Allan Gray Fund Provider

January 2021

CLAUDIA DEL FANTE
MANAGER: PRODUCT DEVELOPMENT
ALLAN GRAY

Thank you for attending our Allan Gray Fund Provider

Last year taught us many lessons, and drove home the fact that it is impossible to predict the future. While the uncertainty brought about by the devastating impact of the global pandemic persists, the recovery of financial markets over the past few months brings fresh hope for investors.

We hope that the material shared at our Allan Gray Fund Provider has armed you with new insights to share with your clients to help them navigate the current environment.

To assist with the detail, we have asked each of the managers to put together a summary of their key messages, which we have collated in this booklet. Please refer any specific questions to the relevant presenter.

We look forward to hosting you at our next event.

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Macroeconomic overview

SANDY MCGREGOR
ALLAN GRAY

MARIE ANTELME
CORONATION

Making sense of the global and local economic context

The COVID-19 pandemic continues to run its course across the globe, but with vaccination rollouts beginning, are the prospects for the global and local economy improving? Sandy McGregor, portfolio manager at Allan Gray, and Marie Antelme, economist at Coronation, tackle questions on this subject.

How do you see the path of recovery, post COVID-19?

Marie Antelme: The pandemic slammed a relatively healthy global economy into the worst recession since the 1930s. This was a supply shock, more like a war than the financial crises that are more familiar. The initial recovery was quite strong as mobility restrictions eased and support was abundant.

The second wave has broken the momentum of the recovery, as economies across the world have shut down again, some with restrictions in excess of those in Q2 2020. As we look ahead, the ongoing recovery will be shaped by the rollout of vaccines, and the effectiveness with which countries can break the link between mobility and containment of the virus, which will allow them to return to more normal activity.

Of course, recovery will also be differentiated by geography. The capacity of economies to manage this process effectively and efficiently, as well as the availability of vaccines, are all considerations.

Sandy McGregor: We may see strong global growth over the next 12 months.

> It is very easy to be gloomy about our economy, but there are key basic building blocks for a recovery which are in place. – Sandy McGregor

China is already on that road. There has been a surge in personal savings and people have money to spend – although it is unclear on what they will spend it. The pandemic may well have changed spending patterns.

There is considerable scope for growth to surprise on the upside. Governments are on a binge of fiscal spending, which will promote consumer spending, which in turn will boost international trade, which would have positive spinoffs for open economies such as South Africa. It is very easy to be gloomy about our economy, but there are key basic building blocks for a recovery which are in place: Our domestic economy is leveraged to the external sector. If the global economy improves, we shall improve.

What about emerging markets specifically?

Marie Antelme: Emerging markets do not have the same fiscal and monetary resources that developed economies have. During last year, the loss of revenue, coupled with necessary targeted interventions, saw emerging markets – like their developed counterparts – run large deficits and add materially to large debt stock, but these may become increasingly hard to manage, especially if growth recoveries take a long time. This would mean revenues don't recover, more fiscal support could be needed and there could be political implications.

As the second wave has hit, many emerging markets have battled to contain the virus, and capacity for procuring and rolling out a vaccine strategy varies widely by country. Looking ahead, the biggest challenges for emerging markets will be these – vaccine strategy and a return to growth – coupled with managing materially weaker fiscal positions.

Sandy McGregor: We need to be specific when talking about emerging markets; it is not a homogenous group. Circumstances are different in different countries. India and eastwards may not do too badly. Africa has a serious debt problem, as does Latin America.

Is Treasury able to address the fiscal deficit?

Sandy McGregor: None of us knows the answer. The deficit is bigger than our savings pool. The only way to remedy a savings shortfall is to borrow more from abroad. US fiscal and monetary policy has profound consequences elsewhere. Large-scale money printing could promote capital flight out of the dollar into other currencies, including those of emerging markets, and we should be among the beneficiaries. If the US Federal Reserve (the Fed) increases interest rates, the dollar would strengthen, and we could be disadvantaged.

If there is no money to fund our deficit we shall be in trouble and our Reserve Bank would be under pressure. In managing this challenge, the SARB wishes to avoid printing excessive amounts of money. Printing money is not an option for SA as it is for the US. The reason for this is the potential consequences: capital outflows and a weaker rand, which would adversely impact inflation and take us in the direction of Zimbabwe.

Can we grow out of our debt problem?

Sandy McGregor: The only way to sustainably reduce debt as a percentage of GDP is to grow our economy. In this regard, things are not currently all bad. There are two sectors of the economy that are doing well: Mining and agriculture. Mining produced record revenues and profits in the last six months of 2020: Our revenue from the 10 biggest commodities we exported grew by US$1bn per month;

3.6% of GDP. Meanwhile, after good rains, agriculture is having a bumper year. However, tourism and much of the hospitality sector are dead.

Sustainable growth requires the government to accept that the private sector is the engine of growth. We need to introduce reforms to allow the private sector to grow the economy. This will present the ANC with political challenges, but the state simply doesn't have skills to manage the economy.

Marie Antelme: Ensuring a sustainable fiscal position is certainly about growth, but not exclusively. Fiscal sustainability is not just about funding a revenue shortfall; it is about addressing the causes of the shortfall to ensure that government can meet its financing obligations through time.

We were vulnerable coming into the pandemic. To create a sustainable fiscal path we need to address two things: Nominal growth and expenditure relative to GDP. At this stage, nominal growth should get a welcome tailwind from the recovery in global growth and trade, which has given us a strong trade surplus, the impact of which I think is underappreciated. Our trade account surplus isn't just a reflection of a collapse in imports, exports in volume terms have improved; this could provide a strong fillip for growth, as well as the fiscus through higher related revenues. Then rightsizing government expenditure in GDP is necessary to return to a more manageable and less vulnerable path.

To create a sustainable fiscal path we need to address two things: Nominal growth and expenditure relative to GDP.
– Marie Antelme

The crisis has highlighted a range of fragilities in our country. We have to address state capacity and the involvement of the private sector to generate better, more inclusive growth: We need to come out of the pandemic doing things differently.

How sustainable is wage containment?

Marie Antelme: We do not have the luxury of being able to expand fiscal expenditures, especially to the wages of civil servants who have been well-remunerated for a long time. Importantly, after a long period of growth, we need to contain wage-expenditure as a proportion of GDP.

The government wage negotiations are always challenging, but the pandemic complicates the process. While the Labour Court of Appeal ruling in favour of National Treasury's wage freeze in 2020/21 helps set a new base, the new agreement will have to strike a balance between political objectives and the economic and fiscal realities that government does not have enough money and that the economy has suffered enormous private sector job loss, which may struggle to recover. In these circumstances, government needs to be circumspect in how it allocates scarce resources. I think unions will be more pragmatic in their demands under these circumstances, but it will be important for government to 'come to the party' and demonstrate it is not wasting money either.

Sandy McGregor: If government does not provide the Treasury the support it requires to achieve fiscal stability, markets and the rand will react adversely. The outcome is very dependent on politics.

Is South Africa's inflation heading towards global norms?

Sandy McGregor: Regarding inflation, SA is on a journey to join where the rest of the world has been for more than three decades. Average wage growth is adjusting downwards to match lower inflation. As a consequence of the pandemic, there is currently a wage freeze in much of the private sector. Growing wages facilitated SA economic growth for the past 20 years by boosting the share of retail spending in the economy, but simultaneously increased the cost of doing business. This era has now come to an end. Remuneration will now grow in line with the economy – as is the case in most of the rest of the world.

We are an open economy – and are influenced by global inflation levels and global trends. Our inflation rate should converge with that of the rest of the world. However, the danger is that global inflation could move dramatically upwards due to the widespread adoption of modern monetary theory.

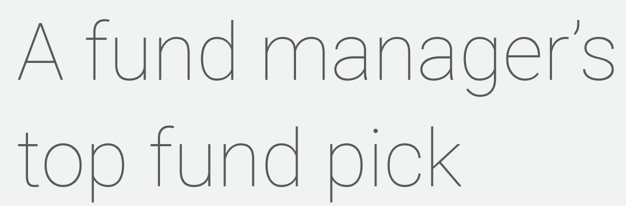
Marie Antelme: Our reliance on foreign investment and foreign portfolio flows leaves us vulnerable to reversal in those flows. This is a potential trigger for higher inflation and an ongoing risk.

So, what happens when you come out of the pandemic? Describe an upside scenario.

Sandy McGregor: Just as World War Two fundamentally changed people, the pandemic will also fundamentally change us. The world will change. We are not going to go back to the old times.

An upside could be a strong recovery in the global economy, which would provide a positive boost for SA. People would then do more business, make greater profits and be joyful.

Marie Antelme: We should move with the global recovery but to capitalise on global growth we must keep the lights on. Our biggest short-term challenge is our capacity to produce the electricity we require and our ability to restore mobility to all sectors of the economy.


A fund manager's
top fund pick

TIM ACKER
ALLAN GRAY

Allan Gray Balanced Fund: Optionality, the most unappreciated asset

One of the most unappreciated assets in a portfolio is optionality – the ability to take advantage of market disparity and to move between and within asset classes. Portfolio manager, Tim Acker, discusses how the Allan Gray Balanced Fund uses this feature to its advantage and explains why we are cautiously optimistic about the Fund's ability to deliver future returns.

2020 was an extremely volatile year and illustrated the value of flexibility in investing. Being able to opportunistically move between asset classes gives us the ability to position the Allan Gray Balanced Fund (the Fund) to take advantage of different opportunities as they arise. In saying this, it can take time for a thesis to play out; patience is key.

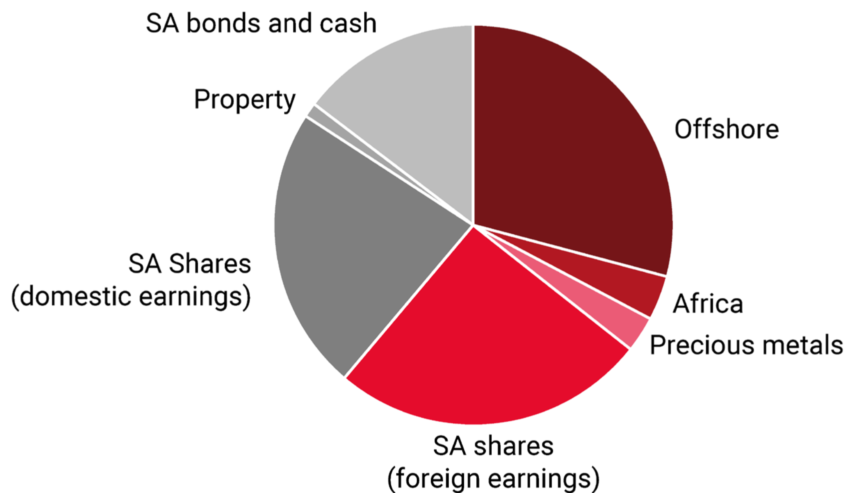
Being able to opportunistically move between asset classes gives us the ability to position the Allan Gray Balanced Fund to take advantage of different opportunities as they arise.

Performance review

Over the past few years absolute returns have been low and, while we have matched our benchmark over five years, returns have been disappointing. Our relatively high exposure to SA inc. shares, our low exposure to resources shares, and not being fully invested in the offshore portion have all detracted from performance. Nevertheless, we believe the Fund is well positioned to deliver future returns (see **Graph 1** on page 11 for a view of positioning).

The FTSE/JSE All Share Index (ALSI) ended 2020 7% up – a result that seemed unlikely when the markets crashed in March.

Graph 1: Asset allocation of Allan Gray Balanced Fund



Source: Allan Gray research, 31/12/2020

However, this doesn't reflect the true health of the local market: Performance has been driven by a handful of large shares, including Naspers, major diversified miners and platinum miners. The average South African share is lower today than four years ago.

The SA market has also substantially underperformed the World Index and delivered disappointing returns, especially when measured in dollars. This reflects the company we keep: Emerging markets on the whole have disappointed. The ALSI is back to 2003 levels relative to the World Index – a poor outcome for SA savers. This is partially a reflection of low valuations for many South African businesses.

Over the last decade, the JSE has been about flat in US dollar terms, including dividends. The US has been the star performing market, with the S&P 500 up 3.5x over this period. Based on this, investors are naturally tempted to conclude that it is best to invest in the US. However, investing by looking in the rearview mirror can be dangerous. After the decade from 2000 to 2010, one would have concluded the opposite.

The S&P 500 had been flat for 10 years and the ALSI was up 6x in US dollars. Currently the US is trading at close to record high valuations, while SA valuations are below historical levels. We think this presents an attractive opportunity.

Select local opportunities

While we are not overly bullish on South Africa, we believe there are some nice opportunities locally. However, SA clearly faces many serious challenges: The fiscal deficit is worrying and the options to bring it under control – raising taxes or cutting spending – will be painful to implement. Meanwhile, the debt-to-GDP ratio is forecast to rapidly approach the 100% level. Notwithstanding this, yields on SA government bonds are higher than they have been for most of the past decade – in an environment where the rest of the world is starved for yield.

While clearly the risks are elevated, we think the yields appropriately compensate investors. We are cautiously optimistic about SA shares and bonds and are buying selectively.

Offshore options

About 30% of the Fund is invested directly offshore, but a substantial portion of the SA share exposure is to companies that earn their earnings outside of the country. Examples include our three biggest holdings: Naspers, British American Tobacco and Glencore. An investor in the Fund therefore has more than half their money invested in assets with underlying exposure outside SA.

When it comes to our offshore positioning, there are two things to note: Firstly, more than one-third of the offshore portion of the portfolio is invested in cash and hedged equities, and secondly, we are underweight the US market.

We are concerned about high valuations in global equity markets, particularly the US, and our offshore partner Orbis is picking opportunities very carefully. A large portion of the S&P 500's performance over the last five years has been driven by the so-called FAAANM stocks (Facebook, Amazon, Apple, Alphabet, Netflix and Microsoft). The World Index is also becoming increasingly concentrated as returns have been driven by large companies. The top 10 shares now account for 17% of the Index – very high by historical standards. Previous periods of high concentration have often been followed by large stocks underperforming.

We are excited about the positioning of both the local and the offshore portion of the portfolio. We think the prospects for relative returns are particularly attractive in the offshore portion, given the wide divergence in valuations for certain global stocks and sectors.

MARC TALPERT
CORONATION

Coronation Optimum Growth Fund: Global investing unconstrained

In an uncertain and complex world, discretionary investors are looking for freedom in investing. Coronation portfolio manager, Marc Talpert, discusses why the Coronation Optimum Growth Fund, with its worldwide flexible mandate, offers an attractive solution for investors.

What do long-term discretionary savers want?

Investors with discretionary savings are not only looking to preserve and protect their capital from the erosion effects of inflation, but to compound their global wealth in real terms over multiple decades. But having that goal and achieving it are two different things. In an uncertain and complex world, having to make those decisions as an investor of where to invest and in what assets can present an overwhelming set of choices.

> While no one can predict the future, when it comes to investing, you can prepare by building robust and resilient portfolios.

The rationale for the worldwide flexible mandate: Optimum Growth

The Coronation Optimum Growth Fund (the Fund) has a worldwide flexible mandate, which offers an attractive solution to counter these complexities. The Fund is not bound by regulatory limits, is geographically unconstrained, is able to allocate to non-equity assets and is managed with the South African investor in mind.

Optimum Growth is a long-term portfolio of the best investment ideas Coronation can find around the world. It can invest anywhere globally and across all available listed asset classes. It is founded on

Coronation's core principles of deep fundamental research and independent thinking. It draws from the full breadth of the asset manager's exceptionally accomplished investment team when deciding on the optimal allocation between growth and income, as well as emerging and developed market assets. It is not benchmark cognisant.

The Fund is aggressive and aims to achieve a long-term return of at least 5% above inflation, so it is best suited to those investing for the long-term who are willing to deal with a higher level of risk than a classic 60/40 global equity/bond multi-asset portfolio. The Fund's average historical equity exposure was between 70% and 80%.

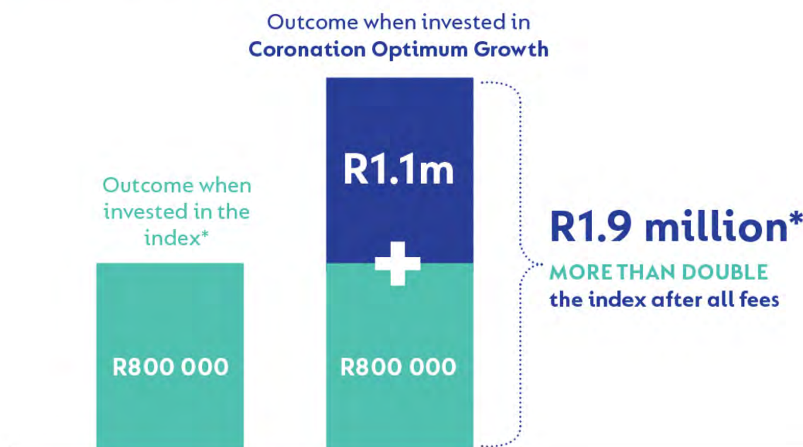
Current views and positioning

There is some reason for optimism as we are closer to the end than the beginning of the COVID-19 pandemic. However, life has changed permanently for many companies and some simply won't survive, while others will thrive. And while global equity markets are no longer cheap at index level, we continue to see fantastic stock-specific opportunities. Many of our holdings across developed and emerging markets continue to operate successfully and are attractively priced.

Being equity centric, the Fund currently has 73% equity exposure across developed and emerging markets. The Fund's negative view on global bonds remains unchanged and it has negligible bond exposure. It has very little exposure in listed real estate across the world mainly represented by residential in Germany. The gold position has been increased, and the Fund has bought some gold shares as they act as a good diversifier.

More than double the index over 20 years

Investors who have remained in Optimum Growth since its launch in 1999 have achieved returns more than



Performed fees quoted net of fees from Morningstar as at 30 November 2020 for a lump sum investment with income distributions reinvested.
* MSCI World Index
** Since inception of the A-class in March 1999
Source: Coronation

double that of the MSCI World Index at end November 2020. While investors should not expect it to deliver a smooth double-digit annual return, for those with patience and seeking meaningful real wealth creation over time, then Optimum Growth could be the right choice.

Can this performance be repeated over the next two decades?

The same factors that have driven the remarkable performance of Optimum Growth remain in place at Coronation today.

For 27 years, the company has remained single-minded in the pursuit of creating wealth for clients, while responding to ever-changing market conditions with acuity. Active long-term investing is about focus, agility and conviction. While no one can predict the future, when it comes to investing, you can prepare by building robust and resilient portfolios.

ROB FORSYTH
NINETY ONE

Ninety One Global Franchise Feeder Fund: Demonstrating resilience

With an attractive combination of resilience and high-quality structural growth driving strong absolute returns and overall outperformance, Ninety One senior investment specialist, Rob Forsyth, unpacks why Ninety One is backing its Global Franchise Feeder Fund as a top fund pick over the medium term.

At the start of 2020, few investors would have predicted the impact the coronavirus would have on markets; fewer still would have predicted – at the market lows in March – that global equities, as measured by the MSCI All Country World Index (ACWI), would ultimately end the year up over 16% in US Dollars. Despite the rollercoaster, the Global Franchise Feeder Fund outperformed the benchmark index over 2020, the fourth consecutive calendar year of outperformance.

> The attractive combination of resilience and high-quality structural growth has again led to strong absolute returns and overall outperformance.

The influence of COVID-19 was felt in very different ways throughout the year, in three distinct phases:

- The first phase (Q1 2020) was the market drawdown following the initial shock and shutdown.
- The second phase was the K-shaped recovery (Q2 & Q3 2020) when growth outperformed value, as policy makers stepped in.
- The third phase was the rotation towards value and cyclical stocks, during a reflation trade that supported cheaper, more economically sensitive shares.

Market drawdown

Global Franchise returned -12.9% versus -21.4% for the MSCI ACWI. Defensive holdings such as Roche and Nestlé contributed to outperformance, while our positions in high-quality structural growth companies also contributed to outperformance. Examples included Microsoft and NetEase, and Moody's, which benefited from rising debt issuance as companies around the world sought to strengthen their cash positions.

Our travel-exposed stocks, Booking Holdings and Amadeus, were the most significant detractors. Other quality cyclical positions also underperformed, for example St. James's Place (given its exposure to market movements), Fox (as live sports events were cancelled and advertising revenues dried up), and Charles Schwab (as zero-bound rates and flat yield curves negatively impacted net interest income). We invested cash in March and April following the market weakness, adding to stocks we believed to be oversold, and initiated positions in two new high-quality stocks, Electronic Arts and Estée Lauder.

Growth-led, K-shaped recovery

Global Franchise returned 22.8% versus 28.9% for the MSCI ACWI. During this period, the market sought growth at any price (while punishing value stocks), with additional monetary stimulus driving further re-ratings. Our purist quality focus steers us away from growth stocks where top line growth does not translate into actual free cash flow growth or sustained levels of profitability, where balance sheets are stretched and where valuations are expensive.

Although some of our highest structural growth names like Moody's, S&P Global, Intuit and ASML did well, the biggest impact to relative performance came from what we don't own. A combination of the strong performance and large index weightings of Amazon, Apple and Tesla, meant that not owning those stocks detracted significantly from relative performance. In addition, the defensive names that had helped in Q1 lagged during the rebound.

Reflation trade and market rotation

Global Franchise returned 9.5% versus 14.7% for the MSCI ACWI. The final quarter of the year saw a rotation away from growth/momentum towards more cyclical/value stocks, notably in November, as positive vaccine news, further fiscal stimulus and reduced political uncertainty all contributed to 'risk-on' sentiment and a reflation trade. Economically sensitive/cyclical areas and especially direct COVID-19 casualties recovered some of their lost ground, with typically lower quality industries such as banks, energy, airlines and autos leading the market, contributing to the Fund's underperformance. Within the portfolio, the main beneficiaries were Booking Holdings, Charles Schwab, ASML and Samsung Electronics, and St James's Place.

Looking forward

Global Franchise delivered smoother returns last year when compared to the index, and the attractive combination of resilience and high-quality structural growth has again led to strong absolute returns and overall outperformance. Moreover, the alpha signature remains consistent and true to label, with the relative performance broadly in line with expectations in each case outlined

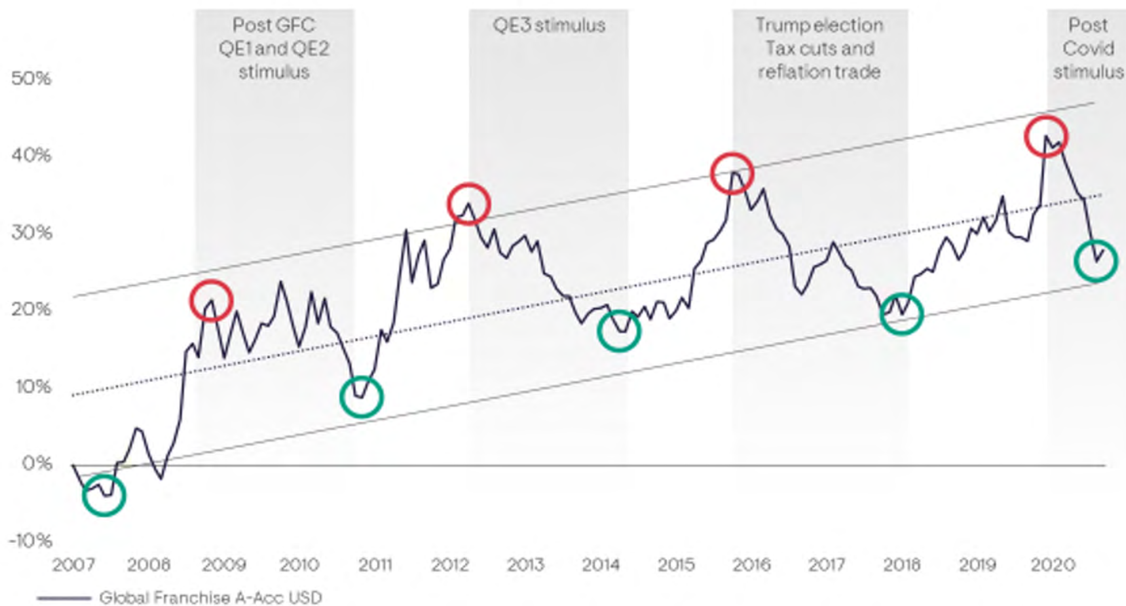
previously: outperforming in the down-market; participating in the up-market; and lagging the market in the rotation.

The quality characteristics we seek remain attractive, as do relative valuations versus the wider market, and the companies we own have invested substantially to future-proof their business models, with significant exposure to key long-term trends such as data usage and digitalisation, ageing populations and health care, and nutrition and wellness. The portfolio is also very well positioned to contend with the growing threat of climate change, with a carbon footprint that is less than 10% of that emitted by the wider market, with further purchases of sustainably growing companies.

Moreover, we remain demonstrably committed to the style at a time when analysis suggests that outperformance may be imminent.

Global Franchise alpha cycle

Cumulative (net) outperformance since inception*



Past performance is not a reliable indicator of future results, losses may be made.
Source: Ninety One, 31 December 2020. Performance is net of fees (NAV based, including ongoing charges, excluding initial charges), gross income reinvested, in USD.
*Inception date 10 April 2007. The performance is based on the OEIC Ninety One Global Select Equity Fund from 10 April 2007 which then merged into Luxembourg-domiciled Ninety One Global Franchise Fund on 04 July 2009. Fund Benchmark: MSCI AC World NDR (pre Oct-11, MSCI World NDR). Highest and lowest returns achieved during a rolling 12 month period since inception: Feb-10: 54.4% and Feb 09: 38.7%. The Fund is actively managed. Any index shown is for illustrative purposes. For further information on indices please see the Important Information section.

SIMON SYLVESTER
REZCO

Rezco Value Trend Fund: Creating value

Simon Sylvester, portfolio manager at Rezco Asset Management, provides a view of the market and how Rezco multi-asset funds are positioned to withstand market volatility.

While 2020 was generally a tough year by most standards, Rezco, as a company, true to our investment style and philosophy of having managed assets through various market cycles, has done well to weather the storm exceptionally well.

Having identified the COVID-19 risk at the end of January 2020 through our active asset allocation style, we dramatically reduced our equity exposure. Having made this call our funds were still able to deliver phenomenal returns at very little or no drawdown compared to our peers and the market.

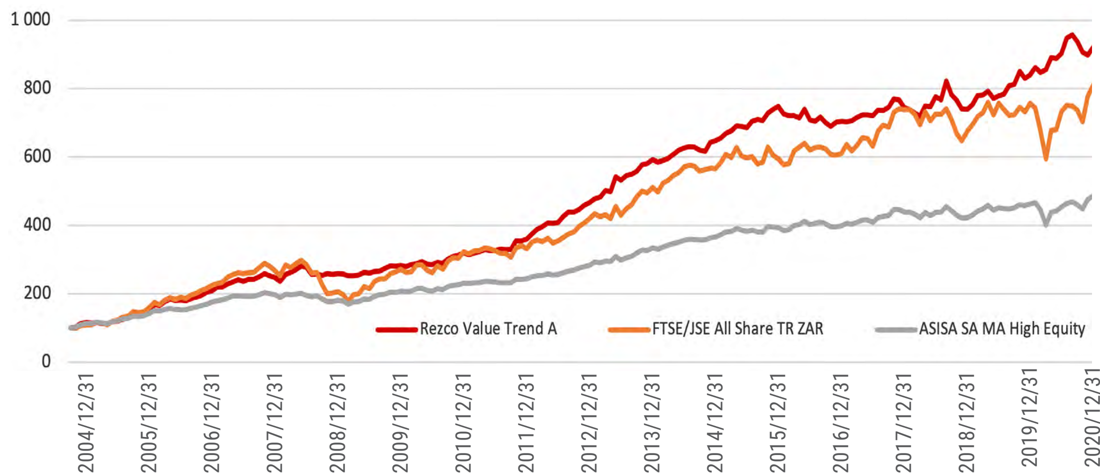
> … trying to time the "pop" is very dangerous, and holding this view works very well with our investment style being benchmark agnostic.

The canary in the coal mine

Recently we have experienced unprecedented volumes of retail investor capital flows, and this can be seen in the mistaken trade of Signal Advance (SIGL) based on a single tweet from Elon Musk.

Another red flag is the amount of capital invested into Special Purpose Acquisition Companies (SPACs) - essentially a company with zero operations, created solely for acquiring other companies, and thereby bypassing the regulatory process of listing on the stock exchange. We feel this brings additional euphoric risk into a market which is already frothy and in danger of overheating.

Rezco Value Trend Fund performance



Source: Rezco

There is consensus among economists and asset managers that technology stocks have possibly run too hard, but the Goldman Sachs Non-Profitable Technology Index demonstrates clearly that the prices for tech securities have broken away from any fundamentals.

What is fuelling the exuberance?

Central banks globally have injected stimulus capital into most economies, with the G4 adding a whopping $29tr to bolster their economies. It is our view that this additional stimulus is adding to the market volatility we are currently experiencing with consequences that are yet to play out. We think that the market is wrong in discounting these effects and the result has the potential to damage the global economy on a scale similar to the dot com crash of the early 2000s.

Additionally, the nature of stimulus is different now than it has been for the last decade, in that the recent stimulus does not return to the US Federal Reserve balance sheet, but remains sloshing around the system.

How does it play out?

With this much stimulus, we feel the logical result is that inflation starts creeping up and accelerates into 2022 - all else being equal. The risk investors face is that the market may start discounting the inflation risk early, leading to increasing interest rates, and ultimately massive capital losses for bondholders, and causing drag on company earnings due to a higher debt burden. In fact, headline inflation does not yet reflect sectoral inflation figures, which will take some time to filter through.

At Rezco, we remain defensively positioned in all our multi-asset funds, with a reference for companies with supply shortfalls.
As history serves us the opportunity to learn and reflect, we are reminded that the dot com bubble didn't burst in 1999 when valuations had skyrocketed. It took some time for the prevailing sentiment to catch up, but the result was arguably catastrophic. We feel that trying to time the "pop" is very dangerous, and holding this view works very well with our investment style being benchmark agnostic.

We continue to search for risk-adjusted returns which can be found at the intersect of active asset allocation and active stock selection.

Top stock pick

DUNCAN ARTUS
ALLAN GRAY

The investment case for Woolworths

Woolworths (WHL) is one of the top 10 holdings in the Allan Gray Equity, Balanced and Stable funds. Allan Gray chief investment officer Duncan Artus discusses the investment case.

WHL's share price peaked at over R100 in 2015 on the back of strong trading performance in South Africa and the acquisition of Australian department store David Jones for over R20 billion, with the aim of creating a Southern Hemisphere retail giant. The market was willing to pay over a 25 price-to-earnings (PE) multiple for WHL's earnings at the time.

> The most important part of an investment case is always comparing the current price we are paying versus our estimate of intrinsic value.

Since the peak, WHL has underperformed the FTSE/JSE All Share Index (ALSI) by over 60%, as the market realised WHL had significantly overpaid for David Jones, the South African economy performed poorly, and the clothing division produced mixed results. This change in sentiment offered an attractive opportunity to build up a position in the portfolio as the share underperformed.

Assessing risk and opportunity

We believe WHL's food division is one of the few world-class businesses in South Africa, and the division continues to produce strong sales and profit growth at return on capital. Competitors have clearly noticed this success and are targeting WHL's high-income customers but, in our view, the brand has large equity with its clients and the competitive moat around the business is strong. The Fashion, Home and Beauty (FHB)

division has had a much tougher time of it over the last few years, and we think profits are well below potential. It is not a certainty that the division can be turned around in a competitive market but, given the upside, this is a major focus of WHL management.

WHL also owns Country Road, mainly based in Australia, which is a valuable brand and has developed a strong omni-channel offering. "Omni channel" refers to the ability to service customers both from physical stores and online. We believe the experience gained in Australia should benefit the South African business as it seeks to build out its online offering.

David Jones remains both a risk and an opportunity as the department store model comes under pressure globally due to structural changes the market is aware of. WHL has already written off half the original investment. At one stage the market was placing a negative value on David Jones, which we considered too punitive, and we are encouraged by the steps new management has taken to make David Jones a smaller and more sustainable business, while realising considerable value from the Australian property portfolio. This has allowed WHL to reduce group debt to manageable levels and therefore reduce a source of potential risk.

The price you pay counts

The most important part of an investment case is always comparing the current price we are paying versus our estimate of intrinsic value. WHL is trading on around 10 times our estimate of normal earnings with further upside from more restructuring. We think that is attractive.

Fund update

DELPHINE GOVENDER
PERPETUA

Is it all doom and gloom for SA Inc?

After years of anaemic profit growth, SA Inc shares are beginning to reveal pockets of opportunity. Delphine Govender, Perpetua chief investment officer, delves into the select opportunities that SA Inc shares offer.

SA Inc includes companies exposed predominantly to the domestic economy

South Africa oriented companies and sectors, commonly referred to as "SA Inc", typically include a cohort of companies and sectors, which derive the majority of their revenue and profits from South Africa – both in terms of being geared to the domestic economy and exposure to the rand. This SA Inc basket typically includes Banks, Insurers, General Retail, Food & Drug Retail, Food Producers, Telcos, general industrial companies, domestic financial services companies and select hospital companies.

> Bottom-up fundamental analysis points to clear pockets of opportunity for outsize returns from SA Inc shares given current prices.

SA Inc companies have recorded anaemic profit growth for several years

Over the past five years, even excluding the effects of COVID-19, SA Inc companies share prices have performed poorly versus the more popular rand-hedge basket of non-commodity and commodity shares. This has been driven by a very difficult and opaque macroeconomic and socio-political environment characterised by low levels of economic growth; weak consumer and business confidence; a lack of fixed investment; rising and heavy levels of unemployment; constraints of fiscal expansion due to high and increasing

government debt levels; deep policy uncertainty and structural challenges in terms of electricity supply. All these headwinds have been manifested in very anaemic profit growth for SA Inc from 2015-2019, where this group of companies collectively achieved no real growth in profits. Then came 2020, when business shutdowns significantly reduced activity as a result of COVID-19 and saw a complete decimation of profits compared to prior years. Facing an already beleaguered situation pre-pandemic, SA Inc companies could in fact hardly afford the effects of the pandemic on business operations and this created immense strain.

The South African stockmarket excluding Naspers has derated meaningfully

Unsurprisingly, just the anticipation of what was expected to happen to profits saw the share prices of SA Inc companies falling precipitously in 2020, many sub-sectors fell by well over 50% during the year. These declines reflected both the expectation for evaporating earnings and also a potential for deeply dilutive capital raises and restructuring to shore up balance sheets and establish liquidity. Excluding large index rand-hedge heavyweight Naspers, the SA equity market trades well below its long-term average at around 10x earnings and also trades at a significant discount to other emerging markets. Within the market too there is wide disparity with several mid- and small-cap domestic shares significantly underperforming the more popular large-cap shares.

A positive macro is not required to see some meaningful rerating in SA Inc shares

As we stand here at the start of 2021, macroeconomic and political factors in SA still look poor and it's hard to present anything but a "low-road" outlook into the medium term as many structural reforms still look very opaque. Notwithstanding this, bottom-up fundamental analysis points to clear pockets of opportunity for outsize returns from SA Inc shares given current prices. There is a clear group of domestic companies who have used the past several months to establish financial stability; flex internal levers of cost control; develop rapid turnaround of divisions; pivot their business models to benefit from structural shifts by agile and aligned management teams seeking to take advantage of the opportunities that can be presented in times of crisis. Most importantly many market participants have been more focused on the disastrous macro than the micro and have failed to acknowledge these internal improvements. This has been compounded by the lack of clarity over the vaccine deployment programme. These factors have resulted in compelling valuations in average to above average quality domestic businesses that we believe will endure post pandemic.

Perpetua sees select opportunity in SA Inc shares

Given research conducted, Perpetua has been selectively building positions in the more neglected, undervalued SA Inc over the past six months given high probability for upside vs downside risk to returns. We have already seen some of this return delivered in recent rerating of SA Inc shares in 2021 to date. We are of the view that from current levels at start of 2020, the Perpetua SCI Equity Fund stands to deliver outperformance vs equity benchmarks over the medium term given our differentiated, more SA Inc mid-cap oriented equity portfolio that currently reflects compelling value with low risk of permanent loss.

SANDILE MALINGA
PRUDENTIAL

Multi-asset funds have bright prospects going into 2021

Over the 10 months since the worst of the coronavirus-related market crash in mid-March 2020, South African asset prices have recovered steadily, with fund performance reflecting this. Sandile Malinga, portfolio manager at Prudential Investment Managers, shares why investors in multi-asset funds have good reason to feel optimistic going into 2021 and beyond.

In the ASISA Multi Asset Low Equity sector, the average fund has returned a very respectable 21.3%, but there has been a wide divergence of returns between funds, with the lowest delivering only 1.8% and the highest producing 36.3%.

> Prudential's Inflation Plus Fund has been one of the top-performing unit trusts in the category with a 33.1% return over the period.

Consequently, the investor experience has likely varied from extreme disappointment to relative satisfaction.

Prudential's Inflation Plus Fund (the Fund) has been one of the top-performing unit trusts in the category with a 33.1% return over the period, and we are excited by its return potential going forward over the next five years. This is thanks to both the very attractive valuations at which we have bought its holdings (some at generational lows), and the fact that such a large and diverse proportion of its total assets have such high prospective returns. Both of these factors increase the probability of fund outperformance into the future under various scenarios.

Looking at the Fund's positioning, it holds large active overweights to SA bonds and SA equities, and a moderate overweight to SA inflation-linked bonds (ILBs). According to Prudential's valuation analysis,

which assumes inflation at 4.5% p.a. over the next five years, although these assets have recovered in recent months, they are still valued at very attractive levels compared to their historic fair value.

For SA bonds, the prospective five-year real returns are the highest they have been since 2004, with the 20-year government bond indicating a real return of 7.6% p.a. and the 10-year bond returning 5.9% p.a. as of the end of 2020. ILBs are also an attractive holding as a diversifier that is offering good value: our analysis shows they should deliver a real return around 4.1% p.a. as an asset class compared to their historic average of 2.0% p.a. real.

As for SA equities, their valuations at the end of 2020 pointed to a real return of 9.5% p.a. for the asset class over the next five years, versus their historic fair value of 6.5%. SA listed property also has a prospective real return of 9.5%, but is trading even more attractively due to its lower historic fair value real return of 6.0%.

Our underweight to listed property in the Inflation Plus Fund is our largest active underweight position and is due to the high prevailing earnings uncertainty in the sector combined with relatively high levels of debt and weak growth prospects. There is a higher degree of safety in other sectors with equally high return potential, such that we prefer taking overweight positions in sectors such as banks (Standard Bank and Absa are among the Fund's top overweights). The Fund has its other significant overweight holdings in large, diversified global companies like British American Tobacco and Anglo American, and in well-valued groups like Multichoice, all with good potential to outperform the market.

As for its offshore positioning, Inflation Plus has a large underweight to global government bonds due to the broadly negative yields prevailing across developed markets. Although historically global bonds have offered an average real return of around 1.8% p.a., currently as an asset class they are set to deliver -0.6% p.a.

The Fund also has a small underweight holding in global equities, since global markets are collectively slightly expensive due to the predominance of the expensive US market. As an asset class, our valuations show the five-year prospective real return from global equities at 4.9% p.a., when historically its fair value has been 5.5%. On top of this, the rand remains undervalued against the major global currencies, so that any appreciation from current levels could contribute to losses going forward in rand terms.

Looking at the Fund's overall asset holdings and their current valuations, the Inflation Plus Fund is set to deliver a real return of approximately 6.3% p.a. over the next five years. This assumes that nothing else changes and asset prices and market ratings stay the same going forward. However, should asset prices reprice towards their long-term "equilibrium" or fair value levels, the Fund has a prospective real return of 9.0% p.a.

It is positioned to outperform its history under a number of conditions, including: if the status-quo continues; if SA equities re-rate; if the SA yield curve flattens from its current steep shape; or if the listed property market rallies. It is likely to underperform, however, if the SA yield curve steepens further; if there is a repeat of the listed property crash we experienced in 2020; or if South African and global equity markets derate going forward.

SHAUN LE ROUX
PSG ASSET MANAGEMENT

An alternative view to the conventional wisdom around perceived "safe" and "risky" assets

PSG Asset Management portfolio manager, Shaun le Roux, discusses how the fund house's alternative view of risk has unearthed opportunities in small- and mid-caps, both locally and abroad.

At current multiples and yields, we believe the consensus 'safe' assets are actually very risky destinations for capital. In addition, extrapolating past economic trends may be a very poor guide to what lies ahead, especially regarding inflation, interest rates and currencies. Applying our alternative view of risk has enabled us to identify a rich opportunity set of underpriced assets, both in South Africa and globally.

> Focusing our research efforts on uncrowded or unloved regions and sectors raises our odds of finding 'quality on sale', with one of the areas being South African small- and mid-caps.

There is a massive bifurcation between the price levels of those assets generally perceived as being low risk and everything else. Many commentators have highlighted the extreme outperformance of the growth factor over the value factor, but this is just one of several 'themes' highlighted in **Table 1** on page 30.

Applying our alternative view of risk has enabled us to identify a rich opportunity set of underpriced assets, both in South Africa and globally. Focusing our research efforts on uncrowded or unloved regions and sectors raises our odds of finding 'quality on sale', with one of the areas being South African small- and mid-caps.

Exploiting the opportunity in small- and mid-caps

While we do not view ourselves as small-cap

Table 1: The matrix of conventional wisdom: circa Q3 2020

Risky ~~"Safe"~~ Assets	Safe ~~"Risky"~~ Assets
US Equities	Japanese, UK and Emerging Market equities
Large Cap Equities	Mid and Small Cap Equities
Index Funds or quasi index funds	Actively managed funds with off index positions
FAANG stocks	Financials, Resources and other cyclical sectors
Growth and Momentum Factors	Value and Free Cash Flow Factors
US Treasuries	SA Government Bonds
"Hard" currencies	SA Rand and other EM currencies

managers, many of the opportunities meeting the attractive valuation criteria highlighted above fall within the ambit of the JSE small- and mid-cap universe. While shares with smaller market capitalisations tend to outperform their large-cap peers over the longer term, they have underperformed over the last 10 years, primarily due to substantial underperformance over the last three years.

This underperformance has been driven primarily by a relative derating of smaller-cap shares, hence the attractive opportunities and high prospective dividend yields we are seeing in this area of the market. Potential reasons for this being such fertile ground for mispricings are:

- Globally, there has been a protracted bias towards growth over value shares. In most cases, South African small- and mid-cap shares are regarded as value shares, given the lack of economic growth.
- Emerging markets have been out of favour and South Africa has not been spared.
- South African small- and mid-cap shares are perceived to be entirely reliant on the local economy. However, many of these companies are more diversified and resilient than perceived and often earn a significant amount of their profits in hard currency.
- There is very little broker research coverage of the small- and mid-cap universe.

To put it bluntly: South African smaller-cap value shares are the most unloved part of an unloved market within an unloved investing style.

In conclusion, as we enter 2021 we find that areas of the market offering the most potential remain very out of favour. The widespread capitulation out of emerging markets and economically sensitive shares by both local and foreign investors has yet to normalise in any meaningful way. Capital flows and positioning continue to suggest a remarkable degree of crowding into areas which have worked well until now. South African assets (apart from the well owned large-cap shares) stand out as being particularly unloved. We believe a differentiated positioning in carefully selected companies will become an increasingly valuable component of an investor's portfolio going forward.

GUY TOMS
PRESCIENT

Investing in income funds in an environment with negative real interest rates

Prescient chief investment officer, Guy Toms, outlines what zero interest rates mean for asset prices and how an income fund investment, with stability in the fund, can provide investors with a safety net from which to fund retirement income drawdowns.

A new world: r = 0%

The interest rate is the price of money, the cost of borrowing it or the return earned on lending it. The price should compensate the lender for the risk of the counterparty it is lent to. Throughout the developed world, interest rates are now essentially zero.

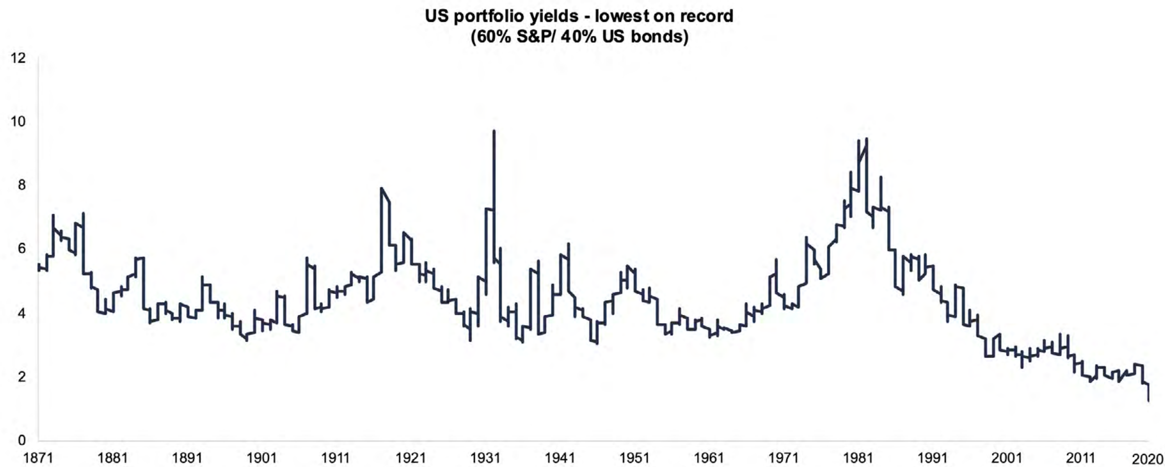
In a period of negative real rates on cash and volatile equity markets, a low volatility positive real yield income fund will provide a safety net from which to fund disbursements.

This zero-state world has huge implications for all asset prices. It means low-income yields on traditional money market and bond investments, and this in turn has resulted in money flowing into other asset classes such as credit, equities, property, commodities, and cryptocurrencies. The result is that asset prices have generally been driven up to highly elevated levels.

What does this mean for investing? The graph on page 32 looks at the income yield (dividends + interest) on a US balanced fund comprising 60% US equity and 40% US bonds, spanning 175 years.

The yield you will earn now is the lowest over 175 years. For most people this means that they will not be able to generate sufficient yield to cover their

DIFFICULT TO RELY ON INCOME TO FUND YOUR PENSION ANYMORE



Source: Robert J Shiller, Stock Market Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015, updated

income requirements in retirement and they will be forced to draw down capital on a continuous basis. If your capital does not grow in real terms, you are going to be in trouble very quickly.

As a simple example of this, assume you have a savings pool of R20m at age 60 and want a monthly income of R50 000 per month growing annually by inflation. If you earn a real return of 3%, your savings will last until you are around 93. If you earn a negative real return of 3%, then your savings will run out at age 77.

You have to ensure that your investments earn real returns. You need a well-diversified portfolio of investments that are likely to generate real returns over time – no big bets that can go wrong.

In optimising the asset allocation in a balanced fund, one wants the right mix of conservative and more aggressive asset class exposures to deliver the required return, with risk controlled. An income fund investment has a very important role to play if it can, over time, and with consistency, deliver around inflation plus 3%. In a period of negative real rates on cash and volatile equity markets, a low volatility positive real yield income fund will provide a safety net from which to fund disbursements.

We can also show how 0% interest rates can be used to explain why growth stocks are outperforming value stocks, and why it is quite possible that this trend can continue. This is important in understanding what is happening to the duration and volatility of the average portfolio and how an income fund investment has a crucial place right now.

$$PV = \frac{FV}{1 + r}$$

PV = present time value
FV = future value
r = rate of interest

Above is the time value of money equation in its simple form. If r = 0, then PV = FV.

It means that where you are holding a portfolio for a period of time, you are indifferent between when you receive your cash flows, or in the case of an equity, dividends.

In the example below a company pays dividends of 10 for 5 years (value stock) and Tesla pays no dividends for the first 4 years, then 60 after 5 years. The PV of Tesla is higher than the value stock because you can afford to wait.

Because interest rates are zero, one can afford to hold more growth or longer duration stocks and bonds where future payouts compensate you sufficiently.

Higher duration portfolios in search of higher yield and future returns mean more volatile returns. This underlines the importance of a conservative income fund investment that can consistently compound reasonable real returns and help to reduce overall portfolio volatility. We are going to have to live with heightened volatility and we need a banker in our portfolio mix to manage cash flows and at the same time deliver the required real returns.

In the graph below we illustrate how the Prescient Income Provider Fund is managed; we focus on delivering and compounding positive real returns. We understand the importance of this.

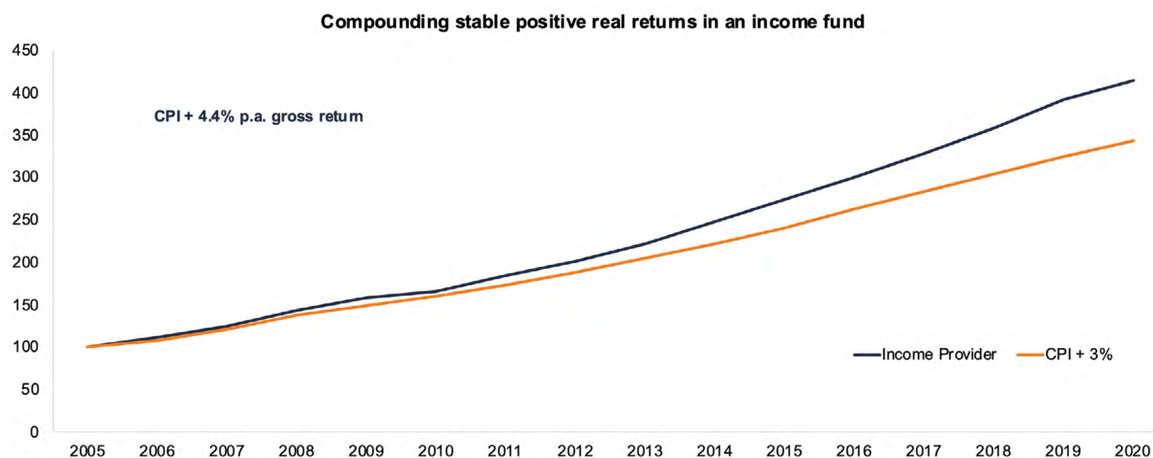
Remain focused on delivering positive real returns. We may be in a low interest rate environment for a long time. Albert Einstein famously referred to compound interest as: “The eighth wonder of the world. He who understands it, earns it. He who doesn’t, pays it.”

Growth vs Value (Simplified example)

PV of Value Stock	=	10	+	10	+	10	+	10	+	10	=	50
PV of Tesla	=	0	+	0	+	0	+	0	+	60	=	60

- Because you are time indifferent on receiving dividends over fixed investment term, Tesla is a BUY.

PRESCIENT INCOME PROVIDER: COMPOUNDING POSITIVE REAL RETURNS



Source: Prescient- Returns to 31 December 2020. Inception of PIPF Fund January 2006.

ABDUL DAVIDS
KAGISO

How to manage a Shariah-compliant balanced fund

Abdul Davids, portfolio manager of the Kagiso Islamic Balanced Fund, provided a brief overview of Kagiso Asset Management's track record managing Shariah-compliant funds, growing from one Shariah-compliant fund with no assets in 2009 to around R3 billion spread across five different unit trust funds presently.

Abdul provided a brief overview of the principles of Shariah-compliant investing that included a brief explanation of Shariah law and its harmonisation with ESG principles related to making a positive impact on society and the avoidance of lending practices that exploit the poor. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) provides global oversight for Shariah-compliant funds and has developed a set of Shariah rules for screening stocks that include both qualitative screening filters and quantitative ratios used in the filtering process.

> Shariah-compliant funds cannot invest in banks and similar financial institutions, so naturally, the perception exists that these funds are resources proxies or only invest in resources stocks.

Some of the qualitative screening criteria are the avoidance of companies involved in the production and sale of alcoholic beverages and weapons, gambling companies and lending institutions. The financial ratios screening attempts to reduce the amount of interest earned or paid by companies by limiting the amount of debt or cash on balance sheet to 30% of total assets. Other requirements for Shariah-compliant funds are to appoint a Shariah Supervisory Board and to

have a clear and transparent process to purify non-permissible income through donations to charity.

The presentation expanded on the building blocks of a Shariah-compliant balanced fund with a discussion of the various asset classes available to Shariah-compliant balanced funds. Each asset class is considered and evaluated independently based on its risk profile and bottom-up valuation process, as well as the applicable Shariah screening.

The equities asset class was highlighted as the dominant asset class in a balanced portfolio and typically constitutes up to 70% of high equity balanced funds. Property and sukuks constitute the yield asset component of a balanced fund and are subject to the Regulation 28 asset class limits applicable to balanced funds.

Abdul provided a practical application of a Shariah-compliant investment process that includes the research universe and research process, the application of the Shariah screening filters and the identification of investment opportunities for portfolios. This process is replicated on global equity research.

The presentation provided a detailed overview of sukuks: what a sukuk is and how it differs from conventional bonds and the various non-interest-bearing yield assets available to Shariah portfolio managers. The sukuk discussion concluded with a practical demonstration of a sukuk portfolio reflecting both yield and duration, and the performance track record of the Kagiso sukuk portfolio and its outperformance of inflation.

The last segment of the presentation comprised a discussion of the Kagiso Islamic Balanced Fund and its asset allocation profile across the various asset classes. The presentation concluded with a discussion of the Kagiso Islamic Balanced Fund performance, its outperformance versus its Shariah peers over the last 1, 3 and 5-year periods and the Fund's relative positioning versus Shariah-compliant equity and balanced fund peers as per the Alexander Forbes Shariah manager survey.

FREQUENTLY ASKED QUESTIONS

1. **Are Shariah-compliant funds restricted to Muslim investors only?**
   No, Shariah-compliant funds are open to all investors and many investors and institutions from other faiths have invested in Shariah-compliant funds.

2. **Are Shariah funds just resources stock proxies?**
   Shariah-compliant funds cannot invest in banks and similar financial institutions, so naturally, the perception exists that these funds are resources proxies or only invest in resources stocks. Certainly the strong run in resources shares over the last few years has benefited some Shariah-compliant funds, but the Kagiso funds have had a less than benchmark exposure to resources stocks from time to time and this is the position currently as well.

3. **Why are Naspers and Tencent not Shariah-compliant?**
   AAOIFI stipulations do not allow for Shariah-compliant funds to invest in filmed entertainment and music businesses. Tencent's growing portfolio of music and filmed entertainment businesses makes it non-compliant and given Naspers' significant exposure to Tencent, Naspers is also considered to be a non-compliant stock.

ALLAN GRAY

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Louis Stassen; Kirshni Totaram

Authorised representatives
Louis Stassen; Gus Robertson; Gavin Joubert; Karl Leinberger; Kirshni Totaram; Peter Leger; Stephen Peirce; Suhail Suleman; Greg Longe; Neil Padoa; Anthony Gibson, Liesl Abrahams (supervised); Steven Barber (supervised) ; Humaira Surve (supervised); Danie Pretorius; Lisa Haakman; Marc Talpert (supervised); Iakovos Mekios (supervised); Paul Neethling (supervised); Floris Steenkamp (supervised); Chris Cheetham (supervised); John Parathyras (supervised) All Key Individuals and Representatives meet the fit and proper requirements as set out in the Board Notices to the Financial Advisory and Intermediary Services Act 37, 2002.

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The appointed Compliance Officers are:

Jamie Rowland
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FAIS requirements
CORONATION ALTERNATIVE INVESTMENT MANAGERS (PTY) LTD
Registration No. 2018/521040/07
Herein after referred to as 'Coronation'

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Key individuals
Louis Stassen; Neville Chester

Authorised representatives
Adrian van Pallander; Gavin Joubert; Iakovos Mekios (supervised); Louis Stassen; Marc Talpert (supervised); Neville Chester; Nicholas Stein; Nishan Maharaj; Quinton Ivan; Seamus Vasey (supervised). All Key Individuals and Representatives meet the fit and proper requirements as set out in the Board Notices to the Financial Advisory and Intermediary Services Act 37, 2002.

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A feeder fund is a fund that, apart from assets in liquid form, consists solely of units in a single fund of a CIS

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BENCHMARKS

FTSE/JSE All Share Index

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