The Fund continued to build on positive momentum in the third quarter (Q3-20), returning 16.6%, which was 10.5% ahead of benchmark for the period. After the vicious market correction in the first quarter of the year (Q1-20), which was heavily felt in the commodity sector, the Fund was 10.5% below the benchmark in Q1-20. Subsequent performance has narrowed the year-to-date (YTD) performance gap to 2.6% behind the benchmark. Longer-term performance is highly compelling against both peers and the benchmark, with the Fund 4.4% ahead of the benchmark over the last decade. The resources sector has performed very well in comparison to general South African (SA) equity benchmarks and we believe it remains attractive, which we explore below.

In the quarter, the Fund benefitted from its positions across the platinum group metal (PGM) stocks as well as Montauk Energy, a new position in the Fund. Primary detractors in the quarter were Gold Fields, Glencore and Merafe. In the quarter, we reduced our PGM exposure and invested the proceeds into the diversified miners, given their relative underperformance. Anglo American, BHP and Exxaro were some of the top buys.

We believe that the commodity sector currently has several elements to it that are unprecedented in comparison to historical cycles which, when combined, present a unique investment opportunity. The sector is displaying remarkable supply restraint in the face of healthy margins and incentive prices in several commodities. The decarbonisation of the world that will take place over the next few decades is incredibly positive for metal demand and stands to produce strong price outcomes when combined with supply, which is yet to meaningfully respond. On top of this supportive earnings environment, management teams have committed to delivering material capital returns to shareholders, made more attractive by historically cheap starting valuations.

If one considers the previous cycle ending in 2015, it played out broadly as follows: robust demand growth driven by China on which miners capitalised. They then extrapolated it into the future by living beyond their means (increasing debt levels and channelling it into capital expenditure to boost supply). Gearing works in a rising price environment, yet increased gearing is a contributing factor to a deflationary price environment. Overexuberant investment into volume growth in good or benign times sowed the seeds for oversupply (bad times). This came to a head when there was a wobble in 2015. A deflationary price environment ensued and collided with stretched balance sheets. Low prices and high debt are a toxic combination. The JSE Africa Resources Index fell 61%, while Anglo American and Glencore fell 80% and 72%, respectively. This led market commentators at the time to question the viability of many of these stocks. Glencore undertook a rights issue and Anglo American expressed a strong desire to do so.

This 2015 near-death experience is firmly entrenched in the minds of mining executives, many of whom have retained their positions in their respective companies. However, they now appear to appreciate the risk of price deflation caused by excess leverage and supply growth and understand that high gearing and mining companies are not very compatible.

On the back of 2015's wake-up call, companies have started running conservative balance sheets. Rather than anticipating demand growth and bringing forward supply using leverage (basically using balance sheets to balance the market), they are using retained earnings (and allowing commodity prices to balance the market). This places the miners on a firmer financial footing and the sector now lags cycles rather than leading them, resulting in far less slack in the system. Take the 2019 Brumadinho tailings dam disaster that saw Vale's production drop by 34% (c. 64 million tons). Global peers have been unable to supply the missing tons due to low flexibility in supply, this has sent iron ore prices up 68% from January 2019 to today.

While we don't expect this capital expenditure discipline to last forever, we expect it to remain in place as long as the current cohort of executives remain in place at the companies and/or while share prices remain at levels attractive to valuation-based investors.

A critical point we feel gets overlooked is that you cannot make energy-intensive industries greener without the use of certain commodities. Reducing carbon dioxide (CO_2) emissions requires either a decrease in the population or for the existing population to use less energy. Both scenarios seem unlikely. The alternative is to focus on energy efficiency and CO^2 intensity per unit of energy. Indeed, it is on the latter point where much of the action today is taking place. Two areas of focus are the vehicle drivetrain and electricity production. In both cases, copper is a critical component given its unrivalled thermal and electrical conductivity.

The vehicle drivetrain is in the process of a shift away from fossil fuel (oil) as a power source to electricity. A typical electric vehicle (EV) requires 150 kilograms of copper. Based on our in-house assumption of a 25% battery electric vehicle (BEV) penetration by 2030, this decarbonisation of the drivetrain would require an additional 1.6 megatonnes of copper and 719 kilotonnes of nickel. This incremental demand represented 7% and 30% of the 2019 supply base for copper and nickel, respectively - enough to push these markets into material deficits in the years to come. Efforts are also underway to transform the electricity mix away from fossil fuels such as coal towards greener energy sources, such as wind and solar. Wind and solar require multiples more copper per unit of power than coal and traditional sources (they require this for the increased cabling, as well as generators, inverters, and transformers). Bernstein estimates that copper demand from wind energy will require an additional 1 megatonnes per annum of copper by 2030.

The PGMs also benefit heavily from the shift towards cleaner air and general decarbonisation. In the medium term, PGMs will benefit from increased regulatory pressure on car manufacturers to reduce emissions, with large fines for non-compliance. Adding palladium or rhodium to the catalyst of an emissions treatment system is a natural solution for vehicle and catalyst manufacturers. Longer term, the PGM complex stands to benefit from the arrival of the hydrogen economy, at least a few decades after it was first heralded to arrive. The last 12 months have seen a step change in political will to tackle climate change from most political parties globally as well as large corporates. The most recent stimulus response out of Europe is a clear example, with a continental "net zero" goal by 2050 and tens of billions of euros committed to the cause. China has also committed to being net zero by 2060. There is a broad consensus that, to fully decarbonise, there is a large role for hydrogen to play across a raft of industries. Fuel cells can be used to power ships, heavy & light duty vehicles and even buildings. Not to mention the burning of hydrogen for heat in heavy industry such as steel and cement manufacturing. Platinum in particular is vital in several elements of a hydrogen-based economy.

We believe the above factors contribute to a favourable commodity price environment in the years to come, with management committed to returning large portions of their free cash flow to shareholders. When coupled with what we see as attractive starting valuations in most of the individual commodity stocks, we believe that, through stock selection, we will be able to generate excess return over and above a rising commodity tide over meaningful time periods.

Portfolio managers
Nicholas Stein and Nicholas Hops
as at 30 September 2020