

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

Global asset markets have had a torrid start to the year, with equities experiencing the worst first half of a year in over 50 years. In a rare, coordinated sell-off, where both core asset classes (equities and bonds) declined, investors had few, if any, places to hide in 2022 so far. Indeed, the declines have been widespread, with REITs declining 20% (according to Morgan Stanley “the worst start to a year on record”) and gold down approximately 5%. Only short-dated USD cash and certain commodities delivered positive returns.

Considering this backdrop, the Fund’s performance suffered, returning -7.2% in the quarter. Over more meaningful periods such as five and 10 years, the Fund has returned 1.7% p.a. and 3.6% p.a. respectively.

While the severity and somewhat indiscriminate nature of the sell-off has been painful to endure, it has also resulted in widespread price dislocation. In equity markets, for instance, good businesses have been jettisoned alongside weak businesses, with little regard for differences between their long-term prospects. Across multiple industries and investment themes, our analysts are finding a range of opportunities that we consider to be very attractive today.

Long-time readers will know that we follow a valuation-driven investment research process. By assessing multiple factors (including the underlying earnings power of a business, the quality of management and key risks), we aim to determine a fair value (FV) – our estimate of what a business is really worth. When the price the stock is trading at in the market is well below our FV estimate, it often signals opportunity.

Using these fair values for each stock, we can calculate a FV (and upside to FV) for the equity portfolio as a whole, which we have tracked over time. This is far more than a mere analytical exercise. As the table below shows, there is a strong positive correlation between the equity portfolio’s estimated upside, and subsequent returns. In previous periods where the upside to FV has been within the 60% - 80% range, subsequent equity returns (over the next two years) were approximately double the Fund’s average equity return. Today, the upside within the equity portfolio is again in the 60% - 80% region. And while there are no guarantees, this is one of the reasons for our optimism about the portfolio’s future prospects.

HISTORIC UPSIDE TO FAIR VALUE VS. SUBSEQUENT RETURNS

| Starting Upside | Frequency (% of time) | Average Subsequent Equity Performance (2 years) p.a. |
|-----------------|-----------------------|--|
| 30 - 40% | 31% | 4.6% |
| 40 - 50% | 25% | 8.6% |
| 50 - 60% | 19% | 10.8% |
| 60 - 70% | 4% | 17.1% |
| 70 - 80% | 7% | 21.0% |

Source: Coronation

To highlight the broad range of opportunities our analysts see today, we have selected a few examples from different corners of the market – spanning multiple industries and style factors – where we believe the long-term fundamentals of the businesses are not reflected in the valuation.

(Some) High growth stocks are no longer expensive

Software has long been an industry where the leaders have enjoyed high growth, high margins, and exceptional returns on invested capital. Large parts of the sector have transitioned from a licensed, on-premises model to a subscription-based (software-as-a-service) model, with even better economics accruing to the winners (for instance, through higher customer retention and lifetime value). This insight has not been lost on the market, and the sector justifiably seldom appears “cheap” on shorter-term metrics. However, valuations became detached from reality, in our view, as the market, fueled by low interest rates, demonstrated a near insatiable appetite for growth stocks during the pandemic with little regard for the price paid. This changed dramatically in 2022 as rising interest rates have led to a repricing of growth, with the sector selling off sharply and indiscriminately. This has enabled us to purchase Adobe, a name that has been on our watchlist for some time.

Adobe is the leading software provider for creative professionals. Its products such as Photoshop, Illustrator and Premiere Pro are market leading, industry standard tools that are essential for users to do their jobs effectively. Adobe thus boasts sticky customer relationships with a high degree of recurring revenue. It is a high-quality compounder that is well placed to benefit from continued growth in the creation and consumption of content, the growing use of technology in effective marketing solutions and the continued digitisation of paper processes.

These positive attributes, coupled with a history of innovation, have enabled Adobe to deliver top-tier revenue growth (22% five-year historic compound annual growth rate), margins (37% at the operating level, and rising), cash generation (over 100%) and returns on invested capital (close to 40%). We believe Adobe has sold off on macro concerns, rather than for any stock-specific reasons, and expect double-digit annual returns from this quality asset going forward.

(Some) Consumer cyclical already anticipate a recession

Capri Holdings is the owner of three iconic, founder-led luxury brands in Michael Kors, Jimmy Choo, and Versace. The latter two were acquired in 2017 and 2018, respectively, and added true luxury cachet alongside Kors’s more accessible positioning.

Versace is a highly regarded fashion brand, known for its innovative and glamorous designs. While celebrities regularly donned its bold creations at red carpet events around the world, the brand was historically severely undermonetised due to a narrow focus on haute couture and bespoke runway items. This has changed under Capri’s ownership, with Versace growing its ready-to-wear ranges and devoting more resources to new menswear, footwear, and high margin leather accessories ranges, as well as developing ecommerce capabilities. Capri plans to more than double Versace’s revenue base over the medium term while expanding operating margins well above 20%. Based on our research, the brand is in excellent shape with strong pricing power, and the aforementioned targets are very achievable. Early evidence of profitable growth leaves us excited about what lies ahead for Versace.

Known for its handbags, Michael Kors operates in the affordable luxury segment. The group was historically over-exposed to department store sales and discount outlets, where they had limited control over pricing and, by implication, brand perception. However, both Kors and key competitor Coach have successfully begun to elevate their brand profiles through narrower distribution, focusing on a smaller number of higher priced items and reducing promotional intensity.

In our view, the resilience of Kors and the significant growth potential of Versace and Choo is being totally overlooked by the market, with Capri Holdings being valued on 6 - 7 times earnings. Management clearly agrees, with a new \$1bn share repurchase programme and the company buying back \$300m of stock (5% of the market capitalisation) in the last quarter alone. We believe Capri offers tremendous value for long-term investors.

(Some) Steady compounders are priced for disruption

Payment processors benefit from a long-term structural shift from cash to electronic payment methods (e.g. cards). This global trend has multiple drivers, including growth in ecommerce, reduction in friction (e.g. tap-to-pay), behavioural changes (e.g. hygiene preferences post Covid) and government incentives. Despite ongoing innovation from challengers, we believe the resilience of a number of incumbents in the payments ecosystem is underappreciated. Similarly, the revenue streams of the payment companies are principally a function of nominal payment volumes, providing a natural hedge in an inflationary environment.

For instance, Visa’s position as the dominant card network allows them to be an enabler of innovation, rather than being disrupted. New market entrants have in many cases found that partnering with Visa is the most effective route to get to scale. Similarly, Visa (as well as MasterCard) remains an indispensable partner for retailers – even Amazon walked away from a high-profile threat to stop accepting Visa cards in the UK. This strong incumbent position affords Visa the resources and credibility to invest in new product lines, like Visa Direct and B2B payments. We estimate Visa can grow earnings by 15% p.a. over the next five years; the current 23 times price-to-earnings (P/E) multiple does not sufficiently capture this growth.

Similarly, a number of merchant acquirers (who accept payments on behalf of merchants and connect to various payment schemes, such as Visa) have seen their shares derate on fears of disruption. Fiserv, which is the second largest acquirer in the US, has in our view been mischaracterised by the market as a stodgy incumbent, weighed down by old technology and overexposure to banks, destined to lose market share. We think this narrative is far too simplistic (and frankly wrong). More than 20% of Fiserv’s merchant revenue is from its software-led Clover POS platform, targeting smaller merchants in the restaurant and retail verticals, which is growing at 30% p.a.; similarly, its new Carat platform aimed at enterprise omnichannel retail is growing at 20%. Fiserv is also the leading provider of core banking software, a slower growing but incredibly stable business, that creates meaningful opportunity to cross sell merchant services in partnership with their banking customers. We think Fiserv can grow revenue at a high single-digit rate and earnings by mid-teens over the next five years, leaving the stock grossly mispriced on 13 times P/E.

Even (some) long-duration, loss-making businesses offer attractive risk vs. reward trade-offs

It has been a particularly brutal year for long-duration growth companies, with many names down 60% - 70%. Many nascent businesses with unproven business models were beneficiaries of the ultra-low-rate environment, where the prospect of future riches – however speculative – was chased to extreme levels. With valuations in many instances detached from reality, a reset was necessary. The subsequent sell-off has been swift but also indiscriminate. With access to cheap capital suddenly limited, many of these early-stage companies now need to pivot from growth at any price, to generating sustainable profits and cash flows. Some of these businesses are likely to fall short of their lofty aspirations, but some will succeed.

While the range of potential outcomes is wide, we see an opportunity for long-term investors to identify disruptive companies with attractive, sustainable business models that offer the potential for outsized gains; we have started to build a modest position in this segment via a basket of winners across industries including ecommerce and food delivery.

At quarter-end the Fund was positioned as follows:

- 31.3% in equity, which includes our commodity equity exposure of 3.7%
- 45.8% in investment-grade fixed income (with 22% in short-dated Treasury bills, and 20% in investment-grade corporate credit)
- 10.2% in high yield fixed income
- 5.3% in inflation-linked investments (gold and inflation break-evens)
- 5.5% in property and infrastructure
- 1.9% in merger arbitrage situations

We continue to find and own a range of businesses which we think offer the prospect of strong US dollar-denominated returns. In addition, the Fund’s portfolio construction is balanced through holdings of long-duration inflation-linked infrastructure assets, undervalued commodity businesses, gold, and select reasonably priced credit (both investment-grade and high yield).

Portfolio managers
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as at 30 June 2022