PRIVATE WEALTH EQUITY FUND

Q2 2020

see money differently

MARKET REVIEW

It has been a strong quarter for risk assets, especially equities and credit. Although there is some merit to the exceptional rebound, the speed and magnitude, alongside weaker fundamentals are leaving most investors questioning the sustainability of this seemingly engineered move higher.

The IMF revised their global growth estimates for 2020 down to -4.9%, with global debt reaching an estimated 101% of GDP. Even though activity indicators are improving, most are still well-off pre-COVID-19 crisis levels.

Evidence of a second wave of COVID-19 infections have appeared in various regions, including China and the US. Although this has led to a localised response by most governments and heightened anxiety among market participants, we have yet to see a decisive move back towards economy wide lockdowns.

South Africa continues to progress the re-opening of the economy, even as coronavirus statistics increase and hospitals rapidly fill up. The Supplementary Budget detailed a revenue shortfall in excess of R300bn, R3bn in support for the Land Bank and ballooning debt service costs, which would result in an expected budget deficit of -14.6%. Large scale re-prioritisation of expenditure and the introduction of zero-based budgeting signalled belt tightening, but it was fiscal consolidation that took centre stage. Inflation remains relatively low with the latest print of 3.0% y/y.

MARKET MOVEMENTS

JSE (SWIX40) posted a second quarter return of +23.4% and the ALSI was 23.2% higher. During the quarter, the top performing sectors were Chemicals (+160.5%), Gold mining (+68.0%) and Industrial metals (+65.4%). On the downside, the decliners were led by Electronic & Electrical (-21.2%), Oil and Gas Producers (-17.5%) and Equity Investment (-12.0%).

FUND PEFORMANCE

The Fund returned +15.60% for the quarter, underperforming its SWIX40 benchmark by 7.80% over this period.

Stocks held which contributed to Q2 performance include RMI (+0.48%) and Facebook (+0.24%). Not holding Clicks (+0.73%) and Vodacom (+0.30%) also added to relative performance.

Stocks held which detracted from Q2 performance included Shoprite (-0.96%), Adcorp (-0.76%) and African Rainbow Capital (-0.58%). Not holding Anglogold Ashanti (-0.85%) and Gold Fields (-0.65%) detracted from relative performance. The Fund's underweight position in Naspers for risk management purposes, continues to detract from performance. Over the past 12 months, **NPN & PRX has accounted for 6.3%** of the fund's relative underperformance.

PORTFOLIO CHANGES

INTERNATIONAL EQUITIES

The fund's current allocation to international equities stands at ~23%, diversified across 11 positions. During the period, the fund added to its position in Comcast, while reducing exposure to Carrier and Otis post the unbundling from United Technologies and the partial re-rating.

During the period, key indices in the U.S. turned positive on a YTD basis, leaving many market participants scratching their heads given the dire economic backdrop. On the one hand, markets are forward looking while economic data releases are backward looking. On the other hand, economic stimulus measures in the U.S. have reached unprecedented levels which should aid the recovery as lockdowns ease. The other anomaly behind this apparent divergence is driven by the fact the S&P500 is typically used as a proxy for "the market." The performance of the S&P500 has been skewed by a handful of mega-caps and the impact of these companies has driven the index higher. Beyond these mega-cap constituents, the balance of the S&P500 does more closely mirror the languishing economy.

The big question facing investors going forward is whether the current measures taken by governments and central banks will be inflationary or deflationary? After many years of a relatively benign inflationary backdrop, we believe investors need to prepare for either outcome when thinking about portfolio construction.

In addition, global markets are currently battling with early signs of second waves of virus outbreaks in regions thought to have been over the worst. It remains to be seen whether or not these second waves can be contained and if they will lead to a re-introduction of lockdown measures.

The fund retains a modest holding in USD cash to take advantage of potential opportunities going into the Q2 results season.

Facebook

Facebook is the largest social media company in the world with more than ~3 billion people using at least one of its four platforms every month. These four platforms include Facebook, Instagram, WhatsApp and Facebook Messenger. To a large part of the world, these platforms are the primary way to stay in touch with other people (WhatsApp and Messenger) or interact socially and share thoughts, photos and videos (Facebook and Instagram). For small and medium businesses these platforms are the core of their online presence, while larger corporates use the platforms to increase their brand value.

Like most other companies in the western world, Facebook's latest quarterly results (Q1 2020) can be separated into two distinct periods. The first period included January, February and the beginning of March, where the COVID-19 pandemic had a limited impact on earnings. However, the second half of March was plagued by a hard lockdown in the U.S. and other European countries. The focus was therefore less on the quarter's results, but rather on management's comments on the impact of the lockdown and other COVID-19 related issues since the start of lockdown. To the surprise of many investors, since middle March, Facebook's revenue growth slowed to be only flat relative to the prior year. This compared to an expectation of a sharp decline in revenue. Another positive in the results was Facebook's guidance for slower expense growth of 29% at the midpoint for FY20, down from a previously guided 35%.

Going forward, recently announced ventures such as Facebook Shop, further integration of payments on the WhatsApp platform as well as the India investment in JioMart, provide new avenues for growth.

In the last few days of the quarter, a social media ad boycott gathered traction by some high-profile, global branded goods companies including; Unilever, Honda, Coca-Cola, Starbucks, Clorox and more. The boycott relates to the #StopHateForProfit campaign seeking to emphasise more stringent filtering of posts relating to racism and hate speech on social media. Facebook has responded and is engaging with its advertising customers.

The diversified nature of the advertising base provides some level of protection should the boycott continue longer than what is currently the case. Facebook has a base of ~8m advertisers, with what we view as low concentration risk given that the Top100 advertisers comprise less than 20% of revenue. The fund holds a ~3% position in Facebook.

Alibaba

In May, Alibaba reported its FY20 results which showed an encouraging continuation of previous trends.

During FY20, the Company's commerce platforms reached $1 trillion in gross merchandise value (GMV), a goal it set five years prior. Alibaba's mobile monthly active users (MAUs) reached 846 million, while its annual active consumers (AACs) reached 780 million at the end of the year. These accounts represented 85% of the Chinese population in developed areas and 40% of China's rural population.

Revenue for the Group increased 35% to $72 billion for FY20. Margins saw a strong improvement driven by a strong performance from its high margin marketplace platforms, while losses from newer ventures eased. Alibaba generated $14.8 billion in adjusted operating income, a 57% increase relative to FY19's depressed levels. Adjusted net income increased 72% to $15.4 billion, or $5.76 per diluted share for the year. Alibaba generated $25.5 billion of operating cash flow and $18.5 billion of free cash flow during the year. Alibaba ended the year with a net cash position of $33 billion or $12.40 per share.

Geopolitical tensions have increased with the recent bill passed by the U.S. Senate which aims to increase oversight of U.S. listed Chinese companies. While Alibaba is comfortable that it will be able to comply with the proposed legislation, its secondary listing in Hong Kong serves as a backup for shareholder continuity in a worst-case scenario.

The fund holds a ~3% position in Alibaba given its dominant position and runway for further growth both from its core businesses as well as from its investment portfolio.

DOMESTIC EQUITIES

Domestic equities – Position sizes reduced

During the period, the fund used strength in the Altron share price to marginally reduce exposure given the relatively large position size. Altron remains a business that is well-positioned in the ICT sector given its broad offering and domain expertise. In May, Altron reported a respectable set of full year results showing a 6% increase in revenue, and a 14% increase in EBITDA. Currently 62% of the revenue base is recurring in nature. In addition, while peers are dealing with elevated gearing levels, Altron is conservatively positioned with net debt to EBITDA of 0.5x.

The fund also used strength in the Prosus share price to reduce exposure, as well as to switch exposure into Naspers given the relative outperformance of Prosus and wider discount at a Naspers level. In combination, Naspers and Prosus remains the fund's largest position despite being materially underweight the benchmark.

Within the discretionary consumer exposure in the fund, Truworths and Foschini were reduced in favour of Mr Price, given the stronger balance sheet and being less reliant on credit sales.

Domestic equities – Position sizes increased

Over the last 12 months, the fund has had limited exposure to the life insurance sector. During the period, the fund used weakness in the Sanlam share price to build a modest position. Over the last five years, based on our assessment, the market was ascribing too large a premium to the business, with the average price to group equity value multiple of ~1.3x. Sanlam is a diversified financial services business, with a management team that is focused on long-term returns.

Recently, the market has become much more punitive on Sanlam given the uncertainty that COVID-19 has on the business. Life insurance businesses are impacted in a number of different ways, given all the moving parts. Lapses on existing policies are expected to increase as affordability becomes constrained, market movements affect fee-based revenue streams and concurrently affect balance sheets and capital levels. In addition, mortality and morbidity claims are expected to rise.

Sanlam currently trades at a modest discount to our expectation of one year forward group equity value. We believe the stronger players in the life insurance sector, that have scale and strong balance sheets, will become stronger and more dominant over time.

Company specific commentary

REM/ RMH/ FSR

During the period under review, the RMH unbundling from Remgro as well as the FirstRand unbundling from RMH were completed. The post-unbundling Remgro portfolio continues to be diversified across a variety of businesses, with both local and offshore exposure. Medi-clinic is now the largest contributor to assets at ~22%, while RMI accounts for ~16% of assets. The fund continues to hold a modest position in Remgro given the large discount to NAV of ~30%, its relatively healthy balance sheet, as well as its positioning for a wide range of macro outcomes.

PSG Group

In April, PSG released a cautionary announcement stating that it was considering a corporate transaction which may materially affect the market price. PSG for many years has incubated several successful businesses, and given its structure and healthy balance sheet, had a few levers available in order to address the large discount to NAV at which the business traded. In May, after much market speculation, PSG announced the unbundling of its 28% stake in Capitec, while the group will retain a ~4% holding in the bank with a view to eventually exiting the holding. The key reasons for the unbundling include; future changes to regulatory requirements which would force PSG to hold additional regulatory capital given its interest in a banking operation as well as an insurance operation, additional regulatory reporting requirements as well as to address the large discount to NAV thereby unlocking value for shareholders.

During the period, the fund managed to increase its position size in PSG at attractive levels. Given the elevated level of market volatility, the PSG rump (assets excluding Capitec) traded at a negative valuation for a brief period. This unprecedented valuation implied that purchasing PSG gave investors access to the largest asset, Capitec, at a 10% discount, while receiving exposure to the remaining assets for free.

Capitec recently released a profit warning, stating that earnings for its interim period to August 2020, will decline by more than 20%. Given the lockdown, doubtful debts are expected to increase materially while transaction volumes and sales of funeral policies were lower than the prior year. Capitec's liquidity and capital position continues to be strong, with the deposit base increasing further during the period.

We believe PSG post unbundling will offer investors a well-balanced and diversified basket of attractive SA assets, led by an able, aligned and return-focused management team. PSG Konsult will be largest contributor to the post unbundling portfolio at ~30%.

CLOSING

The dramatic recovery in asset prices in Q2 showed that staying invested and having a long-term focus is exceptionally important. The Oracle of Omaha, Warren Buffett, said it best; "*In the short term, the market is a voting machine, but over the long term, the market is a weighing machine*". In the coming months we expect earnings season to bring increased levels of volatility which will create further opportunities for the fund to allocate capital to attractive risk/reward payoff profiles. Patience and temperament continue to be two behavioural characteristics that we practice daily. While it is still the case that nobody knows the true effects of the virus, we continue to diligently apply our investment philosophy in order to achieve good long-term outcomes.