

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

Performance

The Fund gained 3.6% in ZAR in the third quarter of 2022 (Q3-22) but declined by 6.2% in USD (as the bulk of the Fund exposure is in non-ZAR denominated assets). This performance should be considered against a backdrop of weak and very volatile global markets, with the MSCI World Index down 6.2% in USD and the Bloomberg Barclays Global Aggregate Bond Index down 6.9% in USD for the quarter. It was a tough quarter for absolute real returns as the world continues to grapple with high inflation, leading to continued central bank monetary tightening.

The confluence of extensive risks present in the world today points to a polycrisis which include significant inflation across much of the world, extensive monetary tightening underway, a huge energy shock, growing concern about Chinese policymaking impacting the Chinese growth outlook, concern about China's intentions with Taiwan and, finally, the ongoing war in Ukraine. The prevalence of bad news is immense, but ultimately our goal is not to avoid risk (of which there is a lot today) but rather to try and accurately price it. In a world faced with so much risk and uncertainty there has naturally been a material repricing of financial assets, which in our view provides exciting opportunities for the long-term investor.

We are acutely aware of the recent poor absolute returns generated by the Fund, but somewhat encouraged by the more recent improvement in performance. We believe that the collection of assets held by the Fund offers extremely compelling long-term risk-adjusted returns with which to deliver on its goal of compounding capital well ahead of inflation. Investors should note that the Fund is likely to go through periods of underperformance in delivering on its long-term goal. This has happened in the past, with these periods of underperformance often followed by periods of significant outperformance. With this in mind, the current weighted average equity upside of the Fund is 97%, which is one of the highest levels since inception nearly 23 years ago. Beyond this, the weighted equity five-year internal rate of return is 22% and weighted equity free cash flow yield for stocks owned is 6%. Over the past five years, the Fund has generated a positive return of 2.9% per annum (p.a.), over 10 years a return of 10.9% p.a. and, since inception over 20 years ago, 12.4% p.a..

Fund positioning

Something that remains front of mind when managing the Fund is the question of whether we are perhaps entering a period of structurally higher inflation, especially in developed markets. Emerging markets have generally been more accustomed to high inflation periods, whereas the developed world has had very low levels of inflation for more than a decade. If inflation persists at higher levels than in the past, then it becomes even more critical to own businesses that can navigate this environment – either those with pricing power and the ability to pass through input cost inflation, those gaining market share or businesses with high gross margins that can better absorb a level of operating cost inflation.

We have continued to observe the trend of a high level of synchronised selling of businesses with different long-term outlooks. This is not uncommon, as during past periods of market stress the correlation between assets often trended closer to 1. This reality, however, presents attractive stock picking opportunities.

The Fund is positioned to take advantage of this environment with exposure to a broad array of what we deem very attractive assets, with us more recently continuing to buy a selection of lossmaking long-duration stocks, with the exposure to these assets moving from 4.6% of Fund in March 2022 to 13.8% of Fund at the end of the quarter. The key attributes of the businesses we own in this category are attractive unit economics, resulting in a sustainably profitable business; and those businesses that are well capitalised and thus not reliant on capital markets.

During the quarter, the largest positive contributors were Mercardo Libre (+30%, 0.56% positive impact), Uber (+30%, 0.45% positive impact) and Coupang (+31%, 0.29 positive impact). The largest negative contributors were JD.com (-22%, 0.69% negative impact), Charter Communications (-35%, 0.61% negative impact) and SA government bonds (-8.7%, 0.56% negative impact).

It should be noted that all three positive contributors for the period fall into the category of lossmaking long-duration businesses which is perhaps an indicator that the market is starting to price these sorts of stocks individually versus painting them all with the same brush and concluding their prospects are all dire.

We have written extensively in the past on JD.com, which remains a top five position in the Fund and a positive contributor to performance over a five-year period, notwithstanding its recent disappointing performance. Despite the very real risks of investing in China, JD remains an extremely compelling investment in our view. It continues to grow its market share whilst delivering significant operational leverage in the retail business, driving EBIT margins higher, leading to increasing free cash flow generation. If you then consider that the business has nearly ~30% of its market capitalisation in net cash, and an investment portfolio (largely concentrated in listed assets) which represents another ~35% of its market capitalisation, the core retail business (using a sum of the parts approach) is trading on ~6 times current earnings, which embeds an EBIT margin of 3.5%. We feel the latter should normalise closer to 7% due to business mix changes and continued operational leverage. In our view, this is an incredibly attractive investment even in a challenged Chinese macroeconomic environment.

The Fund ended the quarter with 72% net equity exposure, slightly lower than that of the prior quarter end (on 30 June 2022) as our put option protection reduced equity exposure, providing valuable protection during the market drawdown. The put option protection, at the time of writing post quarter end, has been reduced to 7.7% of Fund (effective) versus 14.9% at quarter end. This resulted in equity exposure increasing to 80% at the time of writing, with the increase in equity exposure happening after a significant sell-off in equity indices, with the Fund banking some profits from the put options previously purchased.

Our negative view on global bonds is evolving as rates have begun to rise, with some opportunities emerging. We are currently evaluating several potential opportunities post a significant negative performance from the global bond market. We continue to hold SA government bonds that now represent 6.1% of Fund. Our view on the SA fiscal situation has improved somewhat, which coupled with the fact that we are receiving a >11% yield on these bonds is attractive in our view. Furthermore, considering that inflation within South Africa remains relatively lower than that of the developed world, the real yields of SA government bonds remain amongst the highest in the world.

The Fund continues to have a physical gold position of 2.9% and a 1.6% holding in AngloGold Ashanti (4.5% in total gold exposure). The gold price is down 5.8% in USD year to date, and we continue to hold the position for its diversifying properties in what we characterise as a low visibility world with increasingly visible inflation and geopolitical risks. The balance of the Fund is invested in cash, largely offshore.

Notable increases in position sizes (or new buys) during the quarter were B&M Value Retail (UK value retail), Nu Holdings (Brazilian digital bank) and Wise (remittance fintech).

B&M Value Retail is a UK-focused discount retailer with a nascent but growing business in France. It focuses both on groceries and general merchandise and has a very impressive 18-year track record of gaining market share and improving profitability, with a key competitive advantage being their narrow buying focus which drives volumes and scale benefits, allowing them to price at a 10%-15% discount versus the four big grocers. More than half of their sales are food and everyday consumable goods, with the balance being general merchandise with a specific focus on home and toys. The share has come under pressure due to UK inflationary and macro concerns, but being a discount retailer, they should have a relative advantage and benefit from downtrading in this tough environment. The business currently trades on a 13% forward FCF yield, and over a 6% dividend yield, which we think is very attractive, notwithstanding the macro headwinds.

Nu is a disruptive digital first bank based in Brazil with early-stage operations in Mexico and Colombia. They have grown rapidly and now have 65m retail customers and 2.3m SME customers. Their key competitive advantages come from a lower cost to acquire consumers (word of mouth is their primary acquisition tool), cost to serve (being a digital first bank they do not have the same legacy cost structure of incumbent banks), cost of risk (they have proprietary lending models which have thus far exhibited lower loss ratios vs peers), and finally cost of funding (they have a rapidly growing deposit base which provides low cost funding). They have also done a good job of driving customers to use Nubank as their primary bank due to their expanded product offering, which should materially increase revenue per customer from ~\$7 today towards their aspirational target of \$40 (the level of incumbent banks). The bank remains firmly in growth mode and thus current profitability is significantly below normal, but in Brazil they are attacking one of the most lucrative profit pools globally with incumbent banks historically making healthy ROEs of more than 20%, providing ample runway for Nubank to continue to scale up profitability while leveraging their key competitive advantages.

Wise is a UK-based business with a current focus on remittances. The business IPO'd in July 2021, not raising capital as they were already profitable. They have built extensive global infrastructure to lower the cost of international transfers, which is superior in cost (between 50%-80% lower than the traditional banking system) and speed (83% of transfers happen in less than a day versus overseas bank transfers normally taking two to five working days). The business has a core philosophy to reinvest any scale benefits back into the business to drive costs lower, which drives customer loyalty and ignites a flywheel. They have a roadmap to expand beyond remittances over time and are currently benefitting from rising rates as customers leave money in their Wise accounts with them earning a spread, but then reinvesting the bulk of this into the business to expand their feature set and overall customer proposition. The business is growing more than 50%, whilst generating positive FCF and whilst the near-term FCF multiple is elevated at 27 times, this derates quickly to 14 times in early 2026 based on our estimates.

Outlook

There remains an elevated number of unknowns today compared to the past due to a potential structural change in inflation rates across the globe along with geopolitics bringing about another element of risk. We remain aware of these risks, and factor them into our portfolio construction. However, the primary focus remains bottom-up analysis of individual businesses. Against this uncertain backdrop, we remain excited about the outlook for the Fund, which has been built bottom up, with a collection of attractively-priced assets that provide diversification to achieve the best risk-adjusted returns going forward in a variety of future scenarios.

Portfolio managers

Gavin Joubert and Marc Talpert
as at 30 September 2022