Fidelity Special Values

FSV's contrarian approach should help capture the cheap valuations on offer from the UK market...

Update
31 August 2023

Overview

Manager Alex Wright takes a contrarian, bottom-up approach when building a portfolio for Fidelity Special Values (FSV). He looks for companies that are currently out of favour and which have been overlooked by other investors, but Alex, along with co-manager Jonathan Winton and aided by the support of the Fidelity analyst team, believes he can identify those with the potential to change their fortunes and perform a turnaround. The flexibility of the mandate means the trust tends to have a small and mid-cap (SMID) bias when compared to its benchmark (see **Portfolio**).

The focus on stock selection from the bottom up means that this should be the primary driver of performance over the long term. However, the manager's contrarian approach means that the trust typically has a value bias, which has had an impact on relative **Performance**, as has the bias towards SMIDs. FSV has however been one of the top performers compared to its peer group over many time periods though, boosted by strong near-term returns.

Despite this good recent performance, Alex is relatively cautious about the near-term given the macroeconomic uncertainties, and questions the resilience of earnings in certain industries should there be a recession. This is reflected in the trust's below-average Gearing. Nonetheless, he believes that UK-based companies are particularly cheap as a result of negative sentiment, something that has also been reflected in the trust's wide **Discount** versus its own history.

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Analyst's View

We believe FSV's contrarian approach is one of its standout features (see **Portfolio**), as it provides investors with a portfolio with very different exposure to what is available within a tracker, or elsewhere in the AIC UK All Companies sector. Not only this, but the manager's flexibility allows him to identify opportunities within smaller companies that passive investors would miss out on. This approach has helped the trust become one of the top performers in the sector across a number of time periods. The market rotation to value over the past 18 months has been a recent tailwind, but we believe that the manager's stock selection prowess over multiple periods is another key asset of the trust (see **Performance**).

Despite this, the trust is currently trading at a **Discount** that is towards the wider end of the range in the manager's tenure, and over one standard deviation wider that the trust's five-year history. We believe this reflects wider concern over UK companies, rather than the performance and potential of the trust, and could be seen as an opportunity for long-term investors. We understand that the small and mid-cap bias of the trust has been a headwind in the past year, but that current valuations are more than reflecting the negative headlines. Alex has positioned the trust to companies which can show resilience in earnings despite the weakness, and our proprietary KTI Spider Chart (see **Performance**) has demonstrated that FSV has historically had strong downside protection. As a result, we believe not only that FSV could offer some protection to investors in a challenging market, but also that the trust is well-placed to capture the low valuations on offer in the event of a UK recovery.

BULL
Contrarian approach means a differentiated portfolio to peers and benchmark
Performance driven largely by stock selection
Trust is trading at a wide discount relative to its own history

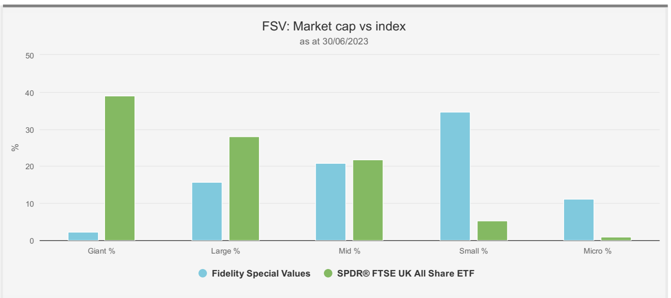
BEAR
Value bias may become a headwind in a low interest rate environment
Small and mid-cap bias could increase economic sensitivity of the portfolio
Non-exclusionary approach may not suit investors for whom ESG is a prominent consideration

Portfolio

Manager Alex Wright takes a contrarian approach when building the portfolio for Fidelity Special Values (FSV). He looks for companies that are currently out of favour and which have been overlooked by other investors, but Alex, along with co-manager Jonathan Winton and the support of the Fidelity analyst team, believes he can identify those with the potential to change their fortunes and perform a turnaround. As a result, the manager has a strong focus on stock selection as a driver of **Performance**.

Alex can invest across the market-cap spectrum, which leads to a bias to small and medium-sized companies compared to the trust's benchmark, the FTSE All-Share Index, as lower levels of analyst coverage in this part of the market means he is better placed to identify overlooked opportunities. The manager is conscious of the liquidity risk in this end of the market, especially with total assets of the trust at c. £1bn and therefore remains cognisant of position sizes in the smaller holdings, with sub 1% positions not uncommon. The smallest of these companies currently is about £100m in size, with around ten holdings in total under a £200m market cap. At the other end of the spectrum, Alex has held between 25% and 40% of the portfolio in the largest companies in the index, which can be held in position sizes of up to between 5% and 6%.

Fig.1: Market Cap Breakdown



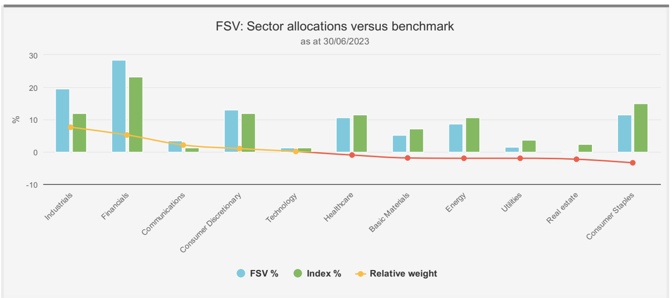
Source: Morningstar

Stock ideas can come from a number of sources, including the well-resourced Fidelity research team (see **Management**), meetings with companies and some quant screening. The team will go through a rigorous analysis process which will look to identify the downside potential of an investment case, including from earnings, financial (i.e. debt), and valuation risks. Beyond this, the managers will want to develop a thesis of how a company can turn around its fortunes. This entails a lot of meetings with company management, as well as competitors, customers, suppliers and industry experts. Alex is a contrarian investor, so the companies which he focusses on are often going through a challenging period, but in his view are capable of turning this around. He will look to identify catalysts for improvement through internal changes, such as a new management team or corporate activity, or from external factors, such as an improving competitive environment. The outcomes of this will help Alex build a thesis in a company and understand the potential upside or downside. His level of conviction in the opportunity, along with other factors, such as liquidity and the correlation to other portfolio holdings, will help him determine what position size to take.

This analysis doesn't stop at the point of investment, though. Due diligence is an ongoing process and leads to Alex taking a gradual approach to buying and selling companies. He is typically early into companies, as identifying the bottom is inherently difficult. Instead, he wants to be adding as a stock falls, building his confidence in the company and investment case, and be well positioned to take advantage of a recovery. Similarly, he will look to take profits from a trade as the investment thesis begins to come to fruition. This can lead to higher turnover than some peers with buy and hold strategies, though annual turnover will typically range from between 30% and 80%.

Alex typically breaks down the trust's exposure into four areas: financials, resources, other GDP-sensitive and defensive. All stocks are selected with a bottom-up approach, though Alex tends to find that companies in the same area become attractive or unattractive at similar times, as external factors affect their investment cases.

Fig.2: Sector Allocations



Source: Fidelity

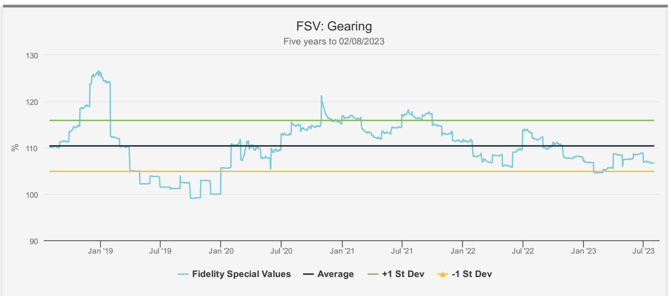
From late 2021 and into 2022, Alex began trading out of defensive companies as he felt that valuations were too high, as investors had sought them out as safe havens when both inflation and interest rates began climbing. However, higher interest rates are good for financial firms and this led to an increase in exposure in 2022, especially to banks. Whilst Alex has been overweight in this sector for a sustained period, the financials sector is now the largest absolute weight in the portfolio. Conversely, Alex has typically been underweight resources, particularly due to low allocations to mining. He believes that the commodities which featured heavily in the UK-listed mining companies, such as iron ore, are highly priced and therefore he has chosen to avoid them. He has traded in and out of oil and gas companies, but having done well in the past 18 months, he trimmed his large-cap holdings at the end of 2022. However, the trust continues to have exposure to more attractively valued smaller and medium-sized energy companies. Despite this, he is underweight both the materials and energy sectors.

One area where Alex has been finding a number of ideas is in support services, such as outsourcing companies. This has been an unloved part of the market because of poor operational performance, but Alex has been encouraged by changes at both a company and sector level. The sector boomed in between the 1990s and early 2000s, but when key customers, such as governments, cut spending, the sector retreated. Since then, there has been a reduction in competition and some changes in management teams, which has led to an improved operational performance and better financial positions. A number of these firms have also benefitted from an increase in work from the defence sector as a result of the Russian invasion of Ukraine. Alex holds positions in Serco and Mitie, both of which are top ten positions. These have been good contributors to performance, though as with his contrarian approach, Alex is now taking some profits following good runs.

Gearing

The manager has full discretion as to what level of gearing he wishes to utilise and will vary it depending on the number of opportunities he identifies, as well as the level of broader valuations in context with his market outlook. The board has set a gearing limit of 25% of net assets, although the trust's policy sets a maximum level of 30% to account for market movements. Rather than a traditional borrowing facility, any additional exposure is taken through derivatives, such as contracts for difference (CFDs). These are financial instruments that allow the manager to take more exposure than the amount invested, hence acting as gearing without the traditional borrowing facilities.

Fig.3: Gearing



Source: Morningstar

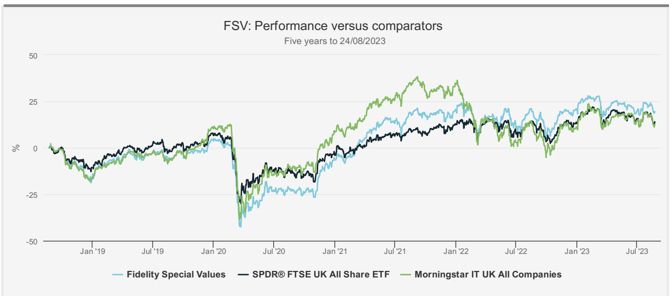
The current net level of gearing on the trust is 5%, as at 31/07/2023. This is below the five-year average of 10.4% and reflects Alex's more cautious stance as a result of macro and geopolitical concerns. Whilst he believes the UK stock market is cheap, as we have discussed in the **Performance section**, there remain concerns over company fundamentals, and therefore Alex has kept gearing towards the lower end of the range in order to mitigate these risks.

Performance

The manager's bottom-up contrarian approach means that FSV's performance should be driven by stock selection. Recent evidence to support this can be seen by analysing Alex's success in the banking sector. Three of the top ten performers over the year to 30/06/2023 have been banks, including top performers AIB Group, TBC Bank and Bank of Georgia. The sector has been a beneficiary of rising interest rates, but has struggled with volatility caused by the bank collapses in February and March 2023. Despite this, Alex's banking exposure has returned 30% over the 12 months to 30/06/2023, whereas the banking exposure in the benchmark, the FTSE All-Share Index, has returned just 17.4%. This has produced considerable alpha for the trust, as has the overweight allocation to the sector.

Whilst stock selection should be the primary contributor, the manager's contrarian stock picking approach means the trust will have a value bias versus the benchmark, which has impacted relative performance. This can be seen in the five-year performance chart below. FSV was underperforming the benchmark, for which we have used an ETF as a proxy, in the first part of this period, but starting outperforming in 2020 when the market rotated from preferring growth to value stocks. Similarly, the manager's bias to small and medium-sized companies (SMID) will have an impact on performance. SMIDs typically do well in rising markets and struggle in periods of recession, something we discussed in a **recent article**. This would have had an impact recently, though the stock selection and style headwinds have partially offset this. FSV's peer group, the AIC UK All Companies sector also has, on average, a SMID bias, which means this is less of a factor of performance versus peers. However, Alex's contrarian approach has helped the trust stand out over a five-year period.

Fig.4: Five-Year Performance



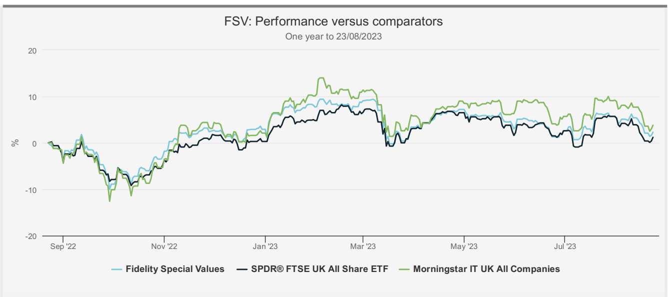
Source: Morningstar

Past performance is not a reliable indicator of future results.

More recently, the allocation to support services companies (see **Portfolio**) has been beneficial for performance. Mitie has been the second biggest contributor to relative performance in the six months to 30/06/2023. The resurgence in travel demand has also been supportive for the trust. PhotoMe was another beneficiary in the period, though Ryanair was the top contributor. Alex purchased the latter of these during the pandemic, believing the low cost base would enable the company to achieve the same level of operation post-pandemic, but with better margins than peers, which has proved accurate and contributed to positive alpha for the trust.

The areas of weakness for the trust are its bias to smaller companies, as well as a number of stock-specific disappointments. Of those, the most impactful has been C&C Group, which provide drinks distribution for licensed premises. The stock was added to in the weakness brought about by the Covid pandemic, but recently, the implementation of a new piece of software has held the company back, as well as concerns over the impact of train strikes and a cost-of-living squeeze. Ithaca Energy has been another disappointment. The company has benefitted from a strong oil price, but the share price has not reacted as expected, as investors have favoured more liquid mega-cap names, such as BP and Shell. Ithaca, and a number of other smaller companies in the space, have also had bigger-than-expected impacts from a windfall tax which has impacted returns. Alex notes that these companies are trading at large valuation discounts to the mega-caps, though, and continues to hold them. These factors have led to slight outperformance of the benchmark over a one-year period.

Fig.5: One-Year Performance



Source: Morningstar

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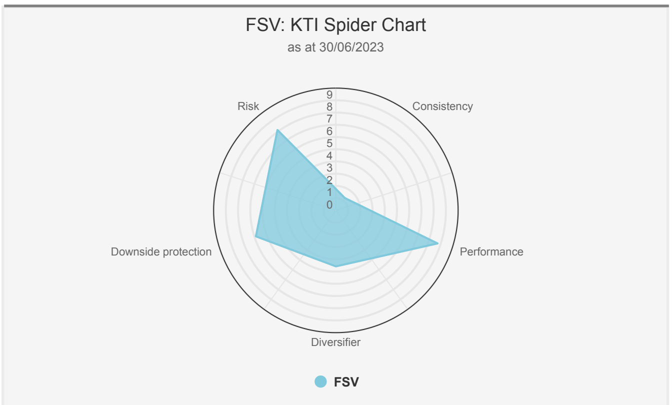
There has been considerable M&A activity in the portfolio over the past couple of years. 2021 was particularly strong, with activity occurring in some big portfolio holdings. More recently, the portfolio has continued to benefit from takeovers, though these have been primarily from smaller positions and therefore they have not had as big an impact as previously. One of the reasons for the M&A activity, though, is low valuations. Alex has pointed to an aggregate forward P/E figure of 7.5x earnings, as at 14/07/2023, which is not only a meaningful discount to the benchmark's 10.7x, but also compared to its own history. While it is not uncommon for the portfolio to be relatively cheap, Alex believes it is surprising it remains so after a period of strong performance.

As a result, Alex believes that valuations are extremely low. The UK market itself is cheap and the average of the portfolio is meaningfully lower. We understand that this is the lowest absolute level in the time Alex has been running the trust. However, some of this is justified by difficult fundamentals. The potential risk of a recession to corporate earnings, in particular the impact on cyclical areas such as chemicals and retail, is a concern for Alex and goes some way to justifying the low valuations. Alex, though, is avoiding areas such as these, and instead is focussing on areas where he believes the market is overlooking the robustness of earnings potential, such as banks. Regardless, a recession is likely to be a global issue that would not just affect the UK, and yet valuations globally have held up better. Whilst he admits there is uncertainty, investors are being compensated for it in the UK.

Our proprietary KTI Spider Chart is shown below. This shows how FSV has performed versus a wider peer group of eight 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. The trust scores very highly for both performance and risk. We believe the former of these is self-explanatory, considering the strong returns over the past five years. The strong risk score has been supported by low volatility of returns, which has then provided good risk-adjusted performance. This theme continues into the downside protection score, which is also significantly above average. We believe the contrarian approach has helped here, as a lot of the bad news of a company is already priced in when Alex starts

Fig.6: KTI Spider Chart



Source: Morningstar

Past performance is not a reliable indicator of future results.

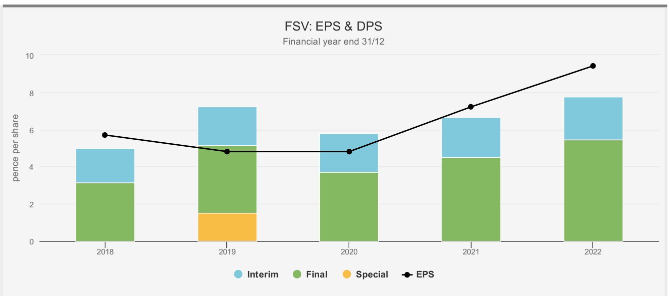
buying shares, meaning that potentially they are unlikely to fall much further. The trust scores around average as a diversifier, though within this, it achieves a high score for its low correlation to bond indices, which we would expect from this contrarian approach. However, it does score considerably below average for consistency, which we would again attribute to having a contrarian approach and, therefore, a different portfolio to that of the peer group.

Dividend

When the manager considers potential investments, he does so with a total return mindset, looking over a two-year period. As such, Alex will look at both a stock's dividend prospects and the capital growth potential as part of the investment case. Therefore, a modest dividend has historically been a feature of the trust, though we would caution this is an outcome of the investment approach, rather than a target. The policy is for the board to pay out dividends semi-annually, but also, when possible, to hold some back as reserves. This will allow the board to keep a smooth dividend for the future, though it will pay out special dividends if these are generated by the underlying portfolio. However, they are not targetted by Alex. The trust last paid a special dividend in the financial year ending 31/08/2019. The following year's revenue struggled due to the impact of the pandemic, but the ordinary dividend was maintained thanks to the revenue reserves, meaning that total dividends (ex-specials) have either grown or been stable for at least five years. The portfolio's revenue has subsequently recovered, meaning the dividend has now been fully covered for the past two financial years. Revenue reserves currently stand at £30.5m, which equates to over one-and-a-half years' worth of cover, based on the most recent dividend amount.

The amount paid last year was 7.75 pence per share, which equates to a yield of 2.9%, based on the share price at the time of writing. However, the interim dividend, which was paid in June 2023, was a 10% increase on the equivalent amount paid in the previous financial year. While positive, this is no guarantee of a full-year increase. As such, we believe that the dividend should be seen as an attractive element of the investment case for FSV, though not a central feature.

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 became co-manager in February 2020.

Alex and Jonathan have access to Fidelity' global equity research team, consisting of 178 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 246 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

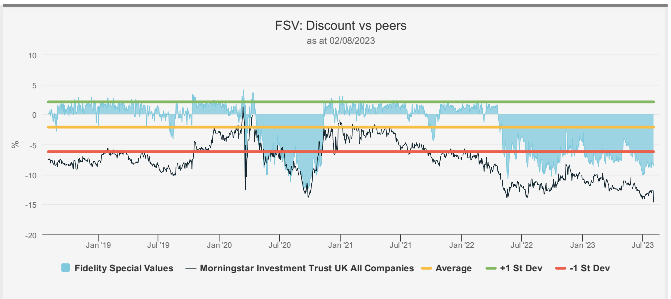
In Alex's tenure, FSV's shares have ranged from a small premium of c. 2% to NAV to a discount of c. 10%. The current level is a discount of 8.4%, which is nearer the bottom end of this range. The discount has widened notably since April 2022, when the trust had been trading at a premium, and has remained there since. In fact, the current level is over one standard deviation wider than the five-year average discount of 2.2%. The AIC UK All Companies sector average has widened too, although FSV has often traded at a premium rating to the peer group.

The shares have also traded at a premium for large parts of the past five years, including when the contrarian investment style was out of favour. The last time the discount was this wide was in the depths of the pandemic, which was particularly challenging for Alex's investment style. However, the period in which the discount has widened recently has actually seen a tailwind from the investment style and, as such, we believe the current discount level is not a true reflection of the trust's performance, nor the investing backdrop.

Instead, we believe UK equities being particularly out of favour at the moment, as we have discussed in **Performance**, may be contributing to the wide discount. However, we believe that if this negativity reverses, it could become a catalyst for the narrowing of the discount of both the wider sector and FSV.

The board has stated it wishes to keep the discount within a maximum limit of 10% under normal market conditions and will buy back shares to help with this. Similarly, it has issued shares in the past in order to manage the premium on the trust, although neither of these tools have been exercised in the most recent full financial year, nor the interim period.

Fig.8: Discount



Source: Morningstar

Charges

FSV has a straightforward management fee of 0.6% of net assets. There is no performance fee.

According to figures by JPMorgan Cazenove, as of 04/08/2023, the trust has an OCF of 0.69%, which compares to a simple average across the eight-strong AIC UK All Companies sector of 0.76%. This makes FSV one of the lowest cost trusts against its peers. It is the second largest trust in the sector, which we believe demonstrates the use of economies of scale to benefit shareholders.

The latest KID RIY is 0.96%, which compares to a simple average of the sector of 1.16%, although we would caution that valuation methodologies do 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 of the factors 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 who 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. As a result, as ESG is not a primary focus for the managers, we believe FSV may not suit investors for whom it is an essential element of their investment decision.

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