many other commentators, Nicholas considers that the global economic cycle is quite advanced. Reflecting this, he is focusing on companies with a proven record of consistently growing their earnings (he is looking for 10-15% per annum over a three to five-year period).

When we wrote in February, Nicholas felt that corporate earnings were close to their bottom. They have since recovered strongly, although Nicholas sounds a word of caution that momentum could suffer should the currency strengthen on geopolitical risks. Despite improving earnings, valuations have remained at what Nicholas considers to be attractive levels. Japan compares favourably with most other developed markets in valuation terms.

Nicholas says that the Japanese companies continue to make progress on corporate governance reform, albeit slowly, which he thinks is helping to drive shareholder returns to a record high. Nonetheless, with companies holding considerable cash, he believes these still have room to grow from here.

From an investment perspective, Nicholas says that a key area of focus is evaluating Japan's long-term challenges and turning these into investment opportunities. Themes include:

- Labour shortages – this is leading to increasing demand for recruitment, outsourcing, automation and child care. Japan is seeing its first overhaul in labour laws for 70 years, amid tight employment conditions, and companies are benefiting from growing demand for personnel and outsourcing services.
- Lack of successors in management – this is leading to increasing consolidation among SMEs
- Growing demand for medical care – for example, there is a shortage of nurses in Japan. This is leading to an increasing focus on home care and greater use of medical devices and medical technology.
- Leisure and lifestyle spending – there is a focus on activities addressing the needs of the elderly as well as ageing-related products.

Asset allocation

Core holdings within FJV's portfolio may be held for three-to-five years, but Nicholas has a strong sell discipline around valuations (annual turnover is circa 80%). The value/growth reversal at the end of 2016, where growth sold down, allowed him to add some names at attractive valuations.

Nicholas took profits in stronger performing cyclical stocks and selectively reduced certain financials stocks as he felt that, following the Trump reflation trade, near-term upside was limited (Nissan Chemical Industries and Mitsubishi UFJ Financial Group are examples). Nicholas has capitalised on what he describes as the underperformance of stable growth stocks, to purchase shares in companies such as M3, Sysmex and Rinnai. Service companies such as Recruit Holdings, Nihon Kohden and M&A Center have also been purchased. Nicholas believes that they are capturing structural growth in areas such as recruitment and advisory services. Keyence, Murata Manufacturing and FANUC have also been added– Nicholas has identified these as market leaders with pricing power in the mobile phone handset and automobile supply chains.

Figure 7: Top 10 largest positions at 31 May 2017

Holding	Sector	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 30 Nov 2016 (%)	Percentage point change
SoftBank	Information technology	6.7	0.0	6.7	3.4	3.3
Recruit Holdings	Services	6.0	0.0	6.0	0.0	6.0
Makita	Machinery	5.0	0.5	4.5	2.2	2.8
Ryohin Keikaku	Retail Trade	4.8	0.3	4.5	2.9	1.9
M3 Inc	Chemicals	4.7	0.2	4.5	3.4	1.3
Nippon Shinyaku	Pharmaceuticals	4.5	0.1	4.4	5.2	(0.7)
Keyence	Electric Appliances	4.4	0.0	4.4	1.8	2.6
Daikin Industries	Machinery	3.8	0.0	3.8	2.4	1.4
Suzuki Motor	Transportation Equip.	2.9	0.8	2.1	2.8	0.1
Yamaha Motor	Consumer discretionary	2.8	0.4	2.4	7.3	(4.5)

Source: Fidelity Japanese Values (monthly factsheet)

Figure 8: Sectoral allocations, as at 31 May 2017

	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 30 Nov 2016 (%)	Percentage point change
Consumer discretionary	33.9	18.8	15.1	43.8	(9.9)
Industrials	31.3	23.39	7.4	19.5	11.8
Health care	17.3	6.7	10.6	15.1	2.2
Information technology	17.2	13.1	4.1	13.8	3.4
Telecommunications services	6.7	0.0	6.6	3.4	3.3
Materials	5.8	10.6	(4.8)	10.9	(5.1)
Consumer staples	5.7	9.9	(4.2)	4.6	1.1
Real estate	4.1	2.0	2.1	3.6	0.5
Financials	0.3	9.4	(9.2)	8.4	(8.1)
Energy	0.0	1.7	(1.7)	0.0	0.0
Utilities	0.0	3.8	(3.8)	0.0	0.0
Other	0.2	0.0	0.0	0.0	0.2
Net cash	(22.3)	0.0	(22.3)	(23.2)	(0.1)
Total	100.0	100.0	0.0	100	0.0

Source: Fidelity Japanese Values (monthly factsheets)

Performance

2016 was challenging year for FJV. The Japanese market was predominantly focusing on large-cap and value stocks, and this proved to be a headwind for Nicholas' small-mid cap growth style. However, as illustrated in Figure 10 below, FJV's NAV and share price have both made good progress this year, which is markedly ahead of the Topix Index and broadly in line with those of the peer group. During the last 12 months, FJV's NAV has been behind the Topix, but both its share price and NAV performances are markedly ahead of the peer group.

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

Source: Morningstar, Marten & Co

Figure 10: Total return performance to 30 June 2017

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 1 Sep 2015 (%)
NAV	(0.2)	6.7	10.8	16.0	64.8	119.2	43.2
Share price	8.3	12.2	22.2	30.5	66.4	136.2	52.4
Topix	0.7	1.9	6.0	24.2	61.1	99.0	39.7
Peer group average NAV	(0.1)	3.9	11.1	12.4	67.2	136.4	44.2
Peer group average price	2.3	7.8	23.4	24.9	77.7	159.9	58.6

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

Looking at individual stocks, strong contributions have come from Yamaha Motor (driven by the performance of its marine engines); Tokyo Base (which the manager describes as a relatively under-researched fashion apparel retailer that is experiencing strong growth); SoftBank (a major mobile carrier that the manager says is expanding across the telecommunication/internet value chain); Suzuki Motor (strong growth in India); and Tasaki & Co (a small-cap jewellery company that was subject to a management buyout).

Significant detractors from performance have been AEON Financial Services (it surprised the market with an equity fund raising); Yonex (a sporting goods maker that saw rising promotion costs in China); Zojirushi (a kitchen appliance maker that faced weakening pricing trends); and M3 (it provides a medical web portal for doctors but the managers says that it faced profit taking due to concerns about potential regulatory risks despite no change in its underlying fundamentals). Regarding M3, Nicholas had previously been taking profits, but has been rebuilding the position.

MARTEN & CO

Company profile | Investment companies

27 July 2017

Fidelity Special Values

Sounding a note of caution

Fidelity Special Values (FSV) is managed with a contrarian style. It benefited from the Trump reflation trade, as value stocks rallied strongly, but, as the market has reset its expectations, value has moved out of favour as investors have refocused on growth. With market valuations close to all-time highs, FSV's manager, Alex Wright, is sounding a note of caution.

The trust's natural level of borrowing is around 10% of net assets, but Alex has moved the portfolio to a circa 3% net cash position. However, Alex believes it is still possible to deliver positive returns in environments that do not favour value and, despite this more cautious stance, FSV's portfolio is currently overweight cyclical stocks and underweight what Alex sees as expensive defensives, which he believes will suffer as interest rates start to rise.

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 while it is an all-cap strategy, there is an inherent bias towards small- and mid-cap companies. The manager has a value/contrarian style.

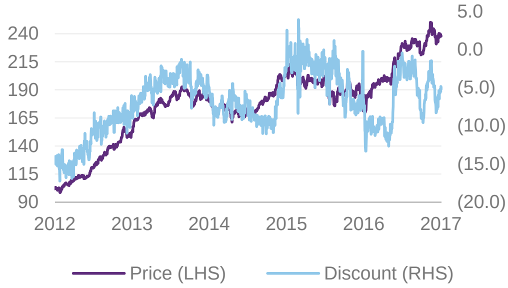
Year ended	Share price total return (%)	NAV total return (%)	Peer group average TR (%)	MSCI UK Value Index TR (%)	MSCI World Index TR (%)
30/06/13	53.2	41.7	25.1	16.3	22.6
30/06/14	20.2	16.8	15.5	11.9	10.0
30/06/15	15.7	11.2	9.0	(2.7)	10.3
30/06/16	(8.7)	(2.4)	(5.0)	(1.3)	14.4
30/06/17	33.2	29.1	23.0	18.7	21.6

Source: Morningstar, Marten & Co.

Sector	UK
Ticker	FSV LN
Base currency	GBP
Price	242.25p
NAV	254.88p
Premium/(discount)	(5.0%)
Yield	1.8%

Share price and discount

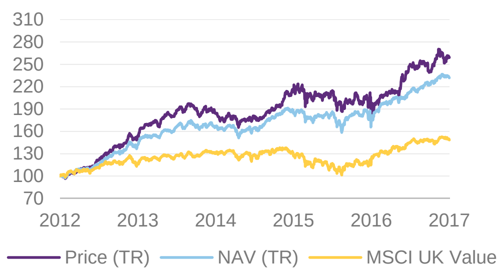
Time period 30/06/2012 to 30/06/2017



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/06/2012 to 30/06/2017



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	17 Nov 1994
Manager	Alex Wright
Market cap.	640.7m
Shares outstanding	264.5m
Daily vol. (1 yr. avg.)	307.8k shares
Net cash	3.3%

Bifurcated markets are a headwind for the value investor

Readers interested in more information on FSV should see our previous Fidelity Closed Funds Reviews and, in particular, the special feature on FSV in the February 2017 edition (see page 4 of this note for further details).

As discussed in our February 2017 special feature on FSV, Alex believes that the high levels of liquidity pumped into the financial system, post the financial crisis, has distorted markets, with companies that benefit from a low inflation/low interest-rate environment becoming increasingly expensive (for example tobacco; personal goods; software and computer services; pharma & healthcare; beverages), and given rise to the so-called ‘expensive defensives’. Similarly, those companies that are challenged by this environment have continued to become cheaper (for example mining, oil & gas, financial services, REITS and banks). In a more usual market environment, these anomalies would not be expected to persist for as long as they have, but this lack of mean reversion has made it difficult for the value investor.

The Trump reflation trade has reversed this year

Markets rallied following the election of President Trump last year, with previously cheaper cyclical stocks ‘leading the charge’. However, the idea that value stocks could continue to lead the market has disappointed, as investors have reassessed their expectations of what he will actually be able to deliver. Investors have switched their attention back to growth stocks (for example technology stocks have seen strong outperformance in the US), whereas value stocks have given up most of the previous outperformance year-to-date.

The Current environment remains challenging for the value investor

Alex says that the current environment is challenging for the value investor and that, looking at cyclically adjusted valuations, markets look expensive. He says that he is still able to find opportunities, but these are less prevalent than they were three years ago or even a year ago. Alex is not expecting to see a sharp market correction, but he does not think that the progress made during the last couple of years is likely to be repeated. Reflecting the balance of these considerations, gearing has been reduced and the portfolio is now circa 3% net cash (a natural gearing level is circa 10% net borrowings). Despite these challenges, FSV’s portfolio retains its pro-cyclical bias, as this is where Alex is finding value. Similarly, he is avoiding expensive defensives. He thinks that these stocks will suffer if interest rates start to rise. Overall, he thinks it is becoming increasingly important to ensure there is good diversification within the portfolio.

Asset allocation

Readers interested in more information on Alex’s investment process should see pages 23 and 24 of our February 2017 review.

The portfolio retains an overweight exposure to banks (this theme is explained on pages 26 and 27 of our February 2017 review). Construction, also discussed, was an area that Alex was adding to, but this has since been reduced. It performed well in the aftermath of the US election, as markets became excited over the prospects of increased infrastructure spending, but, while President Trump is not a lone voice on this, Alex felt that the market had got ahead of itself and challenges remain. The proceeds were allocated to the trust's positions in BT and Shire.

Figure 11: Top 10 overweight positions at 31 May 2017

Holding	Sector	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 30 Nov 2016 (%)	Percentage point change
Citigroup	Financials	5.2	0.0	5.2	6.0	(0.8)
Ultra Electronics	Industrials	4.0	0.1	3.9	4.3	(0.3)
CRH	Industrials	4.4	1.0	3.4	5.6	(1.2)
esure	Financials	3.1	0.0	3.1	2.0	1.1
Ladbrokes Coral	Consumer services	3.0	0.1	2.9	3.2	(0.2)
Phoenix	Financials	2.8	0.1	2.7	3.0	(0.2)
BT	Telecoms	3.4	1.1	2.4	4.1	(0.7)
Shire	Pharmaceuticals	3.9	1.7	2.2	4.1	(0.2)
Cairn Homes	Industrials	2.1	0.0	2.1	1.9	0.2
Bank of Ireland	Financials	2.0	0.0	2.0	1.9	0.1

Source: Fidelity Special Values (monthly factsheets)

Since we last wrote, Citigroup has moved up the rankings to become the trust's top overweight position as at the end of May 2017. The allocation reflects the fact that FSV can invest up to 20% of its portfolio in non-UK stocks and that the trust is able to benefit from Fidelity's global research platform. Citigroup has its share of difficulties, but Alex likes its market leading position, domestic US exposure and that it is trading below book value. Alex thinks that the investment thesis behind Lloyds, a long time FSV banks holding, is starting to play out; he trimmed the holding last year. He believes that income investors are starting to recognise that Lloyds offers a secure and attractive yield.

A recent addition to the portfolio is Booker. Alex says that its CEO, Charles Wilson, is very well regarded and, with the bid from Tesco, the stock potentially offers a very attractive way of accessing the Tesco 'recovery story'. Alex had previously been negative on supermarkets, but Aldi and Lidl, which had been expanding their footprints aggressively, have paused while they focus their efforts on the US. Alex also thinks that Dave Lewis, Tesco's CEO, is making great strides in rationalising the business and improving its profitability.

Figure 12: Sectoral allocations at 31 May 2017

Heading	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 30 Nov 2016 (%)	Percentage point change
Financials	34.6	25.7	8.9	37.7	(3.1)
Industrials	26.6	11.2	15.4	28.4	(1.8)
Consumer services	12.3	11.7	0.6	10.0	2.3
Oil & gas	8.9	11.5	(2.6)	9.6	(0.7)
Health care	5.1	9.4	(4.3)	6.0	(0.9)
Technology	4.9	0.9	4.0	7.5	(2.6)
Consumer goods	4.1	15.8	(11.7)	5.2	(1.1)
Telecommunications	3.6	3.9	(0.3)	4.5	(0.9)
Basic materials	2.5	6.5	(4.0)	3.7	(1.2)
Utilities	0.0	3.4	(3.4)	0.0	0.0
Other*	(6.1)	0.0	(6.1)	(7.7)	1.6
Net cash	3.3	0.0	3.3	(4.9)	8.2
Total	100.0	100.0	0.0	100.0	0.0

Source: Fidelity Special Values (monthly factsheets). * Note: Other includes FSV''s FTSE 250 short position.

Performance

One of the biggest influences on the performance of the fund, apart from Alex's stock selection, has probably been the 'Trump reflation trade' discussed previously. Markets were hopeful that President Trump's efforts to kickstart the US economy would restore global growth. However, an early failure to enact his agenda has left markets worried and the emphasis has switched back to growth plays, particularly the technology sector. Another factor at work has been the political backdrop in the UK, in particular the failure to articulate a Brexit strategy and the Conservative Party's disastrous election gambit, which has also had a dampening effect on markets with cyclical stocks suffering the most, increasing their attraction to a value investor. However, despite these difficulties, FSV has continued to make good progress, beating the UK market (as represented by the MSCI UK Value Index) during the six months to the end of June 2017.

Figure 13: Total return performance to 30 June 2017

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 01/09/12* (%)
NAV	(1.0)	3.9	8.7	29.1	40.2	132.1	122.0
Share price	(0.9)	7.5	4.7	33.2	40.8	159.2	150.4
MSCI UK Value	(2.1)	0.6	1.6	18.7	13.9	48.3	42.6
Peer group average NAV	(3.1)	2.1	7.6	23.1	27.5	84.2	77.1
Peer group average price	(2.7)	1.5	9.3	26.4	23.8	96.0	87.6

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

Strong contributions have come from Burford Capital (a provider of litigation finance, which Alex says the market struggles to understand), Coats, Synthomer, BP and Vodafone.

Figure 14: Fidelity Special Values NAV total return versus peer group since manager change

Source: Morningstar, Marten & Co

At the other end of the spectrum, Royal Mail, BT, LivaNova, International Personal Finance and Prudential have been among the largest detractors. These have all been related to stock-specific issues.

Special feature: Fidelity Asian Values

More information on the rationale behind Nitin's appointment, as well as a discussion of the 'growth story' for emerging Asia, can be found in our previous special feature on FAS (in our October 2015 note).

Fidelity Asian Values (FAS) has been managed by Nitin Bajaj since April 2015. When he took over, he transformed FAS's portfolio, as he adapted the fund to his absolute return, benchmark-agnostic and small-cap biased approach. FAS' performance took a turn for the better after Nitin's appointment although, in the short term, Asian large caps have been outperforming smaller companies.

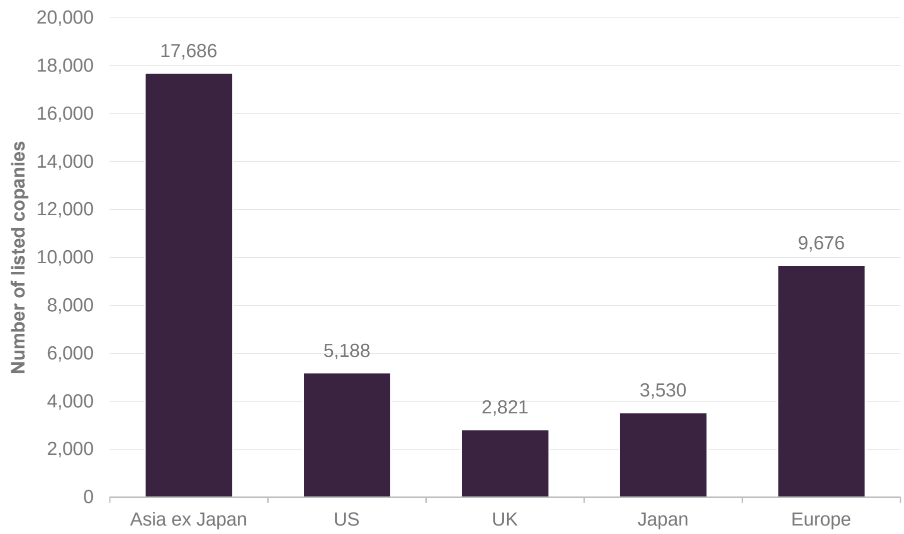
Nitin Bajaj

Nitin has been based in Singapore since 2013. Prior to that, he had a spell in Fidelity's Mumbai office (managing the Fidelity India Value Fund and Fidelity India Special Situations Fund), and before that he was based in London. Nitin has worked for Fidelity since 2003, having previously been an analyst for KPMG in India. When Fidelity sold its Indian business in 2012, Nitin moved to join Fidelity's Singapore operation, taking charge of a SICAV, 'Fidelity Funds – Asian Smaller Companies Fund'. He became manager of FAS on 1 April 2015. The two funds have assets of around $1.2bn. The open-ended SICAV has been soft closed to new investment since April 2017. In other words, FAS is the only way for new investors to access Nitin's funds. This may be one reason why FAS's discount has narrowed over the past year.

Investment approach – smaller companies with a value bias

Nitin is a bottom-up stock picker with plenty of stocks to choose from. There are far more listed companies in Asia than there are in the US, Europe and Japan as you can see in Figure 15. This provides an enormous breadth of opportunity. Many of these are not well covered by analysts and this creates mispricing that the manager can exploit.

Figure 15: large investment universe



Source: World Federation of Exchanges, Morgan Stanley Research, September 2016.

Sifting through these companies takes a disciplined approach to investing. A self-imposed lower market cap cut-off of $100m (for liquidity reasons) helps whittle down the universe. A team of four/five small-cap analysts, drawn from a 50-strong team focused on Asia ex Japan, works closely with Nitin to come up with ideas for the fund. He has the final say on which stocks are selected for the portfolio.

Nitin favours a value style of investing. Simplistically, he believes that high expectations for growth stocks often end in disappointment while investors react very positively when lowly valued stocks exceed expectations. This value approach is coupled with an absolute return mindset. He believes that the most important risk to guard against is permanent loss of capital rather than any underperformance relative to a benchmark. For that reason, the FAS portfolio is highly diversified (180 holdings at end May 2017); benchmark weights are ignored when constructing the portfolio; highly geared and expensively valued companies are avoided; and Nitin puts great emphasis on understanding the business models and assessing the management of the stocks that he invests in.

Nitin wants to invest in companies that can grow their earnings and ROE over time and, for that reason, he looks for companies that have defensible market positions. He adopts a three-to-five-year time horizon when assessing stocks.

Although there is a near 100% overlap between the stocks in the open and closed-end funds, FAS, given its fixed pool of capital, has greater freedom to hold larger weights in less liquid stocks, it can be more fully invested than the open-ended fund (the SICAV has 7%-10% cash to meet possible redemptions) and can use protection strategies.

Currently, about 20% of FAS's portfolio is protected from market falls by a range of long-dated options on the Hang Seng and KOPSI indices plus a shorter-dated option on the Indian market.

Manager's Outlook

Asian markets have been doing well, aided by earnings growth posted by technology companies and liquidity flowing from China. Large-cap companies have been outperforming small caps. There was a rotation from expensive consumer staple companies to value during 2016 and into technology stocks this year.

Increased valuations are making it harder for Nitin to spot new opportunities for the fund – he says that, at current valuations, it is hard to find many businesses which offer a substantial margin of safety.

He is concerned about the build-up of debt in China. He thinks companies have been postponing much needed restructuring. In addition, China's demographic pathway is starting to resemble that of Japan. On the back of this Nitin has been trimming exposure to Chinese industrial companies within the portfolio. On the other hand, he thinks that there are selective opportunities in areas where the market has taken too pessimistic a view of the growth prospects, and this is where Nitin is looking for new investments.

In India, Nitin is concerned that there is something of a 'valuation bubble', especially in small-cap stocks. He thinks that South Korea, by contrast, might be the only Asian country outside China that looks attractive on a relative valuation basis.

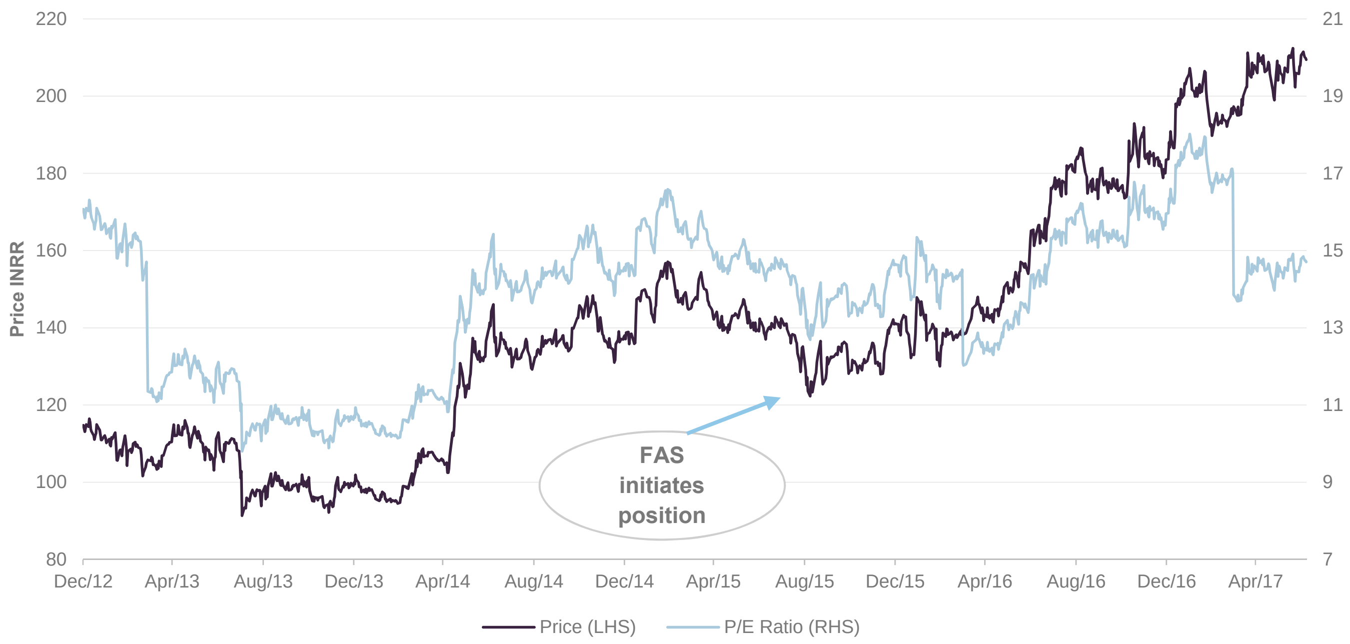
Nonetheless, Nitin makes the point that the macro environment does not affect his investment decisions, and that the portfolio is constructed on a stock by stock basis.

Power Grid corporation – a case study

Power Grid Corporation of India is India's state-owned electricity transmission company. It is a regulated utility. Nitin already owned the stock in his open-ended fund but brought it into FAS's portfolio following his appointment as manager. Nitin's investment thesis can be summarised as follows:

- Strong earnings growth during the previous 10 years (CAGR of 21%) with an expected CAGR over the next three years of circa 17%. Nitin expected its ROE to exceed 15%.
- Nitin considers that Power Grid's strategic importance (he says it is crucial to the value chain) means that it has low operational risk.
- Power Grid's status as a state-owned utility provided it with a strategic advantage in resolving 'right-of-way' issues.
- The company was exhibiting improving cashflows and Nitin felt it had low dilution risk as its capex requirements had plateaued in his view.
- Nitin felt the valuation was supportive: a forward P/E of 10x and a price to book of 1.7x

Figure 16: Power Grid share price and F12m P/E



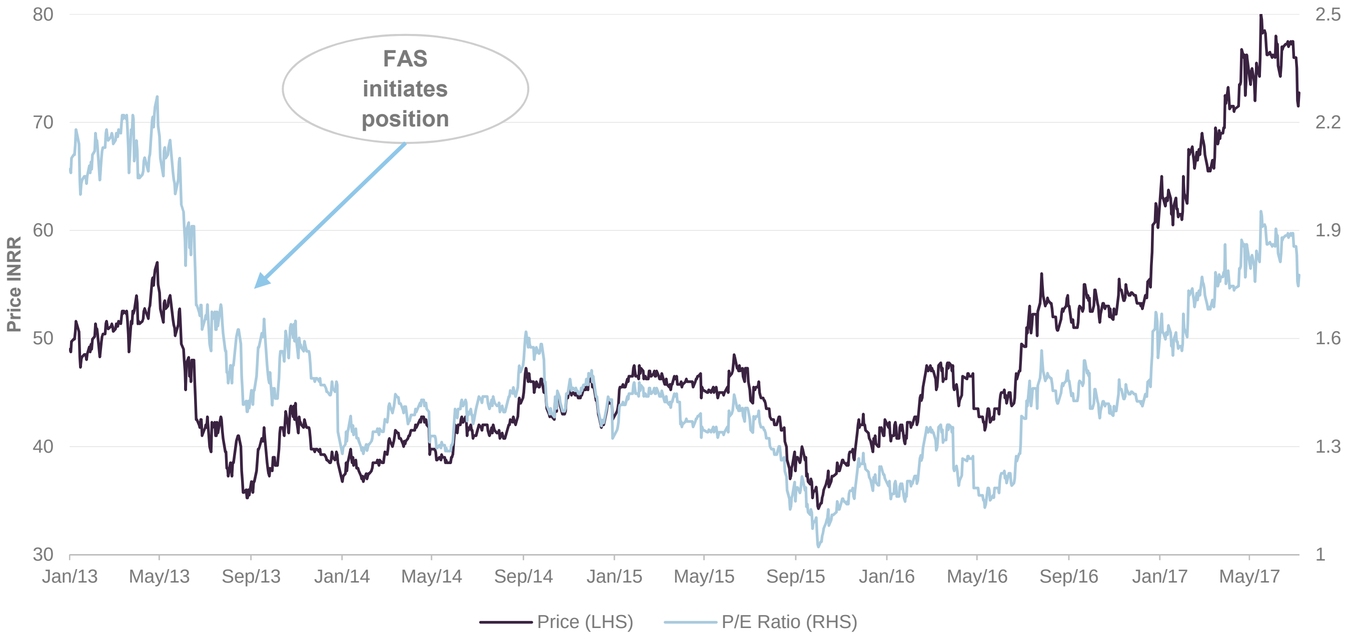
Source: Bloomberg, Marten & Co

TISCO Financial Group – a case study

TISCO Financial Group is a leading auto-finance bank in Thailand and a stock that Nitin has held since 2011 in his open-ended fund. It was already held in FAS's portfolio prior to Nitin taking control and is one of the few stocks that Nitin has continued to maintain a position in following his appointment as manager. Nitin's investment thesis can be summarised as follows:

- Nitin liked TISCO's market leading position in the auto-finance market. He felt that its corporate culture and risk management provided it with a defensible 'moat' based on its underwriting costs.
- Nitin felt that TISCO benefited from a well-capitalised balance sheet.
- Nitin saw positive trends in terms of profitability. In his view, the non-performing asset cycle had peaked and he expected ROA and ROE to improve.
- Nitin considered that TISCO was potentially an attractive acquisition target.
- Nitin viewed TISCO's valuation as attractive: a 4.0% dividend yield, 1.6x forward price to book ratio and 8.9x forward P/E ratio.

Figure 17: Power grid share price and F12m P/E



Source: Bloomberg, Marten & Co

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)

About Marten & Co.

Marten & Co. is a boutique that specialises in the provision of high quality equity investment research to a wide audience and raising the profile of listed companies to potential investors. We are authorised and regulated by the Financial Conduct Authority.

We strive to provide clear, comprehensive and enjoyable research to as wide an audience as possible, in order to give them the information they need to make informed investment decisions. Anyone can sign up to receive research at www.QuotedData.com. Professional investors can opt to receive tailored research tailored by clicking Subscribe