

The fund ended the year down 1.2% compared to the 2.6% return of the benchmark. Over the past 5 years, the fund has generated a return of 7.1% p.a., over 10 years a return of 13.7% p.a. and since inception almost 20 years ago it has generated a return of 13.6% p.a. From an asset allocation point of view, the biggest detractor in 2018 was not owning any South African bonds (ALBI + 7%) and having very low domestic equity exposure was a positive contributor (Capped Swix declined by 11%). In terms of individual instruments, Alphabet was the largest positive contributor to performance (0.9% contribution), followed by Amazon (0.6%) and Adidas (0.6%). The largest detractor was Kroton (-1.5% contribution), followed by British American Tobacco (-1.3%). While these two shares had a disappointing year, we continue to hold both.

Kroton is the top private education operator in Brazil. Disappointing earnings reported and concerns relating to its student base as government-funded students graduate drove the share price down. We would agree that for these reasons the short-term prospects are unattractive but we believe the long-term prospects remain very attractive. Brazil has a dire skills shortage and the return on investment for students who study certain courses is very high. The industry is fragmented and profitability of the smaller players is minimal. Kroton's high market share should not serve as a barrier over long periods of time to continued student growth as the market will consolidate over time. Their scale and strong brands make their degrees more attractive, which raises long-term pricing power. With their solid balance sheet and high profitability, they are uniquely positioned within the industry to offer pioneering financing schemes that allow students to spread out their payments beyond the duration of their degree, which will make them more affordable to marginal students. This will help offset some of the negative impact of lower government student loans. Kroton trades on less than 10x 2019 earnings, with a 3.5% dividend yield and c. 80% upside to fair value.

British American Tobacco is the 2nd largest global tobacco company. The US Food and Drug Administration has proposed banning menthol cigarettes in the US. This, together with general concerns over the transition to alternative nicotine products, drove the move in the share price. We believe that the prospects for the global tobacco companies are very attractive as for the first time these companies have credible alternative (much lower risk) products to make them more sustainable over the long term. The proposed menthol ban will take many years to implement and may be blocked by the courts if (as is likely) challenged by the affected companies. The share price is now at a 7-year low (and rating near a 20-year low) and trades on less than 9x 2019 earnings, with an 8% dividend yield and c. 70% upside to our estimate of fair value.

The fund ended the quarter with 66.5% net equity exposure which was largely unchanged from 65.3% at the end of September, but down from the 70.9% equity exposure as at end- June. Of this, approximately 60% of the equity exposure was invested in developed market equities, 35% in emerging market equities and 3% in South African equities. We had reduced the fund's US technology exposure in the third quarter (from 9% of fund to 6% of fund, including selling out of Amazon) due to less attractive valuations. During the past few months we selectively increased our US technology exposure again due to the sharp share price declines towards the year end. At the end of December, the fund had 8% invested in US technology and we also added 2 non-US e-commerce companies: Zalando in Europe and MercadoLibre in Latin America. The fund also has 7% in total invested in 4 Chinese internet companies (58.com, JD.com and Alibaba and Ctrip). Other meaningful equity positions include global tobacco (6.3% in total in British American Tobacco and Phillip Morris) and 4.5% in US media (Charter Communications and Twenty First Century Fox).

Our negative view on global bonds remains largely unchanged, although we did buy short-dated US treasuries (3.5% of fund) during the third and fourth quarters when US government 10-year bond yields were north of 3%. We also upped the fund's position in L Brands (owner of Victoria's Secret) corporate bonds to just under a 2% position and now yielding 6.7% compared to our initial purchase yield of 7.3%. In total, bonds make up 5.8% of the fund. The fund also has c. 5% invested in global property: largely in Unibail (European & US Retail property) and Vonovia (German residential). Lastly, the fund has a physical gold position of 2.5%. The balance of the fund is invested in cash, largely offshore. As has been the case for a number of years now, the bulk of the fund (over 90%) is invested offshore, with very little being invested in South Africa.

Portfolio managers
Gavin Joubert and Marc Talpert
as at 31 December 2018