PRIVATE WEALTH SMALL AND MID CAP FUND

Q3 2019

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MARKET REVIEW

South African equities lagged their global counterparts over the quarter to September 2019. The FTSE/JSE All Share Index declined 12.4% (in USD terms), compared to -4.1% from the MSCI Emerging Markets Index and +0.7% from the broader MSCI World Index. Even though South African Q2 GDP growth came in stronger than expected at +3.1%, this merely represented a reversal of the -3.1% economic growth reported in Q1. Other data published during the quarter also indicated little positive momentum, and SA corporates continued to note challenging operating conditions in the domestic economy. On the positive front, the Economic Policy Paper published by National Treasury, which sets out a blueprint for growth-enhancing reform, appears to be garnering support. Although most of the proposals contained in the Paper are not novel (and draw heavily from the existing National Development Plan), there appears to be a growing acknowledgment that more concrete action is desperately needed.

The JSE Small and Mid Cap indices fared slightly better than the larger cap-focused Top 40 Index over the quarter. The Small and Mid Cap indices lost 3.1% and 1.8% respectively, while the Top 40 index declined 5.1%. The Small and Mid Cap Indices were buoyed by their relatively larger exposure to gold and platinum stocks, which delivered strong returns over the quarter. Record high palladium prices (supported by continued demand for palladium as an autocatalyst in gasoline vehicles and limited supply additions expected in the near term) drove platinum stocks higher, while a rising gold price on the back of increased global volatility supported gold producers.

FUND PERFORMANCE

The Fund delivered a disappointing performance over the quarter, losing 7.2% against the benchmark's return of -2.1%. The Fund also lagged the peer group average return of -2.4%.

The Fund's lack of Resources exposure materially impeded performance. As noted above, platinum and gold stocks delivered strong gains over the period. Omissions that detracted from the Fund's relative performance include Impala Platinum (-1.4%), Northam Platinum (-0.7%), Sibanye Gold (-0.8%) and Harmony Gold (-0.5%).

In addition, the Fund remains heavily invested in counters exposed to the domestic economy, which we believe have sold off excessively over the last 18 months. In our view, these counters remain high quality businesses that offer attractive upside over the long term. However, waning short-term earnings momentum and a lack of appetite for domestically focused equities drove valuations of these counters even lower during the period. Holdings that detracted from the Fund's performance include Afrocentric (-0.9%), Curro (-0.7%), Stadio (-0.5%), AdaptIT (-0.5%) and Hudaco (-0.4%).

The Fund used the weakness in the Stadio share price as an opportunity to add to its position. Stadio reported 1H19 results which were in line with our longer-term expectations. Like-for-like learner numbers grew 7% and Core HEPS rose 47% (partly boosted by recent acquisitions). In our view, the group remains on track to deliver on its target of 56,000 learners by 2026 (learner numbers stood at 31,573 at the end of August 2019). A key outstanding hurdle remains whether the group will be able to achieve full-fledged "University" accreditation. This could materially strengthen the group's offering if successful, and we expect further developments on this front during 2020. While we acknowledge that Stadio appears expensive on short-term valuation multiples, we think Stadio can deliver significant upside over the long term for investors willing to exercise some patience.

The Fund's top performing holding was Zeder, which added 0.8% to relative returns over the quarter. Zeder's largest portfolio holding, Pioneer Foods, received an offer from PepsiCo which values Pioneer Foods at R25bn in its entirety (Zeder holds 28% of Pioneer Foods). The offer valued Pioneer Foods at a 57% premium to the share price the company traded at immediately prior to the announcement. If the offer is successful, the intention would be for Pioneer Foods to delist and for Zeder to return the majority of its proceeds to shareholders. Zeder remains one of the Fund's largest holdings, and in our view remains undervalued.

CHANGES TO THE FUND

In addition to adding to its holdings in Stadio and Zeder, the Fund also entered into a new position in RMI. RMI was recently reclassified as a mid cap share (from large cap previously) which created an excellent opportunity for the Fund to invest in a high quality counter with attractive underlying assets at an undemanding valuation.

RMI's main assets are Outsurance (49% of assets), Discovery (29% of assets), Momentum Metropolitan (11% of assets) and Hastings (10% of assets). RMI recently reported FY19 results, which saw normalised EPS decline 5%. Outsurance's underwriting results normalised lower after an exceptional performance in the prior period, and Discovery delivered reasonable profit growth from most of its established businesses except for SA Life. Discovery continues to invest for growth, and a key highlight from its latest results was 94% growth from its emerging ventures. Discovery's share price has, however, retraced significantly over the past year, due to fears around the implementation of NHI and sell-side research reports alleging aggressive accounting and potentially excessive debt. In our view, the current RMI share price presents sufficient margin of safety to warrant a holding in the stock. Negative sentiment towards holding companies has also resulted in RMI's discount to NAV widening materially over the last few years. The wider than average discount to NAV that RMI currently trades at further supports our favourable view on RMI.

The Fund exited its position in Distell during the quarter. Even though Distell reported satisfactory results for the year ended June 2019 (especially given the challenging trading conditions exhibited in South Africa and some of its other African markets), in our view the valuation no longer offered sufficient headroom and the Fund opted to redeploy the proceeds into more attractive alternatives.

LOOKING FORWARD

When asked about her views on long-term investing during a recent interview, a colleague of legendary value-investor Bill Miller noted that Mr Miller had quipped that over his almost 40 year investment career, it has never been easier to construct a portfolio that he has conviction will do well over the long term, but it has also never been harder over the short term.*

Mr Miller was referring to how more and more market participants have gravitated towards an intense focus on short-term performance, while investors willing to take a truly longer-term view have become few and far between. We share this sentiment.

In the South African small and mid cap context, we cannot disregard the fact that operating conditions for the majority of domestically focused companies are currently very challenging. Low economic growth is a concern, and companies are running hard just to stand still. However, the rush to move money offshore and into less volatile asset classes has resulted in small and mid cap equity valuations retracting significantly over the last 18 months. In our view, this has created attractive opportunities to reposition the Fund into higher quality companies with more attractive risk-return prospects. At the same time, the longer-term expected return of the Fund is currently amongst the highest that it has been for several years.

Although conditions are currently challenging, we continue to be guided by our philosophy of *"long-term investing, well considered*", and believe that patient holders of the Fund should be handsomely rewarded over time.

* Source: https://millervalue.com/samantha-mclemore-consuelo-mack-talk-long-term-investing/