CORONATION GLOBAL EMERGING MARKETS FUND

Quarterly Portfolio Manager Commentary

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Please note that the commentary is for the retail class of the fund.

The Fund returned -23.3% during the first quarter of 2020 (Q1-20), slightly ahead of the -23.6% return of the benchmark MSCI Emerging Markets Total Return Index. The one-year return of the Fund is -13.8%, which is 3.9% ahead of the benchmark. Over more meaningful longer-term periods, the Fund has also outperformed; by 1.1% p.a. over three years, 0% p.a. over five years, 1.3% p.a. over 10 years, and by 2.2% p.a. since inception almost 12 years ago. We are pleased with the longer-term outperformance generated by the Fund, especially if one considers that the return of the asset class over 10 years (less than 1% p.a. total return) will have been very disappointing for the average investor in emerging markets. The importance of generating alpha is therefore even more pronounced, as only with significant alpha over the last ten years will one have generated a positive real return after fees.

The world has changed very quickly since our last commentary in early January. In the intervening three months, a previously unheard-of virus that originated in China has shut down the second-largest economy in the world and spread at a furious rate throughout the globe, prompting sweeping shutdowns. The world seems to be on track for the biggest quarterly decline in GDP since the Great Depression and many countries will face tough months, if not years, ahead.

Emerging markets are at different stages of preparedness for the impact of the virus. At the one end of the spectrum, we have China, which brought its economy to a virtual standstill by keeping the country on enforced lockdown from the time of Chinese New Year in January until the end of the quarter. Having taken this pain upfront, China looks to be rebounding fairly quickly. Other Asian countries, such as Korea and Taiwan, having learnt from episodes historically (SARS/MERS/Swine flu) have also managed to limit the spread of the virus by taking early, concrete action, and so far look like they may come through this less affected than China.

At the other end of the spectrum (within emerging markets) are Brazil and Mexico, which have started taking measures very late (at a national level) and are likely to experience more negative outcomes on their healthcare systems as a result. Russia and Turkey would probably fall into this category too, although, in the case of Russia, the ability of the state to enforce a full lockdown is significant. Turkey has tried the middle-of-the-road approach of keeping workers active but forcing elders and children into isolation. India and South Africa, with their lockdowns of 3-5 weeks (at the time of writing) are likely to fall somewhere in between in terms of economic and social impact.

While all the above information is useful as a backdrop, it is of relevance in this discussion only in the context of how it impacts the Fund's holdings and potential investments. As a general principle, we have not added to all positions in the Fund that have fallen disproportionately, but have generally been selective in adding only to those that we believe will recover quickly operationally; have the balance sheet to withstand a prolonged severe disruption; and where there hasn't been a material change to our long-term fair value as a result of this crisis.

The standout performer in the Fund in the period was JD.com, the Chinese ecommerce retailer. JD was up 15% in the period and contributed close to 0.8% of alpha. It did well due to great results for 2019 and a better-than-average outlook in China during the height of the country's lockdown. In 2019, revenues grew 25% and the company earned a profit after sustained losses since listing. Their outlook for Q1-20 (to end March) guided to 10% revenue growth, even though the country probably saw double-digit declines in GDP during this period - the peak of the Covid-19 crisis in China. One would expect the appeal of ecommerce to be enhanced in a world of social distancing, but, over and above this, several innovative steps taken by management during the worst of the crisis have underpinned this strong performance. A good example is continued deliveries using their self-owned logistics network, even in the most affected province in China (Hubei), using drones for delivery where possible.

Other notable contributors were Wuliangye Yibin (Chinese baijiu spirits), which declined 15% but contributed 34 basis points (bps) of alpha, as well as Philip Morris International, down 13% for 33bps contribution to alpha. Ping An Insurance Group and Yum China collectively contributed another 50bps of alpha, the latter recovering quite quickly operationally and recently announcing that up to 85% of its stores in China are now open. The Fund does not own Petrobras and the big share-price decline (both the Brazilian market and oil price decline contributed to this) added 40bps to relative performance.

The biggest detractor for the Fund was the underweight in Tencent, which it does not own directly. This cost 1.1% of relative performance and, even though the Fund does own Naspers and Prosus, whose valuations are ultimately derived from Tencent, this was insufficient to offset not owning Tencent directly. Naspers and Prosus collectively contributed 78bps to relative performance and comprise 7.8% of the Fund. We own them in preference to a direct shareholding in Tencent, due to the substantial discount at which they trade to Tencent, as this provides additional margin of safety.

Among stocks owned, Airbus ended up detracting the most from performance, taking 85bps off relative performance. Airbus was a top-10 position (2.8%) at the beginning of the year, and, after holding up well early in the year, we started to reduce the holding significantly as the environment for world travel deteriorated. This aggressive reduction in the position size preceded a 60% collapse in the share price to as low as €49 at some stage.

Airbus is a good example of the extreme market reactions that have taken place. In the short-term, the airline industry – Airbus's customer base - is facing financial ruin, as airline travel has collapsed to a fraction of normal levels for this time of year. The short-term financial impact will be manageable - airlines make regular payments during the build stage of a plane and pay penalties for cancelled or massively delayed orders. A lot of production is outsourced, so the pain is shared with suppliers, while the large proportion of variable costs means that curtailing production can preserve cash. Airbus has a large net cash position (€12.5 billion or 28% of market cap) and access to additional funding of at least this amount. This means they have ample liquidity to see them through the next two years. The duopoly nature of the industry means that customers only really have two choices of supplier, and however tough things may be for Airbus, they pale in comparison to its only competitor, Boeing, which is highly leveraged and still dealing with the aftermath of the grounding of the 737 Max last year. Although not without risk, we are very positive on Airbus long-term and continue to hold it.

The Indian financial companies HDFC (mortgages) and HDFC Bank (full-service banking) declined by 36% and 39% respectively, costing close to 1% of combined relative performance. In our view, these declines are excessive; the short-term impact of India's shutdown does not reduce the fair value of these businesses by anywhere near this quantum. It is reasonable to expect bad debts to spike in India; however, we believe the risk is more pronounced in the corporate sector than the consumer sector, as consumers are likely to receive significant support from the government to help them through this crisis. Because of our concerns about corporate exposure, we sold the small 50bps position held in Axis Bank in order to concentrate our Indian financial exposure in the higher-quality names. In the case of HDFC (4.2% of Fund), the mortgage book is fully secured by residential property (mostly primary residences), with very conservative loan-to-value ratios at loan inception. HDFC Bank (2.6% of Fund) has more consumer exposure than any of its peers, with almost half in semi-urban and rural India, where the disruption from the lockdown is likely to be less severe than in urban areas, in our view. The main competitors are either poorly-run state-owned banks or private sector banks with company-specific issues to deal with. Most recent data on loan growth from the Reserve Bank suggests HDFC Bank are growing their loan book at 2.5 times the rate of the market as a whole.

There has been a high level of activity in terms of new buys and sales to zero in the Fund during the quarter. Notable new buys in the quarter were the South African trio of Shoprite, Spar (both food retail) and Pepkor (entry-level clothing retail). Collectively, these are only 1.9% of the Fund. The trio are among the best businesses in the country, being predominantly cash retailers catering to the mass market. In a tough economic environment, they will benefit from downtrading by consumers and will weather storm better than peers, in our view. All three have declined significantly by 30-50% over the last year, in addition to the 25% decline in the rand since the start of 2020. Relative to peers in emerging markets, they are now quite attractive, with valuations ranging from 12-14 times forward earnings and with 4-5% dividend yields.

Another notable new buy is Indian tobacco business ITC, an affiliate of British American Tobacco (BAT). The share price of ITC has halved since 2017. This highly cash-generative business has declined from 30 times earnings a few years ago to 13 times today. One can separately value ITC's non-tobacco businesses, which they started years ago in an attempt to diversify away from tobacco and which are marginally profitable, and strip this out of the overall valuation. On this basis it is even more attractive at 8 times core (tobacco) earnings. ITC has an almost 85% share of the formal tobacco market share in India (there is a large illicit market), making it a quasi-monopoly. The government has hiked excise taxes consistently, a major reason why the share price has declined. Despite this, ITC continues to grow earnings at low double-digits and are likely to do better than this over time as the non-tobacco businesses improve profitability or are sold to realise value for shareholders. With almost 20% of their market cap in cash and a 5% forward dividend yield, ITC is very attractive.

Members of the team travelled to India, Brazil and Mexico during the quarter to meet current and potential portfolio holdings, before all travel was naturally curtailed in light of global developments. We wish all our clients safety and good health in the weeks and months ahead.

Portfolio managers
Gavin Joubert and Suhail Suleman
as at 31 March 2020