EDISON

Fidelity Special Values

Increasingly positive view on UK market outlook

Investment trusts

Fidelity Special Values (FSV) aims to achieve long-term capital growth from a special situations portfolio of primarily UK equities. The manager has a contrarian approach, looking for unloved stocks and opportunities created by share price volatility and market uncertainty. Although market volatility has been unhelpful to shorter-term performance, FSV's NAV total return has outperformed its benchmark FTSE All-Share index over five and 10 years. While seeing broadly negative sentiment towards UK equities, FSV's manager is increasingly positive on the UK stock market outlook, irrespective of the outcome of Brexit negotiations, and has been adding to portfolio holdings by increasing FSV's net gearing.

12 months ending	Share price (%)	NAV (%)	FTSE All-Share (%)	FTSE 100 (%)	FTSE 250 (%)	FTSE SmallCap (%)
31/12/14	(4.6)	(1.2)	1.2	0.7	3.7	0.9
31/12/15	18.6	12.3	1.0	(1.3)	11.2	9.2
31/12/16	16.0	15.4	16.8	19.1	6.7	14.3
31/12/17	13.9	17.0	13.1	11.9	17.8	18.2
31/12/18	(9.1)	(14.2)	(9.5)	(8.7)	(13.3)	(9.5)

Source: Thomson Datastream. Note: All % on a total return basis in pounds sterling.

Investment strategy: Value contrarian approach

Portfolio manager Alex Wright takes a value contrarian approach to stock selection, seeking companies with potential for share price growth or recovery that has been overlooked by the market, while also carefully assessing downside risks. Fidelity's extensive research team is the primary source of investment ideas and analysts conduct in-depth due diligence on all potential holdings. Principally investing in UK stocks, the manager has flexibility to invest up to 20% of the portfolio in other markets, when more attractive opportunities are identified. The manager is able to adjust net gearing within the current 0% to 20% range set by the board.

Market outlook: Opportunity clouded by uncertainty

Although recent market falls and increased volatility have affected sentiment, a combination of relatively robust global economic growth and world equity valuation multiples at below 10-year average levels provides a relatively positive backdrop for stock markets. UK economic growth is relatively subdued, with global and domestic political and economic concerns weighing heavily on market sentiment, and the 11.3x forward P/E valuation multiple for UK equities is lower than for US, European and Asian regional markets. In this environment, any clarity on the UK's withdrawal from the EU or broader improvement in market sentiment has the potential to act as a catalyst for a market upturn.

Valuation: Trading at a modest premium to NAV

Over the last five years, FSV's share price has ranged between a 13.3% discount and a 2.9% premium to NAV (including income), with a broadly narrowing trend evident since October 2016. The shares are currently trading at a modest 1.0% premium, which compares to average discounts of 0.0%, 3.8% and 4.4% over the last one, three and five years, respectively.

7 January 2019

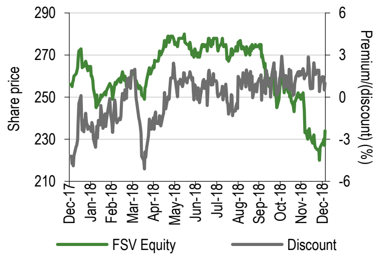
Price	**234.0p**
Market cap	**£630m**
AUM	**£703m**

NAV*	231.7p
Premium to NAV	1.0%

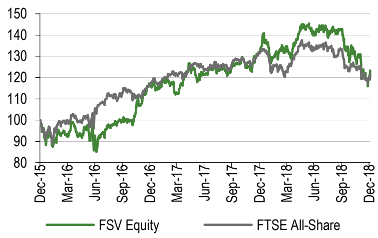
*Including income. As at 2 January 2019.

Yield	2.1%
Ordinary shares in issue	269.1m
Code	FSV
Primary exchange	LSE
AIC sector	UK All Companies
Benchmark	FTSE All-Share

Share price/discount performance



Three-year performance vs index



52-week high/low	280.0p	220.0p
NAV* high/low	279.5p	219.2p

*Including income.

Gearing

Gross market gearing*	20.9%
Net market gearing*	16.9%

*As at 30 November 2018.

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Edison profile page

Fidelity Special Values is a research client of Edison Investment Research Limited

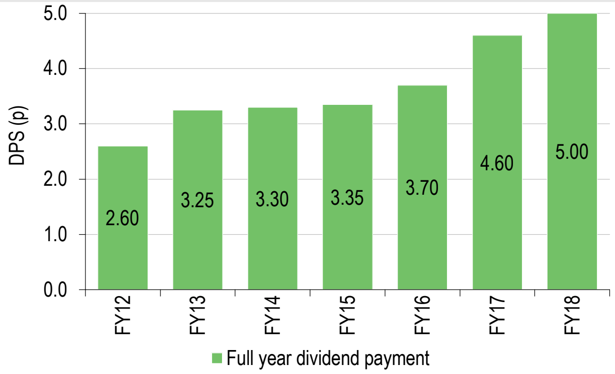
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
Fidelity Special Values' investment objective is to achieve long-term capital growth, predominantly through investment in UK-listed companies. The approach is value contrarian investing, looking for companies with potential for share price growth or recovery that has been overlooked by other investors, and holding these companies until their potential value is recognised by the wider market. Investments are only made in companies where the potential downside risk is understood, to limit the possibility of losses.	■ 1 November 2018: Final results to 31 August 2018. NAV TR +8.7% versus benchmark TR +4.7%. Share price TR +14.0%. ■ 1 November 2018: 3.15p final dividend proposed, taking total FY18 dividend to 5.00p versus 4.60p for FY17. ■ 10 July 2018: New tiered management fee announced, effective 1 September 2018; 0.85% on net assets up to £700m, 0.75% thereafter. ■ 30 April 2018: Interim results to 28 February 2018. NAV TR +2.8% versus benchmark TR -0.9%. Share price TR +4.6%. ■ 30 April 2018: 1.85p interim dividend declared versus 1.80p for H117.

Forthcoming		Capital structure		Fund details	
AGM	December 2019	Ongoing charges	1.04%	Group	FIL Investments International
Interim results	April 2019	Net market gearing*	16.9%	Manager	Alex Wright
Year end	31 August	Annual mgmt fee	Tiered: 0.85% up to £700m net assets, 0.75% thereafter	Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, Surrey KT20 6RP
Dividend paid	June, January	Performance fee	None		
Launch date	17 November 1994	Trust life	Indefinite (subject to vote)	Phone	01732 361144
Continuation vote	Three-yearly (next 2019)	Loan facilities	None – CFDs used (see page 10)	Website	www.fidelity.co.uk/specialvalues

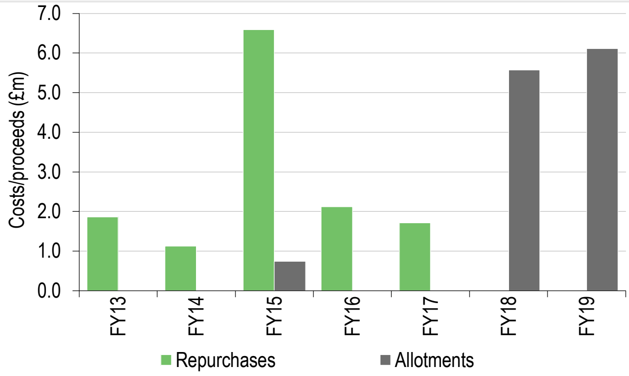
Dividend policy and history (financial years)

Since 2015, FSV has paid interim and final dividends, in order to smooth the dividend payment for the year.

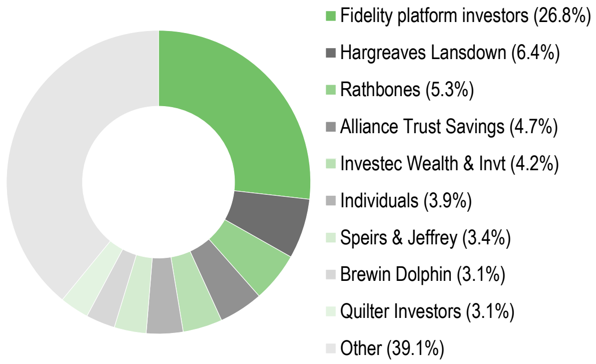


Share buyback policy and history (financial years)

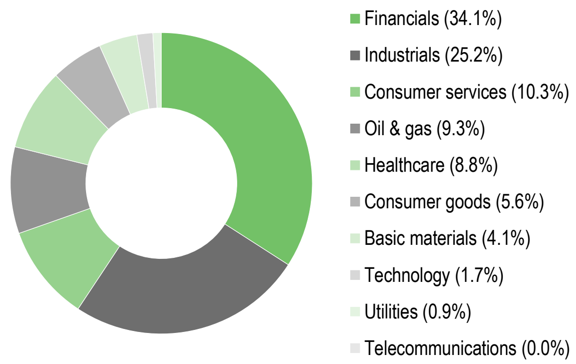
FSV has annually renewed authority to purchase up to 14.99% and allot up to 10% of its issued share capital.



Shareholder base (as at 30 November 2018)



Portfolio exposure by sector (as at 30 November 2018)



Top 10 holdings (as at 30 November 2018)

			Portfolio weight %		Benchmark weight %	Active weight %
Company	**Country**	**Sector**	**30 Nov 2018**	**30 Nov 2017****	**30 Nov 2018**	**30 Nov 2018**
Royal Dutch Shell	UK	Oil & gas	4.4	5.3	8.9	(4.5)
Pearson	UK	Consumer services	4.3	2.6	0.3	4.0
Citigroup	US	Financials	4.2	5.6	0.0	4.2
Lloyds Banking Group	UK	Financials	4.1	3.3	1.8	2.3
Roche	Switzerland	Healthcare	4.0	N/A	0.0	4.0
CRH	Ireland	Industrials	3.9	4.1	0.8	3.1
BP	UK	Oil & gas	3.7	N/A	4.6	(0.9)
Shire	UK	Healthcare	3.3	3.3	1.8	1.5
John Laing Group	UK	Financials	3.3	N/A	0.1	3.2
Phoenix Group	UK	Financials	3.1	2.5	0.2	2.9
Top 10 (% of holdings)			**38.3**	**35.4**		

Source: Fidelity Special Values, Edison Investment Research, Bloomberg, Morningstar. Note: *Gearing net of short positions. **N/A where not in November 2017 top 10.

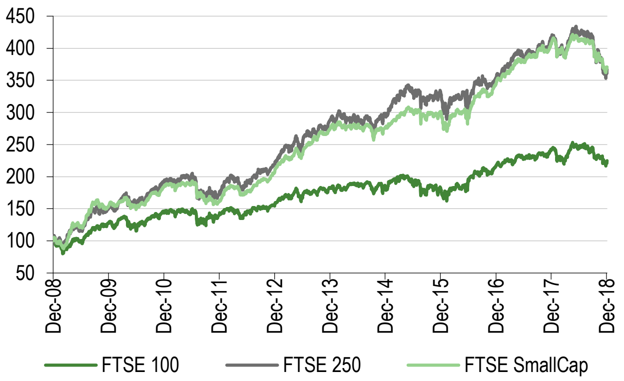
Market outlook: Uncertainty creating more opportunity

In its October 2018 outlook, the International Monetary Fund (IMF) maintained its expectation for a continuation in the steady expansion that has been underway since mid-2016, but lowered its projections, now seeing global growth remaining at the 2017 level of 3.7% in both 2018 and 2019. In addition, the IMF highlighted that economic growth has become less balanced and may have peaked in some major economies, indicating a rise in downside risks and less potential for upside surprises. The IMF forecasts UK economic growth at 1.4% for 2018 and 1.5% for 2019, which is below the euro area and advanced economy averages in both years. However, the modest rise in the pace of UK growth in 2019 contrasts with a slowdown in most other advanced economies.

Against a backdrop of relatively robust, but moderating, economic growth expectations, global stock markets have experienced elevated volatility throughout most of 2018, with sharp falls seen in many stock markets in the second half of the year. Share prices have been broadly affected by a number of geopolitical uncertainties, such as the US-China trade dispute, the pace of US interest rate hikes, and the UK's negotiations on its withdrawal from the EU, which have all compounded fears of a potential sharper slowdown in the global economy.

Exhibit 2: Market performance and valuation

FTSE 100, FTSE 250 and FTSE SmallCap indices over 10 years



Datastream UK market valuation metrics

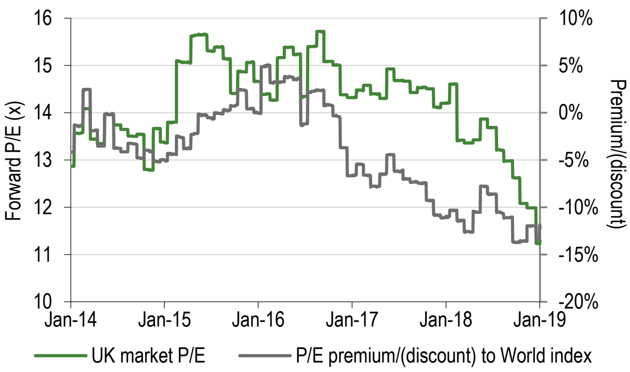
	Last	High	Low	10-year average	Last as % of average
P/E 12 months forward (x)	11.3	15.7	8.3	12.5	90
Price to book (x)	1.4	2.1	1.2	1.7	83
Dividend yield (%)	4.3	5.8	2.7	3.5	124
Return on equity (%)	11.7	14.8	2.5	9.6	122

Source: Thomson Datastream, Edison Investment Research. Note: Valuation data as at 4 January 2019.

As shown in Exhibit 2 (left-hand chart), the FTSE 250 and FTSE SmallCap indices have both significantly outperformed the FTSE 100 index over the 10 years since the 2008 global financial crisis, with all three indices declining by more than 10% from their peak in 2018. As shown in Exhibit 2 (right-hand table), the 2018 market setback has taken UK stock market valuation multiples well below 10-year average levels, and its dividend yield is considerably higher than average.

Exhibit 3: Market valuation comparison

Datastream UK market forward P/E multiple vs Datastream World market



Datastream market forward P/E multiples comparison

	Last	High	Low	10-year average	Last as % of average
UK	11.3	15.7	8.3	12.5	90
Europe	11.5	15.6	7.6	12.2	94
US	14.7	19.0	11.0	15.1	97
Asia	11.7	17.4	10.5	13.1	90
World	12.9	16.3	9.8	13.5	96

Source: Thomson Datastream, Edison Investment Research. Note: Valuation data as at 4 January 2019.

Exhibit 3 shows the valuation of the UK stock market compared with those of major regions and the world. While all regional markets are trading at discounts to their 10-year average forward P/E multiples, the UK is trading at the joint-widest discount and its 11.3x forward P/E multiple is the lowest of all the regions shown, in absolute terms.

A combination of relatively robust global economic growth and world stock market valuation multiples at below 10-year average levels suggests a broadly positive outlook for markets. Global macroeconomic concerns are weighing heavily on market sentiment and risks to global growth appear skewed to the downside. However, evidence of a path towards resolution of the US-China trade conflict or some clarity on the UK's withdrawal from the EU could trigger an improvement in sentiment. Markets could also take cheer from any further slowdown in the projected pace of US interest rate rises, even if this is in response to weaker economic data. While the investment outlook in the UK is relatively subdued due to continuing economic and political uncertainty, any resolution of negotiations with the EU and accompanying improvement in sentiment, combined with the current relatively low market valuation, has potential to reverse the market downtrend. In the current uncertain market environment, investors may find appeal in a fund with a more discriminating investment approach and strong attention to limiting downside risk.

Fund profile: Diversified UK special situations portfolio

FSV is an LSE-listed investment trust with the objective to achieve long-term capital growth primarily through investment in UK equities (and related financial instruments) that the investment manager believes to be undervalued or where future potential has not been widely recognised. The trust's investment objective was previously to achieve long-term capital growth predominantly through investment in UK-listed companies; this was rephrased at end-October 2018 to align it better with new regulatory reporting requirements introduced at the start of the year. There has been no change to the portfolio manager's investment approach, and he continues to seek to fulfil FSV's objective by investing in special situations, adopting an active contrarian approach, seeking out undervalued opportunities and taking advantage of volatility and market uncertainty.

Managed by Anthony Bolton from its launch in November 1994 until December 2007, then Sanjeev Shah from January 2008 to August 2012, FSV has been managed by Alex Wright since September 2012. Wright has 17 years' investment experience, having worked as a pan-European sector analyst at Fidelity from 2001 to 2008, and has managed the £370m Fidelity UK Smaller Companies open-ended fund since its launch in February 2008 (co-manager since February 2013). He has also managed the £2.9bn Fidelity Special Situations open-ended fund since January 2014.

Wright's approach is similar to those of both previous managers, referred to as value contrarian investing, which involves identifying companies whose potential for share price growth and recovery has been overlooked by other investors, then holding the shares of these companies until their value is recognised by the wider market. Additionally, Wright only invests after making a thorough assessment of potential downside risk, in order to limit the possibility of losses.

FSV's portfolio typically comprises 80-120 holdings (96 at 31 August 2018; 107 at 31 August 2017) and 0-10 short positions (four at 31 August 2018; 10 at 31 August 2017). The investment approach is flexible and portfolio construction is driven by bottom-up stock selection, with positions held in large, medium and smaller-sized companies, across all industries. Performance is benchmarked against the FTSE All-Share index but sector allocations are not constrained by index weightings. FSV may invest up to 20% of the portfolio in companies outside of the UK in order to enhance shareholder returns. Gearing is permitted up to a maximum 40% of net assets, with the manager having flexibility to adjust net gearing within the current 0% to 20% range set by the board.

The fund manager: Alex Wright

The manager's view: Increasingly positive on UK market outlook

Portfolio manager Alex Wright emphasises that his investment process continues to target unloved stocks where companies are undergoing positive change, which has not yet been recognised by the market. Finding a plentiful supply of unloved companies in the UK stock market today, he sees his task as identifying those with the strongest margin of safety and the best chances of positive change. Given the high number of small- and medium-sized listed UK companies, and the lower levels of investor scrutiny that these are subjected to, he expects the portfolio will retain significant exposure to small and mid-cap companies. However, he points out that portfolio weightings are influenced by relative valuations between different size categories, as well as the outlook for different industries and companies, noting the significant increase in FSV's exposure to FTSE 100 stocks over the last year (31.7% at end-November 2018 versus 24.4% at end-November 2017).

While acknowledging that the uncertainty surrounding Brexit has led to a de-rating of the UK stock market, Wright counters the strong consensus view – reinforced by fund manager surveys and press coverage – that UK small- and medium-sized companies are deeply out of favour and are under-owned compared with their larger and more international FTSE 100 peers. He highlights that since the UK's EU referendum in June 2016, small- and medium-sized companies have outperformed the FTSE 100, continuing the trend of previous years. He also observes that the FTSE 100 is now cheaper on forward earnings estimates than the more domestically-oriented FTSE 250 and comments that he has incrementally been finding more interesting opportunities in larger companies, rather than among apparently unloved UK small- and medium-sized companies.

At end-August 2018, Wright cautioned that, over his six-year tenure as FSV's portfolio manager, the UK stock market had delivered an annualised return close to 10%, which is well above long-term historical averages, and regarded it unwise to expect such unusually high returns to continue. However, he now has an increasingly positive view on the outlook for the UK market – particularly relative to other markets – mainly due to the negativity of other investors, who mostly appear to be underweight in UK stocks, with many global investors entirely avoiding UK exposure. In his view, the Brexit narrative has led to UK assets becoming deeply unloved, and therefore interesting from a contrarian perspective. He believes that whatever the outcome of UK negotiations with the EU, any clarity over the future relationship should lead to a period of stronger performance for the UK stock market. He expects any agreement to act as a catalyst for investors to revisit UK equities and sees potential for significant fund inflows due to the many good quality companies trading at discounts to peers in other developed markets, such as the US, where valuations are much higher.

Wright's experience suggests not to wait for the good news to become obvious before investing, but to buy stocks when all the bad news is 'in the price' and no good news is expected. Accordingly, he took advantage of market weakness in the second half of 2018 to add to portfolio holdings and increased FSV's net gearing (0.0% at end-May 2018 versus 16.9% at end-November 2018). He stresses that a selective approach remains important, highlighting that there are many domestic businesses being unfairly ignored, but there are also companies that are structurally compromised or financially unsound and therefore best avoided. Most recently, he has found attractive valuations among more defensive and larger-cap stocks, although he also notes that the financials sector has remained a fertile source of ideas.

Among the leading contributors to FSV's performance over the last year, Wright highlights Ladbrokes, which was acquired by GVC Holdings. He explains that Ladbrokes was a deeply unloved UK domestic consumer stock that the market fundamentally misunderstood, but where due diligence and scenario analysis by Fidelity's analyst uncovered significant value and limited downside, which was ultimately recognised by a corporate buyer. Another positive contributor was pharmaceutical company Shire, which received a bid from Japanese group Takeda Pharmaceutical, following a protracted period of underperformance. Royal Dutch Shell made a strong contribution, benefiting from rising oil prices as well as improved cash generation, and FSV retains its holding in the company as Wright believes its valuation continues to look attractive. Pearson performed well in 2018, but remains deeply unloved, despite what Wright sees as an exciting future for the company, and he has added to FSV's holding. Significant detractors from performance over the last year include BT Group and Italian defence contractor Leonardo, which have both been sold.

Financials is FSV's largest sector exposure (accounting for c 35% of the portfolio compared to 26% for the benchmark), spread across banks, financial services and diversified financials. Wright comments that within banks, FSV holds Citigroup, Lloyds Banking Group, Bank of Ireland Group and RBS Group, which are all trading on cheap valuations. While these banks have seen a strong pick-up in earnings and have been steadily rebuilding their balance sheets following the global financial crisis, he believes this is not fully reflected in their share prices. FSV also holds positions in insurers such as Phoenix Group Holdings and Aviva, which Wright observes are more defensive businesses than banks but also trading at very attractive valuations.

Wright indicates that FSV's investments in the oil and banking sectors are based on a combination of stock-specific and industry changes, whereas portfolio investments in defensive sectors are more stock-specific. The trust remains underweight in consumer goods, but invested c 1% of NAV in Imperial Brands following the dramatic sell-off in the tobacco sector. Wright points to the company's attractive risk/reward profile, emphasising its low valuation, with the stock trading on a 7% dividend yield, comfortably covered by free cash flow, but says it is unlikely to become a large position, given the negative structural trends in the tobacco industry and the company's high leverage. FSV also bought a new position in Irish brewer C&C Group following its acquisition of distributor Matthew Clark, which Wright believes transforms its previously struggling UK business.

Asset allocation

Investment process: Value contrarian stock selection

The manager seeks to meet FSV's capital growth objective through investing in a diversified portfolio of predominantly UK-listed equities. While portfolio exposures versus the benchmark FTSE All-Share index are monitored, stock selection is not constrained by benchmark sector weightings. Opportunities are found across the market capitalisation spectrum and the proportions of portfolio investments in large, medium and small companies may vary over time, as this is the outcome of the research-driven, bottom-up stock selection process. The portfolio manager has a contrarian style and focuses on significant valuation anomalies in stocks which are out of favour with other investors, yet show potential for change.

FSV's portfolio investments typically have the following two characteristics:

- **Unrecognised potential for positive change**: the portfolio manager seeks evidence of a company embarking upon a period of positive change, aiming to invest before its improved prospects are recognised by the wider market, when there is potential for substantial upside. Indications of this potential may come from:
  - **Internal change**: self-inflicted issues that can be rectified, a new management team, corporate activity or restructuring.
  - **External change**: supply reduction in low-return sector, regulatory or disruption uncertainty.
- **Limited downside risk**: the portfolio manager invests in companies where he believes that market expectations are low, with any negative developments already reflected in valuations. Ideally, the company will possess an asset or characteristic that provides a valuation floor. Factors assessed include:

– **Earnings risk**: how low margins and earnings could fall in a stressed scenario, along with market expectations for earnings.
– **Financial risk**: whether the balance sheet is appropriate given earnings volatility.
– **Valuation risk**: how valuation compares to history and peers.

The investment process is designed to deliver an asymmetric return profile for the portfolio, which means that some winners should see outsize returns, while downside from losers should be minimised. This return profile is reflected in Fidelity's analysis of FSV's returns for the five years to end-September 2017. The analysis shows that the portfolio had a larger proportion of winners than losers over this period, with the largest positive stock contribution to performance more than three times the size of the largest negative stock contribution.

There are three main sources of investment ideas:

- **Fidelity analysts**: Fidelity has extensive research capabilities, with 40 pan-European analysts that evaluate companies, conducting regular management meetings and assessing sensitivities to changes in the macroeconomic environment. The portfolio manager works closely with the Fidelity analyst team, who provide the main source of investment ideas.
- **Stock market screening**: the portfolio manager regularly screens the market for pronounced share price underperformance and other factors, such as companies reporting trough margins, which may indicate a potential suitable investment opportunity.
- **Sell-side analyst research**: the portfolio manager also has access to a wide range of research produced by third parties.

Once identified as a potential portfolio investment, all candidate companies are studied in detail by Fidelity's sector-specialist analyst to validate the investment thesis. This involves talking to competitors, suppliers, customers and industry experts, as well as the company management and the level of due diligence conducted is seen as a key differentiating feature of Fidelity's approach. The final stage of the investment process is portfolio construction, with stock weightings determined by the portfolio manager's level of conviction in the investment case. A number of factors influence the level of conviction, including the number of aspects to the positive change story, stock liquidity and downside risk. An initial position in a new holding will typically be started at 25-100bp, then increased to 2-3% of the portfolio, with a full weighting usually reached within 12 months.

Up to 20% of FSV's portfolio may be invested in companies listed on overseas exchanges. While not actively seeking non-UK investments, the manager frequently finds alternatives to UK stocks with similar but stronger investment cases, supported by the research of Fidelity's European or global sector-specialist analysts. An example of this is FSV's third largest holding Citigroup, which has similar global exposures and broadly similar risk characteristics to FTSE 100 constituent HSBC. The portfolio manager believes Citigroup is more attractively valued than HSBC, with higher profitability and its share price supported by a share buyback programme, while HSBC has greater property exposure, which is considered to present higher risks. Other examples of overseas alternative portfolio holdings are Sanofi and Roche, which are held in preference to FTSE 100 constituent GlaxoSmithKline. FSV can also invest in overseas companies, where there is no equivalent UK-listed stock and Fidelity's analyst has a particularly high-conviction investment case. An example of this is former portfolio holding Electronic Arts, where the potential was seen in 2012 for a new games console cycle to drive growth in a depressed sector.

FSV may invest directly in shares or indirectly, via contracts for difference (CFDs), warrants or convertible bonds. Debt securities may also be held and up to 5% of gross assets may be invested in unquoted securities. Single company exposure is limited to 10% of the portfolio at the time of investment. Derivatives, including CFDs, futures and options, are used for three main purposes:

- as an alternative, lower cost form of gearing to bank loans or bonds;
- to hedge the downside risks from a falling stock market at a reasonable cost; and
- to take short exposures on individual stocks considered to be over-valued.

The portfolio manager is also permitted to reduce currency exposure through the use of CFDs when investments are made in stocks in foreign currencies.

Short exposure typically equates to 2-3% of FSV's portfolio, with up to 10 individual short positions being held. The portfolio manager looks for stocks that he considers are clearly overvalued and where he sees a catalyst for the share to de-rate. An example of this was funeral services provider Dignity in 2017, where the company was pricing aggressively and seemingly out of kilter with its competition. Market risks are generally hedged using a FTSE 250 index future, representing up to c 10% of net assets (4.0% at end-November 2018).

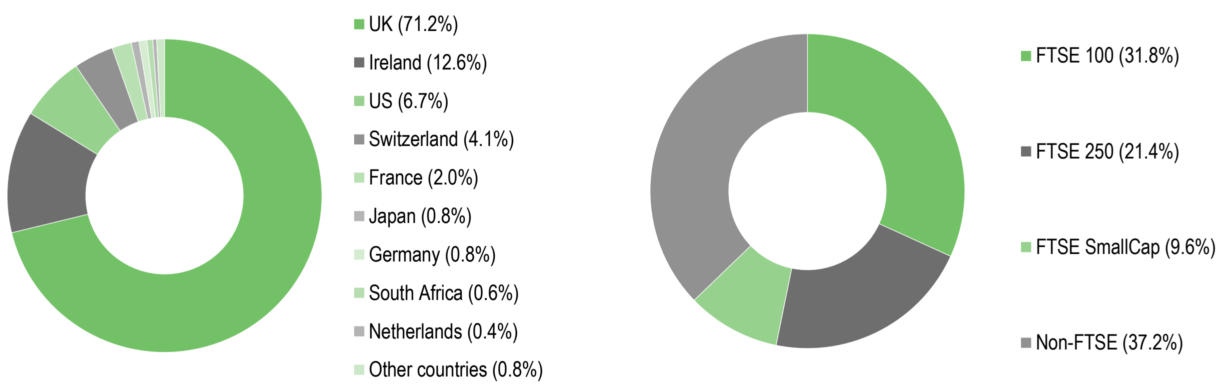
Current portfolio positioning

FSV's portfolio includes c 100 long positions, but exposure is relatively concentrated in the top 10 holdings, which accounted for 38.3% of the portfolio at end-November 2018, compared with 35.4% a year earlier (Exhibit 1). Portfolio turnover could be considered relatively high at 50.6% for FY18 and 54.2% in FY17, but this partly reflects the portfolio manager's active approach to topping up or trimming existing holdings, rather than investments being short term in nature. There are three changes to the top 10 holdings compared with a year earlier, including new positions in BP and Swiss healthcare company Roche, while John Laing Group was previously a top 20 holding.

Exhibit 4 (left-hand chart) shows that the portfolio manager continues to take advantage of FSV's flexibility to invest up to 20% of the portfolio outside of the UK market – with Irish-domiciled holdings largely being UK-listed, such as FSV's top 10 holding CRH. Exhibit 4 (right-hand chart) shows that FSV's portfolio is significantly overweight in FTSE 250 and FTSE SmallCap stocks, which together account for only c 19% of the benchmark FTSE All-Share index. Non-FTSE portfolio exposure includes stocks listed outside the UK as well as CFD positions.

Exhibit 4: Portfolio geographic and market cap exposures at end-November 2018

Portfolio geographic exposure by company domicile | **Portfolio market cap exposure – classified by FTSE index**



Source: Fidelity Special Values, Edison Investment Research. Note: Figures are adjusted for gearing and index futures.

As shown in Exhibit 5, FSV's largest sector exposures at end-November 2018 were financials and industrials, which together accounted for c 60% of the portfolio, and these sectors also represented the portfolio's most significant overweight exposures. While there is a similar spread of exposures compared with a year earlier, there have been notable reductions in consumer services and financials, while portfolio weightings in healthcare, consumer goods and oil & gas have been increased. The new holding in Roche accounts for a near doubling in the healthcare weighting, although FSV remains underweight this sector, while telecommunications exposure has been cut to zero following the sale of BT Group. The portfolio's most significant sector underweight position is in consumer goods, while increased exposure to oil & gas from FSV's new holding in BP has reduced the underweight in this sector.

Exhibit 5: Portfolio sector exposure vs benchmark index (% unless stated)	Portfolio end-Nov 2018	Portfolio end-Nov 2017	Change (pp)	Index end-Nov 2018	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	34.1	37.5	(3.5)	25.6	8.5	1.3
Industrials	25.2	25.6	(0.5)	10.7	14.5	2.4
Consumer services	10.3	14.7	(4.4)	11.5	(1.2)	0.9
Oil & gas	9.3	6.2	3.0	14.0	(4.7)	0.7
Healthcare	8.8	4.5	4.4	10.3	(1.4)	0.9
Consumer goods	5.6	2.2	3.4	13.7	(8.1)	0.4
Basic materials	4.1	3.3	0.8	7.4	(3.3)	0.6
Technology	1.7	3.3	(1.5)	0.9	0.8	1.8
Utilities	0.9	0.3	0.6	2.8	(1.9)	0.3
Telecommunications	0.0	2.3	(2.3)	3.2	(3.2)	0.0
	100.0	100.0		100.0		

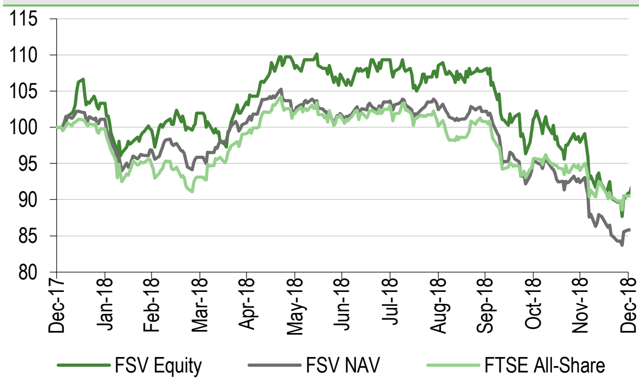
Source: FSV, Edison Investment Research. Note: Figures are adjusted for gearing and index futures.

Performance: Long-term outperformance record

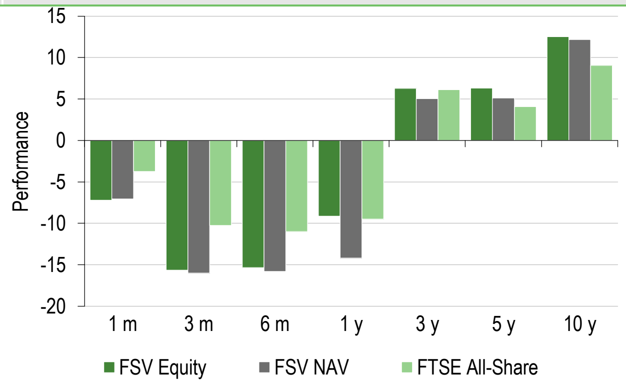
As illustrated in Exhibit 6, FSV's one-year share price and NAV total returns were clearly affected by the market declines in January, October and December 2018. The share price conspicuously outperformed both the NAV and benchmark FTSE All-Share index during January 2018, when it moved from a c 5% discount to NAV (including income) to parity, and this outperformance has been retained through to end-December 2018, when the share price stood at a 1.5% premium to NAV.

Exhibit 6: Investment trust performance to 31 December 2018

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

As shown in Exhibit 7, while FSV's NAV total return has lagged the benchmark over one and three years, this reflects a short period of underperformance over the three months to end-December 2018, and the trust has outperformed its benchmark over five and 10 years. The contrarian nature of the manager's investment selection process means performance may diverge appreciably from the benchmark over shorter time periods, particularly during periods of elevated market volatility, and this may not reflect the portfolio's potential to outperform significantly over the longer term.

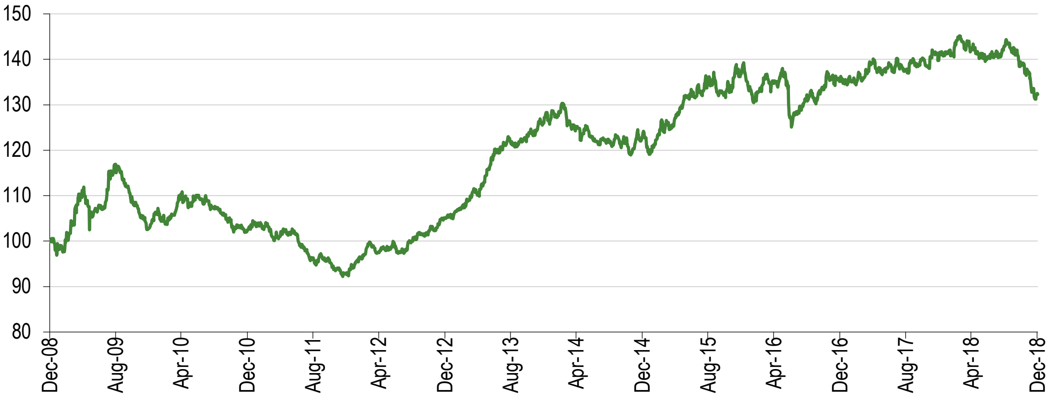
Exhibit 7: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to FTSE All-Share	(3.6)	(6.0)	(4.9)	0.4	0.5	11.3	36.6
NAV relative to FTSE All-Share	(3.4)	(6.4)	(5.4)	(5.2)	(3.1)	5.2	32.5
Price relative to FTSE 100	(3.8)	(6.7)	(5.7)	(0.4)	(1.3)	12.4	47.1
NAV relative to FTSE 100	(3.7)	(7.0)	(6.2)	(6.0)	(4.8)	6.2	42.7
Price relative to FTSE 250	(2.2)	(2.7)	(0.6)	4.8	10.2	8.3	(10.0)
NAV relative to FTSE 250	(2.0)	(3.1)	(1.1)	(1.1)	6.3	2.3	(12.6)
Price relative to FTSE SmallCap	(3.8)	(5.9)	(5.5)	0.4	(1.7)	1.0	(11.6)
NAV relative to FTSE SmallCap	(3.6)	(6.3)	(6.0)	(5.1)	(5.2)	(4.5)	(14.2)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-December 2018. Geometric calculation.

Exhibit 8 illustrates that, apart from several shorter periods of relative weakness, FSV has achieved a reasonably consistent outperformance of its benchmark since December 2011.

Exhibit 8: NAV total return performance relative to benchmark over 10 years



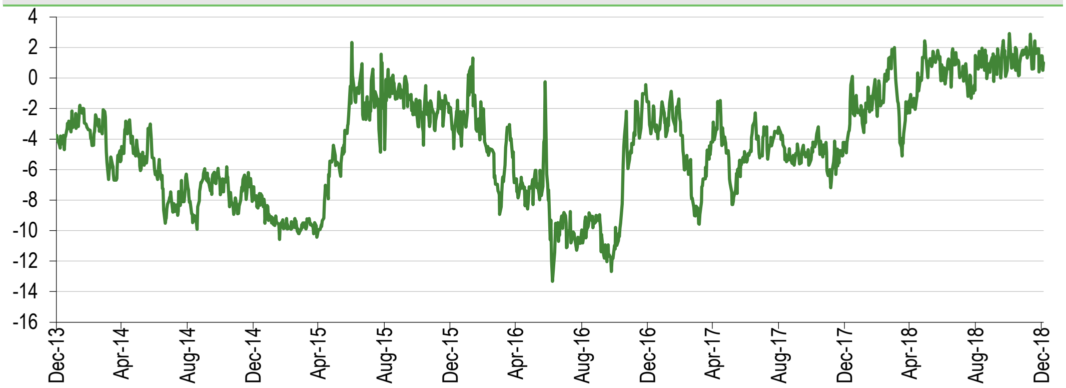
Source: Thomson Datastream, Edison Investment Research

Discount: Shares trading at a small premium

The board monitors the discount/premium closely and pursues an active management policy, taking action when it feels it will be effective and in the best interests of shareholders. When the shares are trading at a discount, the board seeks to maintain the discount in single digits in normal market conditions by buying back shares, either for cancellation or to be held in treasury. The board will reissue shares from treasury when the premium is sufficient to ensure that the issue is not dilutive.

As illustrated in Exhibit 9, over the last five years, FSV's share price has ranged between a 13.3% discount and a 2.9% premium to NAV (including income), with a broadly narrowing trend evident since October 2016. The shares are currently trading at a modest 1.0% premium, which compares to average discounts of 0.0%, 3.8% and 4.4% over the last one, three and five years, respectively.

Exhibit 9: Share price premium/discount to NAV (including income) over five years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

FSV is a conventional investment trust with a single share class. At 4 January 2019, FSV had 269.1m ordinary shares in issue, with a further 1.6m shares held in treasury. FSV has annually renewed authority to repurchase up to 14.99% of its outstanding shares at a discount to NAV, and to increase its issued share capital by up to 10% through the allotment of new or existing shares at a premium to NAV. Only one minor share repurchase has been made since November 2016, when the discount last stood wider than 10%, while a total of 4.6m shares (1.7% of issued capital) have been allotted from treasury since March 2018, when the shares started to trade regularly at a premium to NAV.

A five-for-one sub-division of the shares took place in June 2015 to address the substantial rise in share price (from 100p at launch in 1994 to 925p as at 22 April 2015), which was hindering smaller investors and those participating in monthly saving plans or dividend reinvestment schemes.

FSV's maximum permitted gross gearing is 40%, and the board has currently set a 0% to 20% range within which the portfolio manager should maintain net gearing in normal market conditions. Within these restrictions, the board allows the manager to raise and lower gearing according to the availability of attractive investment opportunities. The board views the use of gearing as a structural advantage for FSV over its open-ended counterparts, and expects it to continue to add value for shareholders over the long term. FSV uses long CFDs to add gearing, normally at lower financing costs than the equivalent bank loans or bonds. Net gearing was increased during weaker market performance, rising from 0.0% at end-May 2018 to 16.9% as at end-November 2018.

On 1 September 2018, a tiered annual management fee structure was introduced, with a charge of 0.85% on the first £700m of net assets and 0.75% thereafter, which compares to the previous flat rate of 0.875% on net assets. The fee for non-portfolio management services (including company secretarial, fund accounting, taxation, promotional and corporate advisory services) was reduced from £0.6m per annum to £0.1m, also with effect from 1 September 2018. The FY18 ongoing charge was 1.04%, which was slightly lower than the 1.06% reported for FY17.

FSV is subject to a three-yearly continuation vote, with the next vote due at the 2019 AGM.

Dividend policy and record

Since 2015, the board's distribution policy has been to pay dividends twice yearly in order to smooth the dividend payment for the reporting year. In order to provide shareholders with a more balanced interim and final dividend than those previously paid, the interim dividend was increased by 80% to 1.80p per share in 2017, while the final dividend was increased from 2.70p to 2.80p per share, translating into a 24.3% increase in the FY17 total dividend to 4.60p. The FY18 interim dividend was increased to 1.85p, with the final dividend (to be paid on 16 January 2019) increased to 3.15p. The total 5.00p dividend for FY18 represents an increase of 8.7% over FY17.

FSV's portfolio is managed actively in pursuit of capital growth and the dividend paid in each financial year will vary according to the level of dividend income received from investments. However, as an investment trust, FSV distributes at least 85% of its net income and the total dividend has been increased in each financial year since 2009 (the 2008 dividend was boosted by a one-off repayment of VAT on management fees). FSV's revenue return for FY18 was 5.70p per share, making the FY18 total dividend 114% covered and adding 0.70p per share to revenue reserves. Adjusting for payment of the FY18 final dividend of 3.15p per share, FSV has revenue reserves equating to 2.55p per share, which can be used to smooth future dividend distributions.

Peer group comparison

Exhibit 10 shows a comparison of the trusts in the AIC UK All Companies sector that have a market cap over £100m. FSV is one of two larger trusts in this peer group that have a track record of more than five years. While performance is negative over one year, reflecting the recent UK market sell-off, and also lower than the peer group average, FSV's NAV total return is similar to the peer group average over three years and ahead of the average over five and 10 years. The trust's ongoing charge is at the higher end of the peer group range but it does not charge a performance fee, unlike many of its peers, and management and administrative fees have been reduced from September 2018. FSV has the highest level of gearing in the peer group, although the figure shown includes short exposure and net market gearing is c 17%. Reflecting its capital growth objective, FSV's dividend yield is moderately lower than the peer group average.

Exhibit 10: Selected AIC UK All Companies sector peer group as at 4 January 2019*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Premium/ (Discount)	Ongoing charge	Perf. fee	Gearing	Dividend yield
Fidelity Special Values	628.0	(14.6)	16.1	27.6	210.8	0.5	1.05	No	121	2.1
Artemis Alpha Trust	107.8	(13.3)	8.4	2.7	114.7	(18.6)	0.91	Yes	100	1.9
Aurora	103.4	(10.7)	17.3	3.9	80.9	0.8	0.54	Yes	100	1.5
Baillie Gifford UK Growth	248.4	(13.2)	8.2	0.3	181.7	(5.4)	0.64	No	100	2.7
Crystal Amber	196.7	18.2	58.9	57.8	153.6	(7.9)	1.96	Yes	100	2.5
JPMorgan Mid Cap	237.0	(20.5)	0.5	34.8	290.7	(4.5)	0.86	No	104	2.8
Keystone	206.2	(14.8)	(1.6)	12.7	138.4	(11.7)	0.55	Yes	115	3.7
Manchester & London	114.7	(4.8)	53.5	60.8	94.3	(11.1)	1.02	No	109	2.9
Mercantile	1,408.3	(16.9)	5.6	29.9	266.8	(10.4)	0.47	No	102	3.3
Schroder UK Mid Cap	166.2	(15.0)	7.5	18.1	304.6	(14.9)	0.91	No	106	3.5
Woodford Patient Capital Trust	697.2	6.7	1.7			(16.4)	0.18	Yes	117	0.3
Average	**374.0**	**(9.0)**	**16.0**	**24.9**	**183.7**	**(9.1)**	**0.83**		**107**	**2.5**
Rank in peer group	**3**	**7**	**4**	**5**	**4**	**2**	**2**		**1**	**8**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 3 January 2019 based on ex-par NAV. TR = total return. Gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

FSV's board comprises five non-executive directors, four of whom are considered to be independent of the manager. Chairman Andy Irvine (appointed director April 2010, chairman July 2016) has over 30 years' experience in commercial property development and investment and is a director of BlackRock North American Income Trust. Senior independent director Sharon Brown (appointed April 2010) was finance director of Dobbies Garden Centres from 1998 to 2013 and is a director of BMO Capital and Income Investment Trust. Nigel Foster (appointed September 2015) has over 35 years' experience in the investment management industry, including 27 years as global head of derivatives at BlackRock and predecessor firms. Dean Buckley (appointed November 2015) was previously the CEO of Scottish Widows Investment Partnership, and is a director of JPMorgan Asian Investment Trust. Nicky McCabe (appointed December 2004) was Fidelity's head of investment trusts until December 2017 and so is deemed not to be independent. She is a director of Artemis Fund Managers and Aberdeen Asian Income Fund.

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