Fidelity Special Values

FSV gives exposure to UK equities underestimated by the market...

Kepler INCOME & GROWTH RATING

Update
30 October 2024

Overview

Alex Wright, the manager of Fidelity Special Values (FSV), which celebrates its 30th anniversary this year, takes a contrarian investment approach, focusing on finding overlooked and undervalued opportunities across the whole UK market-cap spectrum. This approach drives Alex to seek investment opportunities in areas of the market that are often ignored by his peers (see **Portfolio**).

Alex's contrarian approach has proven effective over both the long term and more recent periods, with FSV outperforming its benchmark over numerous timeframes. For instance, the trust has outpaced the FTSE All-Share Index over one and five years, and has delivered c. 1.5x the annual returns of the index since Alex's appointment in September 2012 and c. 1.7x since the trust's launch in November 1994. Notably, FSV has also been the best performing investment trust in the AIC UK All Companies sector over the past five years (see **Performance**).

Despite the strong performance in both the short and long term, the shares of FSV continue to trade at a c. 9% **Discount**, which is wider than the five-year average of 4.2%. FSV has historically traded at a premium rating to the sector average, though this has notably narrowed over the past c. 18 months.

Whilst the past 12 months have been a strong period for UK equities, they remain at lower valuations than their international counterparts. Alex believes they remain attractive in the current uncertain macroeconomic environment leading to a **Gearing** level of c. 8%, slightly below the five-year average.

FSV primarily focuses on capital growth, but still pays a **Dividend** with a historic yield of c. 2.8%. It also has a 14-year track record of dividend growth, while the dividend has grown c. 19% annually between 2014 and 2023.

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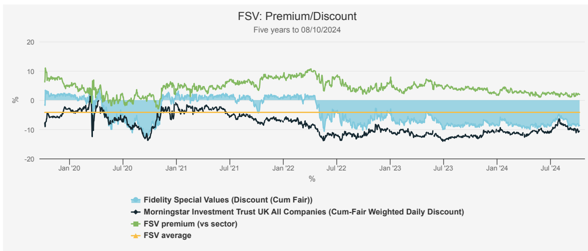
Key Information:

Price (p)	314
Discount/Premium(%)	-9.3
OCF (%)	0.70
Gearing (%)	8
Yield (%)	2.8
Ticker	FSV
Market cap (£)	1,017,670,609



Kepler View

In our view, FSV's consistent outperformance of the FTSE All-Share Index both over the long and short term is testament to the effectiveness of Alex's strategy across various market environments. We think that Alex's contrarian strategy is an attractive feature of FSV, as the trust typically provides exposure to areas of the UK equity market that many of its peers overlook, given their frequent preference for growth stocks. Alex's value-biased approach results in a differentiated performance profile and the lack of competing investors in that space creates opportunities for Alex to generate alpha.

Despite some recent strong performance, Alex believes UK equity valuations remain attractively valued versus their international peers. In our view, continuing takeover bids may indicate that some market participants consider a large part of the UK equity market to be undervalued, and these activities may serve as a catalyst to correct their undervaluation. As such, we consider FSV to be a compelling choice for investors looking to capitalise on these opportunities given its focus on attractively valued companies with improving fundamentals.

Additionally, we think the trust's multi-cap exposure is another appealing characteristic of the trust, as it allows Alex to identify overlooked and undervalued opportunities across the entire market-cap spectrum. Small and mid-caps (SMIDs) typically receive less analyst coverage than large caps, which we believe creates a fertile ground for discovering mispriced opportunities. However, we caution that SMIDs tend to be more volatile than large caps.

Finally, FSV is trading at a wide discount, presenting an additional opportunity for potential gains. We believe that a combination of strong performance from both FSV and UK equities, along with renewed investors' interest in the asset class could lead FSV's discount to close over time.

BULL
Strong long-term and recent outperformance of the FTSE All-Share Index
Contrarian approach leads to exposure to areas of the UK equity market often ignored by peers
Typically a beneficiary from M&A activity given focus on attractive valuations

BEAR
May lag peers and benchmark in a growth rally
Exposure to SMIDs adds risk
UK equities remain an unloved asset class

Portfolio

Fidelity Special Values (FSV) is managed by Alex Wright, a contrarian investor seeking to identify companies overlooked and undervalued by the market, but with potential catalysts for a positive re-rating. Although Alex's approach draws him to value stocks, as they tend to reflect the characteristics he looks for, he also finds opportunities in sectors not typically associated with value investing. This strategy leads FSV to diverge significantly from the FTSE All-Share Index, the trust's benchmark, with active money above 80% as of 09/10/2024. FSV typically holds 80 to 120 positions, with a bias to small and mid-caps (SMIDs), which we would argue, increases the opportunity to add alpha, although it is likely to increase volatility.

Downside analysis is a key element of the investment strategy. It includes assessing earnings risk, which allows Alex to evaluate a company's potential earnings volatility and its key drivers, crucial for identifying potential turnaround stories. Alex also considers financial risk and avoids highly leveraged stocks, which should help ensure that FSV is not exposed to high-risk situations. Finally, valuation risk is another important component of downside analysis. Alex aims to understand how a company's valuation compares both to its peers and its own history. We believe this approach can help Alex identify arbitrage opportunities where a company may trade at a cheaper valuation than its competitors for unjustified reasons. This results in a portfolio that is cheaper compared to the FTSE All-Share Index, both on a P/E and P/B basis, with lower leverage and stronger growth and return metrics, as shown in the table below.

Because Alex's strategy focuses on undervalued equities, he does not buy stocks with the intention of holding them forever; he will sell a holding once the investment thesis matures and is reflected in the share price. As a result, annual turnover can fluctuate depending on individual holdings and market conditions. We understand that while it can range from 30% to 80%, in recent years it has been at the lower end of this range, which is roughly equivalent to an average holding period of three years. Sales can be gradual to capture recovery momentum or rapid if fundamentals deteriorate. While Alex's approach may incur an opportunity cost if a stock continues to perform well after the sale, we believe it provides the safety of locking in profits and protects against potential downturns. If the investment thesis proves invalidated, Alex will sell rapidly if downside protection is compromised, or more gradually if downside protection remains intact but his thesis has changed. We think this approach sets FSV apart from many of its AIC UK All Companies sector peers, which tend to invest in quality growth stocks and follow a 'buy and hold' philosophy.

As discussed under **Performance**, FSV's approach has delivered strong absolute performance both over the long term and in recent periods. Since Q4 2023, UK equities have experienced a recovery, leading valuations to rise somewhat, although they remain cheaper than their international peers, as shown in the table below. Given the elevated level of global risks, including a fragile economy and heightened geopolitical tensions, Alex believes that undervalued UK equities offer better compensation for these risks compared to their more expensive international peers.

FSV Portfolio Vs Benchmark Ratios

	FSV			FTSE ALL-SHARE INDEX		
	2024	2025	2026	2024	2025	2026
Valuation						
P/E underlying	10.3	9.1	8.0	12.1	11.9	11.4
Price/Book	1.3	1.3	1.2	1.7	1.7	1.6
Leverage						
Net debt/EBITDA	0.6	0.5	0.4	1.3	1.2	1.1
Growth						
Sales growth (%)	2.9	3.8	5.0	2.7	-1.4	2.4
Operating profit growth (%)	15.3	9.1	6.6	3.0	-2.2	2.3
Returns						
ROE (%)	13.5	14.5	15.4	15.4	14.6	14.1
ROIC (%)	11.2	12.2	13.2	12.1	11.7	11.6

Source: Fidelity, as at 27/09/2024

Estimated P/E

	2024 P/E	2025 P/E	2026 P/E
UK	12.6	11.6	10.7
US	24.2	21.1	18.7
Europe ex-UK	15.5	14.1	12.8
Japan	15.6	14.4	13.2
Asia-Pacific ex-Japan	15.4	13.7	12.3

Source: Fidelity, Citi Research, Worldscope, MSCI, as of 27/09/2024

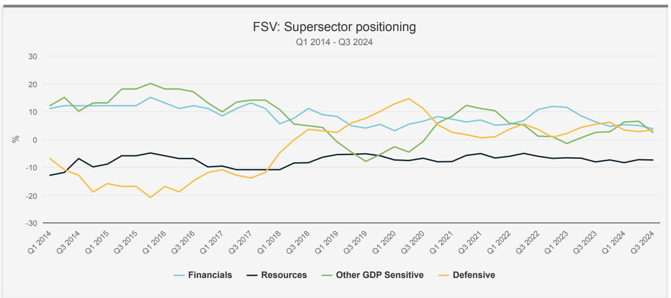
We would argue that the lower valuations of UK equities, particularly those held in FSV's portfolio, is reflected in the intensity of M&A activity observed over the past few years. Since 2022, Alex has seen several of his holdings receiving takeover offers, including seven between January and July 2024 alone. While Alex does not invest in a stock with the expectation that it will become a target of a takeover, we believe it provides another avenue for FSV to generate alpha, one that is less of a feature for its AIC UK All Companies sector peers, who focus more on quality growth stocks that tend to trade on higher valuations, more in line with their international peers.

As discussed in a **previous note**, Alex divides his portfolio into four 'supersectors': financials, defensive, resources and other GDP sensitive. The financials supersector, which has included many contributors to performance in recent years amid higher interest rates, has come down since Q1 2023 but remains the largest overweight relative to the FTSE All-Share Index as at October 2024. Alex still sees a lot of value in this supersector, especially among banks and insurers that he believes the market underestimates. This conviction is reflected in current overweight positions such as AIB Group (bank) and Aviva (insurance, including life insurance) and top ten holdings NatWest (bank) and Standard Chartered (bank).

Similarly, the allocation to the defensive supersector has decreased in recent quarters, although Alex has recently introduced Tesco, a consumer defensive stock, into the portfolio. However, with wages now growing faster than inflation, giving UK consumers more disposable income, Alex believes the outlook should be better for the retail company, noting that Tesco Finest is the fastest growing segment of the business. He has also recently topped up existing holdings falling into this supersector such as GSK (healthcare), National Grid (utilities) and Reckitt Benckiser (consumer defensive).

The 'other GDP sensitive' supersector is another area that offers very attractive valuations due to prevailing short-term negativity. An example of this includes names exposed to the UK housing market, which is an area that has suffered from higher interest rates. However, with UK inflation decreasing, and the Bank of England lowering interest rates as a result, along with positive trends emerging in housing transactions and house prices, Alex has increased the portfolio's exposure to this part of the market. For example, he has introduced housebuilder Crest Nicholson into the portfolio and added to his holding in plastic piping systems manufacturer Genuit. As UK inflation recently fell below 2%, opening the path for further rate cuts for the Bank of England, we believe the real estate sector – a particularly rate-sensitive sector – could experience a recovery. Moreover, we believe that the UK government's plan to build 1.5 million houses over the next five years could provide the real estate sector with a structural tailwind.

Fig.1: Supersector Positioning



Source: Fidelity International

Falling inflation tends to have the opposite effect on the resources supersector, as it often leads to reduced demand for commodities. As such, we believe that FSV's underweight (relative to the FTSE All-Share Index) in the resources supersector – a long-standing feature of the trust – should be beneficial at this juncture, although it has been a detractor to relative performance in recent years. As discussed in a **previous note**, Alex believes that commodity prices are too high and currently does not hold any of the UK mining giants or BP, while Shell is a large underweight position relative to the FTSE All-Share Index. In recent quarters, Alex has sold Ithaca Energy and OMV, due to his investment theses on these two stocks not materialising. However, Alex still finds opportunities in this supersector, and has recently purchased Schlumberger, a provider of services and technology to the oil and gas industry, illustrating how his positioning reflects stock level opportunities rather than top-down views.

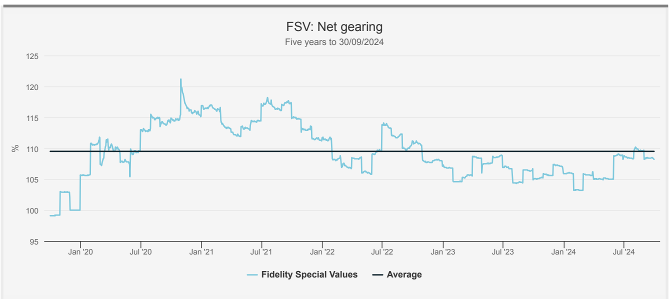
Gearing

The board's policy allows for a maximum gearing level of 40% of net assets, though gearing is expected to remain within a 0% to 25% range under normal market conditions. As of 30/09/2024, FSV's net gearing was c. 8.2%, which is slightly below the trust's five-year average of c. 9.5%.

Rather than using 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.

FSV previously had higher levels of gearing in the early 2020s when valuations were significantly depressed. The UK has recovered since the nadir, though Alex believes valuations remain compelling as we have discussed in **Performance**. Furthermore, we understand that higher borrowing costs have decreased Alex's willingness to take on gearing.

Fig.2: Net Gearing



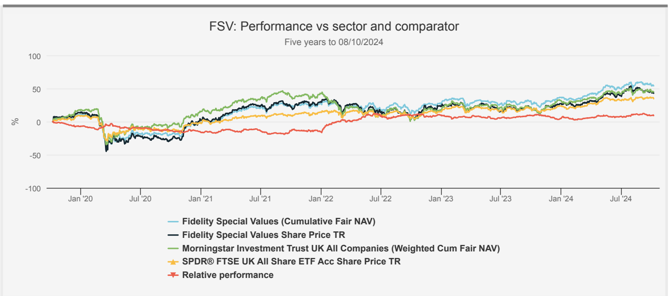
Source: Morningstar

Performance

FSV has been the best-performing investment trust in the AIC UK All Companies sector over the past five years to 08/10/2024. In the chart below, the red line shows the relative performance of FSV compared to the Morningstar Investment Trust UK All Companies sector. We can observe that FSV started to outperform its sector at the end of Q1 2022, which we would attribute to Alex's contrarian investment style. This approach leads him to seek out-of-favour stocks trading on low valuations, which often leads to a value bias. We believe this has supported performance relative to its many growth-oriented sector peers, which will have struggled in a rising interest rates environment.

Over the past five years, FSV has returned 54% in NAV total return terms, outperforming the FTSE UK All-Share Index — represented by the SPDR FTSE UK All-Share ETF — which returned c. 35%.

Fig.3: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

While an environment supportive of the value factor can provide a tailwind for Alex's strategy, we believe that FSV can still outperform its benchmark over the long term regardless of the prevailing market factor. Since Alex's appointment on 01/09/2012 through 30/09/2024, FSV has delivered an annual return of 11.2%, compared to 7.3% for the FTSE All-Share Index. Since the trust's launch on 17/11/1994, FSV has achieved an annual return of 11.9%, versus 7.2% for the index, as shown in the table below. We think it highlights the capacity of FSV's contrarian strategy to deliver outperformance over the long term in different market environments.

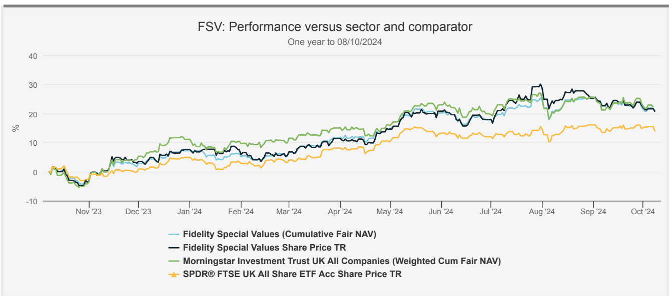
Annualised Total Returns

ANNUALISED TOTAL RETURNS	SINCE INCEPTION (%)	SINCE TENURE (%)
Fidelity Special Values (NAV)	11.9	11.2
FTSE All-Share Index	7.2	7.3
Excess return	4.7	3.9

Source: Fidelity, LSEG DataStream, as at 30/09/2024

Over the past 12 months (to 08/10/2024), FSV has also outperformed the FTSE All-Share Index during what has been a strong period for the UK equity market, with the FTSE 100 Index notably hitting an all-time high. Although valuations have increased somewhat as a result, UK equities remain cheaper than their international peers. We believe this valuation gap, combined with FSV's even lower valuation and attractive discount, present an attractive starting point for potential outperformance, and we would argue that FSV is well-positioned to capture these opportunities across the entire market-cap spectrum.

Fig.4: One-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Top contributors to relative performance against the FTSE All-Share Index over the past 12 months (to 31/08/2024) have come from a variety of sectors, including Keller (industrials), Just Group (financials) and Bakkavor (consumer defensive). This shows how returns can be expected to come from stock selection and not sector allocation.

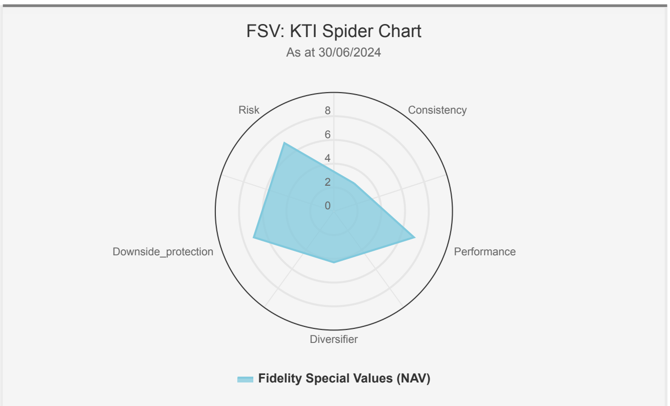
Conversely, the portfolio's lack of exposure to Diageo, BP and Prudential has also boosted relative performance, as these stocks have declined by approximately c. 18%, c. 22%, and c. 23%, respectively, over the same period. In a recent meeting, Alex mentioned Diageo, alongside AstraZeneca and Unilever, as example of 'well loved' UK stocks that he considers to be too expensive. In our view, this demonstrates the benefits of incorporating valuation risk into the investment process.

As it has been the case in recent years, takeover activity in the UK has also helped FSV's performance over the past 12 months. For example, Ascential was one of the main contributors to performance in the 12-month period ending 31/08/2024, as the company's share price soared after receiving a takeover bid from Informa. While Alex does not invest in stocks simply on an M&A angle, FSV's investee companies are often the target of takeover bids. We believe this is due to Alex's emphasis on identifying undervalued businesses whose market prices do not reflect their intrinsic value. In a recent meeting, Alex noted that these takeover bids are often made at a 30% to 50% premium, which he believes more accurately reflects the intrinsic value of the companies.

FSV's bias toward small and mid-caps (SMIDs) has also been beneficial, as they have outperformed large caps over the past 12 months. The FTSE 250 has returned 22.5% over the year to 09/10/2024 versus 14.2% for the FTSE 100. Although FSV's SMID bias has been a headwind over the past five years due to the high interest rates, we believe an easing monetary policy and improving outlook for the UK may continue to support a SMID recovery. It is also worth noting that SMIDs have historically outperformed large caps.

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

Fig.5: KTI Spider Chart



Source: Morningstar

Past performance is not a reliable indicator of future results.

FSV scores highly for performance due to the significant alpha generated over the period. It also scores highly for downside protection and risk, which we would attribute to Alex's investment process putting a strong emphasis on downside analysis and avoiding earning, financial and valuation risks. However, FSV gets a low score for consistency, which we believe may reflect the behaviour of a contrarian strategy.

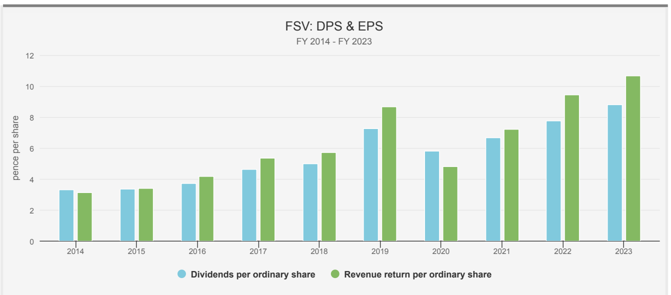
Dividend

FSV's primary goal is capital growth, but the trust also pays a dividend, as the board recognises the importance of dividends for long-term total returns and their benefit during periods of more muted stock market performance. In fact, FSV has a 14-year track record of dividend growth, with the trust's dividend increasing c. 18.6% annually between 2014 and 2023. As a result, an investor who bought shares on 16/10/2014 at a closing share price of 161.90p is now receiving a yield of c. 5.4% on that initial investment. As such, we think the dividend could be a valuable part of the investment case for long-term shareholders.

The board's policy is to pay one interim and one final dividend each financial year to provide smoother dividend payments. Ordinary dividends have been raised in each of the past ten years (we note the figure for 2019 in the chart below includes a special dividend). The interim dividend for the financial year 2024 was 3.24p, paid on 20/06/2024, representing a 28.1% increase from the 2.53p interim dividend paid in 2023. Based on current forecasts, the board aims to maintain the final dividend at least at last year's level of 6.27p and intends to fund it entirely from the revenue earned during the reporting period.

Assuming the final dividend is held at 2023's level, and combining that with 2024's interim, the trust offers a prospective yield of 3% on the current share price. Revenue reserves at the end of the financial year 2023 were sufficient to cover 1.5x the dividends paid that year. We believe the dividend is well-supported moving forward, adding a positive element to the investment case.

Fig.6: DPS & EPS



Source: Fidelity

Past performance is not a reliable indicator of future results.

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, and is largely similar in approach to FSV. Alongside Alex is co-manager Jonathan Winton. They have worked closely together since 2013 in the UK equities team, before Jonathan formally became co-manager in February 2020.

Alex and Jonathan have access to Fidelity's global equity research team, consisting of 133 equity analysts covering the US, Europe, Pan-Asia, and Emerging Markets. This team also have specialists in shorting and quant analysis, as well as a team of ESG specialists. Overall, Fidelity has over 360 investment professionals and research staff 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.

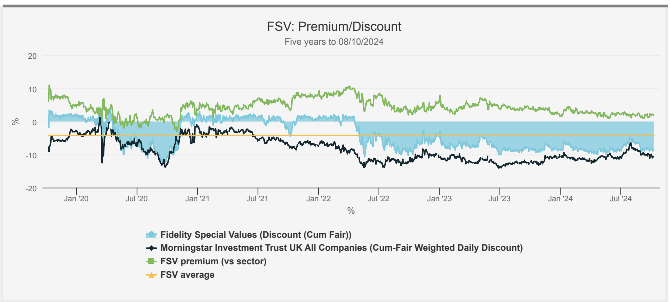
Discount

As of 08/10/2024, FSV's shares are trading at an 8.7% discount, which is wider than the trust's five-year average of 4.2%. We believe this discount is partly due to a lack of appetite for UK equities, as the Morningstar Investment Trust UK All Companies sector itself also trades on a wide discount. This has arguably been driven by the higher interest rate environment which has made risk assets less appealing. However, with the Bank of England one of several central banks beginning to lower interest rates, we believe this could soon turn to a tailwind and contribute to the narrowing of FSV's discount. FSV has typically traded at a premium to its peer group. However, this premium has gradually narrowed since Q2 2022. and stands at 1.9% as of 08/10/2024.

Despite the recent strong **Performance** of UK equities, valuations remain below their international peers. FSV's contrarian portfolio means it is likely to trade at lower valuations than the market average, which, coupled with the wide discount of the trust itself, means we think that this could make for a compelling entry point for long-term investors.

The board has a discount management policy aiming at keeping the discount to NAV in single digits under normal market conditions. To achieve this, the board is prepared to buy back shares to help stabilise the share price discount. However, the board has not repurchased shares since October 2020, as FSV has not traded at a double-digit discount for a sustained period of time since then.

Fig.7: Premium / Discount



Source: Morningstar

Charges

With over £1 billion in assets under management, FSV is one of the largest investment trusts in the AIC UK All Companies sector, allowing it to benefit from economies of scale. Consequently, FSV's fees are competitive compared to its sector peers. The most recently published ongoing charges figure (OCF) for FSV is 0.7% as of 31/08/2024, while the simple average of the AIC UK All Companies sector is c. 0.8%.

The OCF includes a single-tier management fee of 0.6%, introduced in January 2021, and is based on net assets. FSV does not charge a performance fee.

ESG

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

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

Despite not taking an exclusionary approach, the ESG characteristics of the trust are not that far from that of the index. Morningstar scores the trust below average compared to the peer group, though, scoring two out of five globes, although we note that c. 5% of the portfolio is not covered by Morningstar.

Disclaimer