CORONATION GLOBAL EMERGING MARKETS FLEXIBLE [ZAR] 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 -29.4% in the first quarter of 2022 (Q1-22), -14.6% behind the benchmark MSCI GEM (ZAR) Return Index. This comes on top of a difficult period in 2021. Although such a large deviation from the benchmark over a short period is not totally inconsistent with our approach (the Fund has twice outperformed its benchmark by more than 15% in a calendar year), it is extremely disappointing, and we recognise that the Fund's recent performance is clearly well below client expectations. It is perhaps important to note that up until a year ago (March 2021), the Fund's outperformance since inception, was in excess of 1.9% p.a., and north of 1% p.a. over 3, 5 and 10 years, so the significant underperformance has been largely concentrated in the last year.

The biggest positive contributor to relative performance was Sendas, a Brazilian Cash & Carry retailer, which returned 33% for a 0.7% relative contribution to performance (alpha). AngloGold Ashanti returned 6% for 0.6% alpha. Other material contributors were Anglo American (+0.5% alpha), Petrobras (+0.4% alpha) and the zero weights in Tencent and Meituan (+0.3% alpha from each). Not owning Gazprom contributed 0.5%, however the overall Russia impact was, by some way, the biggest driver of underperformance in the quarter.

We started the year with around 11% in Russian equities; our approximate internal maximum exposure limit (at cost) since we increased the risk premium applied to Russian assets in 2014 after the annexation of Crimea, which was also the primary driver of introducing this risk limit. The exposure comprised a mix of food retailers (over 40% of the exposure), banks, the local Moscow exchange, the leading internet asset Yandex and other smaller positions. At that point in time, Russian equities reflected valuations that were lower than at any point since the Global Financial Crisis. The upside to fair value of the Russian stocks in the Fund was over 100% and Magnit (2nd largest food retailer in Russia), for example, was trading at 7 times earnings and paying a 14% dividend yield in the run-up to Russia's invasion of Ukraine on 24 February.

During January and early February, while we did not reduce Russian exposure, we also didn't add to the exposure, and rather went the route of changing the mix of the Russian exposure to reduce its risk profile. At the same time, we increased the Fund's overall commodity stock exposure as a hedge against potential conflict in Ukraine, due to Russia being a large source of supply for several commodities globally. The largest change in the Russian exposure during this period was to reduce the Sberbank position (the only State-owned Russian stock held in the Fund and likely to be far more affected by potential sanctions in our view) in favour of a new position in Lukoil (an oil price hedge in the event of conflict). We also switched Sberbank to other existing positions, in particular Magnit. As a food retailer supplying essential goods in a fragmented market, we believed Magnit would likely be less affected by the broader economy and sanctions and would continue to take market share from weaker operators in a tough economic environment. This was very much the case in 2014-15. As a result of this switching, Sberbank went from being a 3% position late last year to being a 1.0% position the day before the invasion.

Our seemingly high overall Russian exposure (10.2% of Fund the day before the invasion of Ukraine) reflected a combination of the extremely attractive valuations (over 100% upside to fair value) and a base case view that a full and violent invasion of Ukraine (as opposed to just going after the eastern Donbass region for example), while being a possibility, was low probability. With the benefit of hindsight, we were clearly wrong. In addition to this, the apparent poor performance of the Russian military (who annexed Crimea within days in 2014), combined with the courageous fightback by the Ukraine army was not anticipated. It seems clear now that Russia's president Vladimir Putin believed he would take Kyiv and the whole of Ukraine within a few days, a view that was shared by most geopolitical and military experts. It was, in turn, these unexpected developments (a conflict going on well beyond a few days) that created the time and opportunity for the West to cooperate with each other and put together an unprecedented sanctions package, including sanctioning of a large part of the Russian Central Bank's reserves. At the same time, Switzerland abandoned an almost timeless neutrality policy and Germany changed decades old policies with regards to military spend and supply of lethal weapons. In other words, it wasn't just the full invasion of Ukraine in isolation: it was the four factors taken together (a full and brutal invasion of the whole of Ukraine, the poor military performance of Russia, the courageous fight back by Ukraine, and the resultant unprecedented sanctions package put together by Western countries in cooperation despite different vested interests) that made this an extreme event. Nonetheless, the fact is that the impact on performance has been significant, and while this terrible event is by no means over (making it difficult to reach firm conclusions), we are carefully thinking through whether there were any flaws in our process (with a focus on the process as opposed to the outcome) in the months leading up to the invasion, and what lessons are to be learnt here.

The impact on the Fund has been a write-down to zero of all the Russian assets, costing the Fund 8.7% of relative performance in the quarter. Magnit had the biggest impact, costing 3.8%, followed by Yandex (-1.9%) and TCS Group Holding (-1.3%). Other Russian holdings cost a combined -2.5%. The only material positive contributor was the zero weight in Gazprom, which provided +0.5% of relative performance.

The Russian asset write-down is not necessarily reflective of economic reality but is at least partly due to technical factors. On the day of the invasion and the day or two that followed before trading was halted, Russian companies with GDR listings in London were subjected to significant selling pressure in what appeared to be a 'get out irrespective of price' approach. The result of this is that most Russian London listings traded all the way down to less than 1c, with Magnit (the entire company) for example being valued at $6m in London. Magnit, in our estimates, should generate around $500m in free cash flow this year, which, using a market cap of $6m, puts it on an 8,333% free cash flow yield. In Moscow, Magnit has now started trading again, and while the market price may be artificial (foreigners cannot yet participate in the market), there are willing local buyers and sellers in what is reasonable volume. The Moscow listing of Magnit is now almost back to its pre-invasion share price level and is being valued at $5bn and a resultant 10% free cash flow yield.

All of the Fund's Russian holdings have a Moscow listing and using Moscow current share prices and the current USD/RUB exchange rate of 85 (which is clearly inflated, in our view, due to capital controls and other factors) the Fund's 10.2% pre-invasion Russian exposure is currently worth about 9% of the Fund. Adjusting for what is in our view a more sensible USD/RUB exchange rate, this equivalent percentage is 7% of Fund. It is too early to conclude whether the London pricing of Russian equities is correct (in effect that all Russian stocks are worth zero) or whether the Moscow pricing is correct - the answer may lie somewhere between the two: one just doesn't know at this point. Given that we have written off all Russian holdings, there is now only upside optionality sitting in the Fund. In early March, we placed an indefinite firm-wide moratorium on the purchase of any new Russian equities, and this is now likely to remain in place unless there is regime change in Russia. At the same time, when Russian markets become accessible to foreigners again, we will manage existing Russian exposure in the best interests of clients, as opposed to a "sell at any price" approach.

Other than Russia, it was predominantly Chinese names that hurt performance in the quarter as China continues to pursue a 'zero Covid' strategy with continuous lockdowns, most notably in Shanghai, the country's economic capital. JD.com, Wuliangye Yibin, Tencent Music and China Literature were all small detractors as a result. Most frustratingly, Naspers/Prosus (combined 6.9% of Fund) cost 1.9% of relative performance as the discount at which they trade to the value of just their Tencent stake (valuing all other assets at zero) widened to record levels. The current market cap of Prosus is now around €95bn – well below the €122bn value of its Tencent stake alone. The substantial other investments excluding Tencent are worth around €60bn in our view, with around €50bn of this outside of China. Naspers trades at a substantial further discount to Prosus, providing even greater upside.

China internet, in total, makes up around 11.4% of the Fund, albeit in large part concentrated in two positions for specific reasons, with Prosus/Naspers (providing significant exposure to Tencent but at a material discount) and JD.com making up around 65% of the Chinese internet exposure. In both cases we believe the upside to fair value is in the order of 150%. After over a year of relentless new internet regulations (and resultant declining share prices) there have been a few recent developments on gaming approvals (these have resumed after an 11-month hiatus) that provide some light at the end of the tunnel.

There were several new buys in the quarter, the largest of which was Glencore PLC (1.5%), the global diversified miner and trading house. Given the fact that Glencore has had a listing in South Africa for several years, it is a company that we have covered in detail for some time, and it has been a sizeable holding in our South African portfolios for the past few years. Additionally, commodity stocks make up 25% of the South African equity market so this is an area where the South African team spend a lot of time, which we believe is a competitive advantage in our process. In addition to this, commodity companies are now being appreciated more for the role they are playing in helping the world transition off fossil fuels. Those that produce copper, nickel and cobalt also stand to benefit from this meaningful boost to demand growth. In Glencore's case, these 3 commodities make up half of our fair value. Glencore trades on less than 6x this year's earnings and almost a 10% dividend yield, albeit with elevated commodity prices in selected cases. Even with more normalised commodity prices Glencore is attractively valued.

The weighted average upside to fair value in the Fund is now over 90%, which is close to an all-time high. Furthermore, this 90% upside does not include any contribution from Russia, which only has upside optionality as it has been written down to zero already. The 5-year IRR (internal rate of return) is a very compelling 21% p.a.

Portfolio managers
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as at 31 March 2022