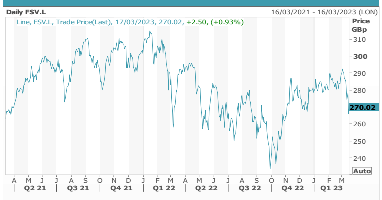
Closed-Ended Investments



Source: Refinitiv

Market data

EPIC/TKR	**FSV**
Price (p)	**269.0**
12m high (p)	315.0
12m low (p)	232.0
Shares (m)	324.1
Mkt cap (£m)	871.8
NAV (16 Mar'23, p)	287.86
Discount to NAV	-6.6%
Country of listing	UK
Currency	GBP
Market	STMM
Benchmark	FTSE All-Share

Description

Fidelity Special Values PLC (FSV) aims to achieve long-term capital growth by investing predominantly in UK equities believed by the manager to be undervalued.

Company information

Chairman	Dean Buckley
NEDs	Claire Boyle (Chair AC), Ominder Dhillon, Nigel Foster (SID), Alison McGregor
Fund managers	Alex Wright (manager) Jonathan Winton (co-manager)

investment-trusts.fidelity.co.uk/fidelity-special-values

Key shareholders (Jan'23)

Fidelity Platform	19.6%
Evelyn Partners	9.8%
Interactive Investor	7.2%
Hargreaves Lansdown	7.0%
Rathbones	6.8%
RBC Brewin Dolphin	6.6%
Investec	3.7%
AJ Bell	3.2%

Diary

Apr/May	Interim results
31 Aug	Year-end

Analyst

Brian Moretta +44 (0)203 693 7075
bm@hardmanandco.com

FIDELITY SPECIAL VALUES PLC

Making a case study for outperformance

With FSV having recently reached a decade of outperformance under fund manager Alex Wright's stewardship, we look at what has made this happen. We outline the investment process, and then provide a couple of detailed case studies to illustrate how it works in practice. The approach is essentially a contrarian one, using Fidelity's experienced team of analysts to look for unappreciated companies where there is a catalyst for change. This is underpinned by low valuations, which are used to provide downside protection, rather than being the source of outperformance that a conventional value approach might take.

- **AIB Group (Allied Irish Bank):** The Irish economy had a boom that lasted almost two decades, but blew up the banking sector in the financial crisis. We discuss how the country and banks have dealt with the legacy issues, and are still underappreciated despite a concentrated market and improving profitability.

- **Serco:** This was a "market darling" for over a decade, with strong growth. However, management controls were inadequate, and operational and accounting issues brought the share price crashing down. We talk about how the company is back on a sound footing, but still underrated.

- **Valuation:** With quoted investments, there are no valuation issues. FSV aims to keep a single-digit discount in normal market conditions. It has mostly done this, aided by an active discount management policy. The company has both bought back and sold shares, adding a small amount to investor returns.

- **Risks:** With a value-based investment philosophy, value being out of favour has constituted a headwind, although one that the manager's stock-picking has largely overcome to date. The UK market has been a long-term underperformer relative to global markets, and there is a risk that it will remain out of favour.

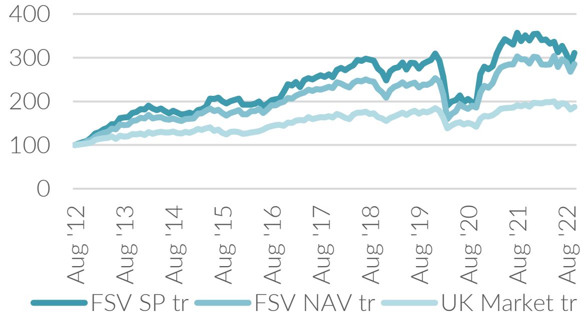
- **Investment summary:** While FSV currently trades in the middle of its discount range, this is better than that of most of its peers. Meanwhile, the stability of the team and the investment process suggest that this performance is built on solid ground. The dividend yield is higher than the average of its peers, suggesting that it should be attractive to investors looking for income alongside capital growth.

Financial summary and valuation

Year-end Aug (£000)	2020	2021	2022	2023E	2024E
Investment gains/losses	(131,085)	252,899	(64,441)	91,924	66,031
Gains/losses on CFDs	(11,820)	55,323	(14,992)	13,193	9,375
Investment income	20,282	27,890	37,135	34,336	38,758
Inv. manager fees	(5,627)	(5,098)	(5,607)	(5,290)	(5,858)
PBT	(133,330)	329,504	(43,235)	132,919	107,033
Investments	563,763	886,710	835,672	943,294	1,023,749
Cash	9,802	63,780	80,450	80,450	80,450
NAV	579,505	954,090	922,599	1,030,221	1,110,676
NAV per share (p)	199.7	304.8	284.7	317.9	342.7
Dividend (p)	5.80	6.67	7.75	8.14	8.54
Prem./disc (-) to NAV	25.8%	-13.3%	-5.8%	-18.2%*	-27.4%*
Yield	2.2%	2.5%	2.9%	3.0%	3.2%

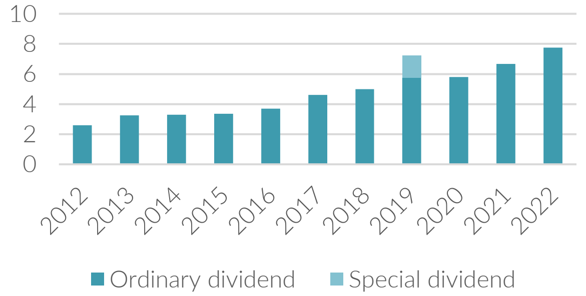
**Although our calculations generate discount figures for 2023 and 2024, the Trust has a policy that aims to keep the discount in single digits in normal market conditions, and will repurchase or issue shares to help stabilise the share price discount; Source: Hardman & Co Research*

FSV has outperformed its benchmark over the past decade (indexed to 100 at Aug’12)



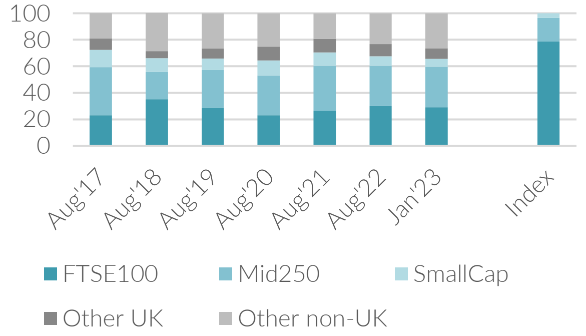
- Over the medium and long term, FSV has materially outperformed its benchmark.
- FSV has shown consistency too, outperforming in six of the ten years since the current manager was appointed.

Consistent dividend payer, with yield above the sector average



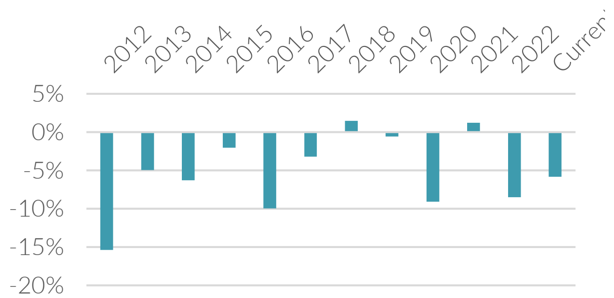
- The dividend has increased steadily over the past decade, with a special dividend in 2019, owing to higher-than-usual income.
- Although 2020 saw many companies cut or suspend dividends, FSV topped up its dividend from reserves.

FSV’s portfolio mix by index exposure (%)



- FSV invests across the market cap spectrum – in practice, it has consistently been overweight mid- and small-cap stocks.
- The company is allowed up to 20% overseas exposure, which the manager uses consistently.

Active policy has kept the discount to NAV consistently within the target range



- FSV aims for a single-digit discount in normal market conditions – the current valuation is in the middle of the range, but it is still better than that of most of its peers.
- FSV has actively both bought back and issued shares, consistently adding a small amount to returns.

Source: Company data, Hardman & Co Research

A successful investment process

Many of the discussions about UK equity funds, including those on FSV, focus on the economic environment and the relative attractions of the UK market. However, what distinguishes FSV is its investment approach.

In a recent interview, Alex Wright, who is FSV's lead fund manager, estimated that fewer than 10% of UK equity funds follow a contrarian/value approach. Since the decade following the financial crisis, "growth" has mostly outperformed "value," and, perhaps inevitably, the style of UK fund management has drifted in that direction.

However, that categorisation is somewhat simplistic. In the decade since Alex Wright took over as manager, FSV has been a consistent outperformer. Although some might characterise the management style as a value, clearly Fidelity is doing something different from the typical "value" fund.

Concepts

The difference is that the manager is using a contrarian approach, underpinned by value. The manager looks for unloved and undervalued companies where there is a catalyst for change that will alter investor perception. These catalysts can be internal, such as fixing previous self-inflicted damage, or new management, or external, such as a changing competitive environment or overdone worries about regulation or disruption.

Additionally, companies should have downside risk protection, where tangible assets or other factors underpin the current share price. So, for FSV, value gives protection but is not in itself the source of performance.

Idea generation is supported by the Fidelity Research Team. Currently, this comprises 30 European analysts, whose sector coverage includes UK companies. Typically, these actively cover 15 to 35 companies each, with updated notes and financial models for each company at least every 120 days. Some of this coverage is specified centrally, but analysts also have some freedom to seek out the best ideas in their area. Portfolio managers may also do their own research, use third parties to complement internal research, or discuss the research with colleagues in the portfolio or the senior investment team management. They can also tap into the global Fidelity network, which they found particularly useful during the pandemic.

Portfolio construction and risk management

These are managed dynamically. The weights of investments are adjusted over time, with the managers identifying three key stages for successful investments:

- **Beginning of change**: Typically, a small initial position is taken. This will be increased gradually if additional evidence for the change thesis increases the managers' conviction.
- **Market recognising change**: Once the market starts to agree with the managers' thesis, the managers will allow the position size to increase.
- **Change fully "priced in"**: Once a company's rating reflects the recovery, and other investors are buying into it, downside protection will have been removed and position sizes will be reduced.

As of January 2023, 44% of the portfolio fitted the first category, 52% was in the second category, and only 4% was in the third. Stock volatility and variable news flow can mean that this is not always a linear process, and some investments will see weights decreased, and then increased during their holding period.

Unsuccessful investments follow a different pattern: ongoing monitoring will disprove the change thesis, or the downside protection will be compromised. In the former, sales tend to be gradual, while the latter leads to a rapid sale.

There is day-to-day risk monitoring of the portfolio. Primary risk management is based on absolute risk. Some of this monitoring is straightforward maxima, such as a 6% limit for one position (less for mid- and small-cap companies). The Barra risk model is used to monitor stock-tracking error contributions, the portfolio beta and large sector positions. A Factset model is used to monitor geographical revenue exposure.

Quarterly risk management includes additional reporting to the senior team within Fidelity, monitoring of macro exposures and more detailed factor analysis of tracking error contributions. Additionally, Fidelity's processes bring the usual controls that a high-quality investment house has, such as separation of portfolio management and trading, and additional monitoring by risk and compliance.

Ultimately, position sizes are driven by manager conviction with risk overlays.

Putting it into practice

That is all fine in theory, but the proof is in its execution. Below, we select two positions from FSV's current portfolio, and give some background as to how the approach is being applied.

AIB Group (Allied Irish Bank)

It may seem strange to start with a company that isn't UK-based, but the clarity of the thinking that this demonstrates makes it an excellent example. FSV can invest up to 20% of its assets outside the UK, and it usually takes advantage of this. The analyst team has pan-European coverage, so is well-placed to discern when overseas stocks offer better value than their UK counterparts. The manager has also recently spoken about another example in the FSV portfolio, with his preference for Sanofi over Glaxo.

It is worth noting that, before managing funds, Alex Wright was an analyst who covered, *inter alia*, financial companies. An ongoing feature of his management of FSV has been its financial exposure.

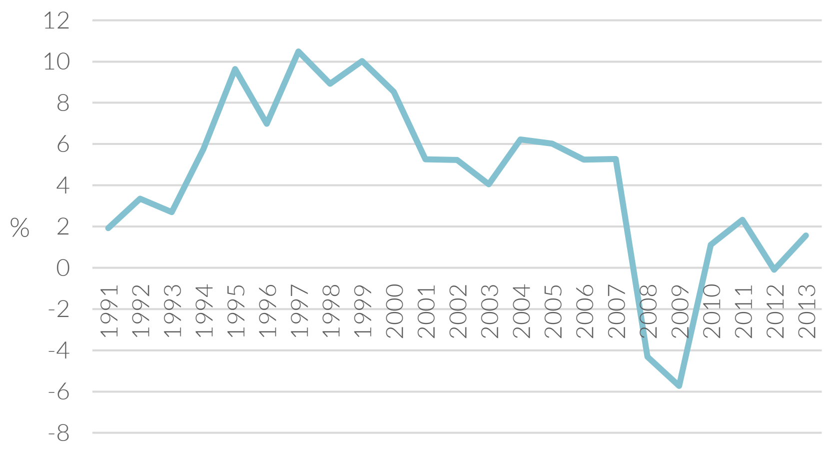
Crisis

The Irish banking market can only be understood in the context of what happened in the 2007-09 financial crisis. For the better part of two decades prior to that, the Irish economy had been booming. Inward investment had been strong, especially from US companies that saw Ireland as a country with lower language and cultural barriers than others in the EU. A lower corporate tax rate didn't hurt, either, with the government willing to cut deals to encourage investment.

As a country with a population of only 3.5m in the early 1990s, its reputation for being a source of immigrants elsewhere was reversed[1]. Some of the diaspora came home, while other immigrants were attracted by the surging economy. This led to a huge increase in demand for property, both commercial and residential. Prices shot up, and a construction boom ensued.

[1] Current population of Ireland is now 5m.

Annual Ireland GDP growth (1991-2013)



Source: OECD, Hardman & Co Research

Sadly, when the financial crisis hit, in 2007, it all came crashing down. The Irish economy was over-levered, primarily secured against property that was suddenly worth much less than before. All the Irish banks took huge losses, with the mis-managed Anglo-Irish Bank going bust in a spectacular way, and those banks that survived requiring government support to pull through.

Restructuring

In September 2008, the Irish government guaranteed the debt of the six largest banks for two years, which, fortunately, was never called on, although it did have to be renewed. In 2010, the National Asset Management Agency was created to manage out bad debts from the banks and allow them to continue trading normally. This followed methodology used in Scandinavia in the early 1990s, which had worked well.

The government required external financial support, and this led to ongoing political repercussions. Government and bank finances remained intertwined until 2013, when Ireland exited the Troika bailout. The Irish economy started to grow again, albeit the underlying situation was initially not quite as strong as some statistics suggested.[2] Nevertheless, over the next few years, it returned to a more normal situation.

Banks after the crisis

The banks required much internal restructuring. For example, Allied Irish was taken over by the government in 2010, and new management was brought in. As well as passing out many of its bad debts, it also sold its Polish and stockbroking companies. By 2013, it had started to move away from the state guarantees. In 2015, it had returned to profitability and started to repay state funding, and, in 2017, it had an IPO, although the government retained 71% ownership. It has been reducing this since 2021.

It has still not been an easy ride for the banks post the crisis. After the demise of Anglo-Irish, Ireland was left with five meaningful banks. Although this was a quasi-oligopolistic situation, the economy was merely ok rather than strong, and banks were under pressure from earlier "misbehaviour", notably on tracker mortgages.

[2] It is thought that the profits of some shell companies flattered GDP figures in 2014 and 2015.

This is the circumstance that initially attracted Fidelity's attention. As the problems are being put behind them, the Irish banks find themselves in a market that is less competitive than elsewhere. Yet, from a stock market perspective, they haven't shaken off the double reputational whammy of being a bank (still cheap everywhere) and in a country that has been struggling.

The thesis has been aided in the past year by further market changes. NatWest, which owns Ulster Bank, and KBC have both announced their withdrawal from the Irish market. So, five banks will become three. While some loan books have been sold, current and deposit accounts are being closed – so the remaining banks will get substantial new business in the next couple of years.

While interest rates have not risen as much as in the UK, they have gone up, and this will also benefit profits. Fidelity observes that many deposits by banks are multi-year – so, even if there are no further rate rises, banks will continue to benefit over the next few years as these roll off and get repriced.

All this suggests that AIB Group is moving into Fidelity's second phase of the market, recognising change, and it is now FSV's second-largest position.

Serco

Serco is a leading supplier of outsourced services to national and local governments. It too has had a crisis, which has caused it to be unloved.

Crisis

For the first decade and half of this century, Serco was flying high operationally. From a small base, it won contracts in the UK across a wide range of areas, including defence, transport (including train services), border security, work and pensions, prisons and more. It boosted these by acquisitions, and, for a long time, seemed able to do no wrong.

Serco share price (March 2010 to March 2018)

Source: Refinitiv, Hardman & Co Research

However, not everything was going well. With hindsight, it perhaps grew too quickly, and did not have the correct controls in place. Alongside G4S, it was accused of overcharging the government for services it effectively was not supplying. It was also accused of covering up sexual abuse at an immigration centre and of using immigrants as cheap labour. This led to a public outcry, the loss of contracts, some of which had to be refunded, and fines.

Perhaps owing to the additional scrutiny, although, most likely, it would have come out anyway, it transpired that Serco had some accounting issues. It effectively brought forward some profits on long-term contracts. Although it was not alone in doing this, it was perhaps the most guilty of it. This led to four profit warnings in just over a year and a share price that fell from a peak of 514p to 74p.

Restructuring

New management came in and tried to clear the decks. In 2014, the company made a loss of £991m, and it sold off "scores of divisions". As a tainted company, it was some time before politicians could award the company new contracts. Initially, it was probably debatable whether the company had the controls in place to take them on, anyway. In the meantime, numerous existing contracts expired and were not renewed.

Although the outsourcing contracts were not as profitable as first appeared, this was true for the industry as a whole, not just Serco. While the high-profile failure of Carillion in 2018 removed a large competitor, the lower margins have led to less competition in the market as a whole.

Rebirth

Getting its house in order took several years, but Serco has done so, and the business has started to grow again over the past five years. It has quietly expanded its international operations, and it now has two thirds of its revenue from abroad. Perhaps as importantly, the UK has been at the forefront of government outsourcing, and there is more growth potential overseas than domestically.

With more robust accounting in place, Fidelity has greater confidence that margins are secure, and there is the potential for continued mid- to high-single-digit growth. Notably, this should be robust in the face of any forthcoming economic downturn. The company has performed well, pretty much doubling since 2018. However, this performance merely reflects actual earnings improvement. Consequently, Fidelity sees a P/E of ca.12x being significantly lower than that of other companies with similar margin and growth profiles. Reducing that gap could lead to further outperformance.

Final comments

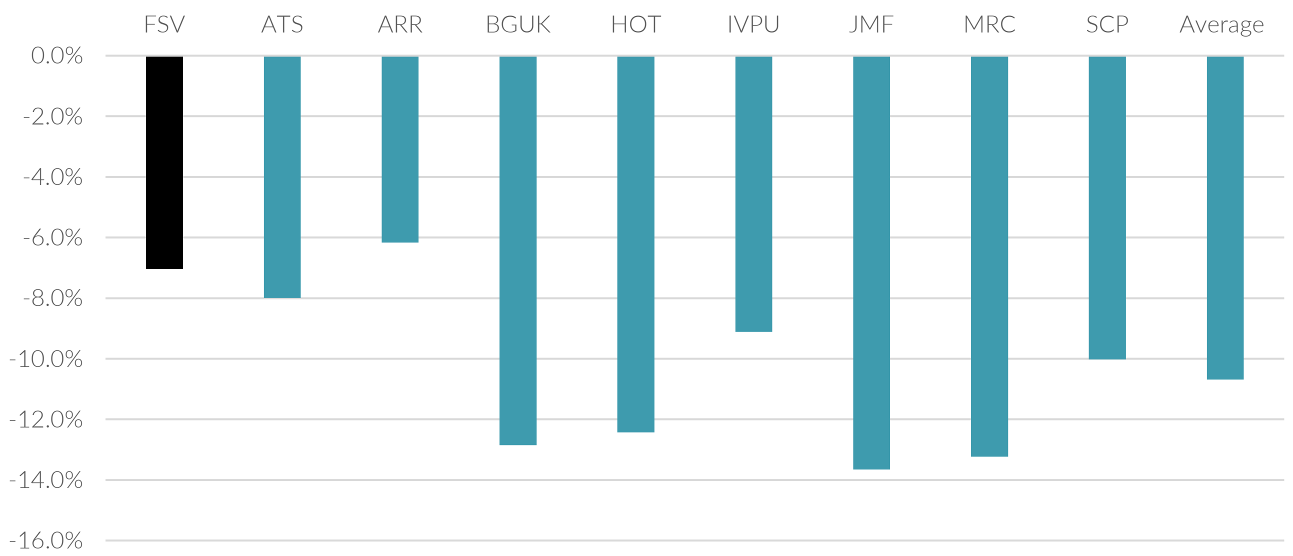
Although the causes of Serco's issues were fundamentally different from those of AIB Group, we can see the same pattern at work. A company has a crisis, and the brand name is tainted. New management comes in, and, over a period of time, sorts out the issues and turns around the business. Yet memories are sometimes long, and the market doesn't recognise, or perhaps believe, that the companies are ok now, and that there is nothing bubbling away under the surface.

Both of these studies also illustrate Fidelity's depth of research, and its ability to spot changes early and before the market appreciates them. This is something we often see as we look at FSV's portfolio. Applying this process consistently has led to a decade of outperformance, and we believe it is well-placed to maintain this going forward.

Valuation

As can be seen in the chart below, FSV's discount to NAV is significantly better than that of most of its peers in the AIC UK All Companies subsector. We note that discounts have widened across the sector in the past year.

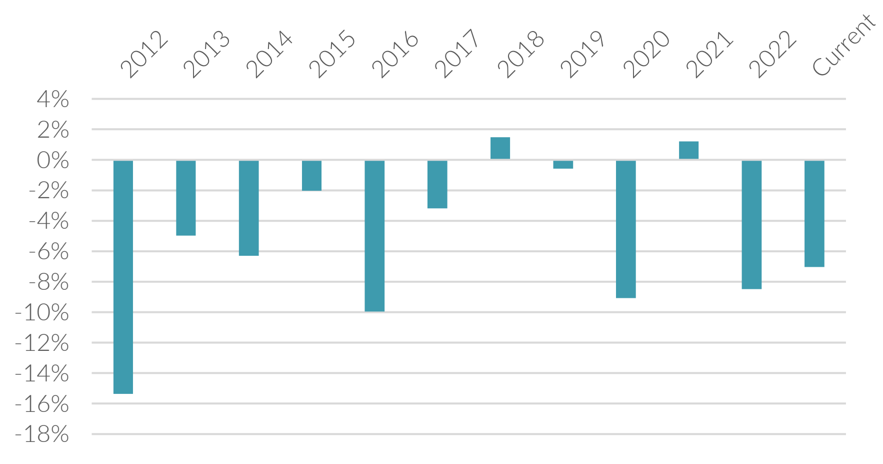
Other UK investment companies' discounts/premiums to NAV (%) in AIC UK All Companies subsector



Source: LSE, priced on 15 March 2023, Hardman & Co Research

As can be seen in the chart below, since the 2016 results, FSV has generally traded at a much narrower discount to NAV. This discount has been somewhat wider in the past few months than in the preceding couple of years.

FSV – historical discount to NAV (at end-Aug) and latest



Source: FSV Report and Accounts, NAV announcement, dated 16 March 2023, LSE, Hardman & Co Research

Financials

We have introduced 2024 forecasts. For 2023 and 2024, we have assumed an 8% annual return.

Income statement (£000)

Year-end Aug	2022			2023E			2024E		
	Revenue	Capital	Total	Revenue	Capital	Total	Revenue	Capital	Total
Gains/losses on investments		(64,441)	(64,441)		91,924	91,924		66,031	66,031
Gains/losses on long CFDs		(14,992)	(14,992)		13,193	13,193		9,375	9,375
Investment income	37,135		37,135	34,336		34,336	38,758		38,758
Other interest	877		877	973		973	1,042		1,042
Derivative expenses	0		0	0		0	0		0
Investment manager fees	(5,607)		(5,607)	(5,290)		(5,290)	(5,858)		(5,858)
Other expenses	(838)		(838)	(838)		(838)	(838)		(838)
Foreign exchange gains/losses		5,874	5,874		0	0		0	0
Profit/(loss) before fin. costs & taxation	31,567	(73,559)	(41,992)	29,182	105,117	134,299	33,104	75,406	108,509
Finance costs	(1,243)		(1,243)	(1,380)		(1,380)	(1,476)		(1,476)
Profit/(loss) before taxation	**30,324**	**(73,559)**	**(43,235)**	**27,802**	**105,117**	**132,919**	**31,627**	**75,406**	**107,033**
Taxation	(196)		(196)	(180)		(180)	(204)		(204)
Profit/(loss) after taxation for the year	30,128	(73,559)	(43,431)	27,622	105,117	132,739	31,423	75,406	106,829
Earnings/(loss) per ordinary share (p)	9.42	(23.00)	(13.58)	8.52	32.43	40.96	9.70	23.27	32.96

Source: FSV Report and Accounts, Hardman & Co Research

Balance sheet

@ 31 Aug (£000)	2018	2019	2020	2021	2022	2023E	2024E
Investments	704,997	635,539	563,763	886,710	835,672	943,294	1,023,749
Current assets							
Derivative instruments	4,939	3,028	7,619	1,968	28	28	28
Other receivables	4,043	11,685	3,921	6,674	10,940	10,940	10,940
Amounts held at futures clearing houses & brokers	2,235	18,002	860	40	8,190	8,190	8,190
Fidelity Institutional Liquidity Funds	14,588	46,881					
Cash and cash equivalents	2,303	2,207	9,802	63,780	80,450	80,450	80,450
Total current assets	28,108	81,803	22,202	72,462	99,608	99,608	99,608
Total assets	733,105	717,342	585,965	959,172	935,280	1,042,902	1,123,357
Current liabilities							
Derivative instruments	(5,371)	(17,879)	(1,946)	(3,161)	(9,200)	(9,200)	(9,200)
Other payables	(2,764)	(795)	(4,514)	(1,921)	(3,481)	(3,481)	(3,481)
Total current liabilities	(8,135)	(18,674)	(6,460)	(5,082)	(12,681)	(12,681)	(12,681)
Net current assets	724,970	698,668	579,505	954,090	922,599	1,030,221	1,110,676
NAV	**724,970**	**698,668**	**579,505**	**954,090**	**922,599**	**1,030,221**	**1,110,676**
Number of shares (m)	266.5	276.2	290.2	313.0	324.1	324.1	324.1
NAV per share (£)	**2.72**	**2.53**	**2.00**	**3.05**	**2.85**	**3.18**	**3.43**

Source: FSV Report and Accounts, Hardman & Co Research

Disclaimer

Status of Hardman & Co's research under MiFID II

Some professional investors, who are subject to the new MiFID II rules from 3rd January 2018, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'

The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2031-EN-F1-1.PDF

In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.

research@hardmanandco.com

1 Frederick's Place
London
EC2R 8AE

+44(0)203 693 7075

www.hardmanandco.com