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

Performance

The Fund increased by 10.9% in ZAR in the first quarter of 2023 (Q1-23). This continued improvement in the short-term performance is encouraging and we remain excited about the Fund's prospects given that the assets owned remain extremely attractively priced in our view.

During the quarter, a regional banking crisis in the US unfolded which included the collapse of Silicon Valley Bank (SVB) and the takeover of 167-year-old Swiss Bank Credit Suisse by a peer. All of this happened while developed market inflation remains at high levels, resulting in central banks across the world continuing to hike rates to levels not seen in decades, and finally still set against the backdrop of the ongoing war in Ukraine. There is no shortage of risk or volatility, but times like this often present opportunities for the long-term investor.

In order to take advantage of these opportunities, we believe it is imperative to apply a robust investment process, something Coronation has consistently done for nearly 30 years. This allows for the estimation of intrinsic value using through-the-cycle assumptions and focusing on the normal earnings and free cash flow power of a business. Through this process we continue to uncover what we deem incredibly attractive opportunities, making us excited about the future prospects of the Fund.

With this in mind, the Fund's weighted average equity upside is currently 65%, which remains one of the highest levels since its inception nearly 24 years ago. Beyond this, the weighted equity five-year internal rate of return (IRR) is 16% and weighted equity free cash flow (FCF) yield for stocks owned is 5%. Over the past five years, the Fund has generated a positive return of 8.8% per annum (p.a.), over 10 years a return of 10.4% p.a. and, since inception 24 years ago, 12.8% p.a.

A topic we have previously written about is the benefit that low interest rates had on financial markets, and how a normalisation, at higher levels, could ultimately show which companies were swimming naked while the tide was going out. The collapse of SVB could be considered a product of this due to poor interest rate risk management which seemed to involve an extrapolation of low interest rates into perpetuity. We believe there are still other businesses that could be impacted by this normalisation.

During the quarter, the largest positive contributors were Meta (+75%, 1.05% positive impact), Spotify (+70%, 0.87% positive impact) and Mercado Libre (+55%, 0.81 positive impact). The largest negative contributors were Charles Schwab (-36%, 1.14% negative impact) and JD.com (-23%, 0.67% negative impact).

Charles Schwab is a financial services business focused on wealth management. It generates revenue from custody fees charged on underlying investments held, and interest income from cash balances sitting in customer accounts. The latter has been impacted by increasing interest rates with "lazy" cash balances moving into money market accounts (due to better yields on offer) which results in structurally lower revenue should the reduction in these "lazy" cash balances persist into perpetuity. While we don't believe this negative mix effect will persist into perpetuity, it is difficult to gain conviction on where the mix ultimately settles, and thus what impact this has to the normal earnings power of this business. Our initial assessment is that there will be a material decline in the normal earnings power of the business which has reduced the risk-adjusted upside, notwithstanding the share price falling. For this reason, we exited our position in Charles Schwab in the quarter as this risk-adjusted upside was no longer compelling.

Fund positioning

The Fund ended the quarter with 81% net equity exposure, similar to the prior quarter. Equity exposure remains higher than the Fund's historical average primarily due to the compelling stock-specific opportunities on offer. This view is not premised on an assessment that the outlook for aggregate level index returns will be high, but rather due to specific stock picking opportunities.

Our negative view on global bonds continues to evolve as rates have begun to rise with some opportunities emerging. We have acted on a specific opportunity in the quarter; being the purchase of Delivery Hero convertible bonds which now represent ~1.5% of the Fund. We already own Delivery Hero equity with the bonds having a different risk profile but offering what we deem to be an attractive risk-adjusted return. The bonds have sold off and were purchased at ~60% of their par value which implies a ~11% EUR IRR until 2027. We are comfortable with the liquidity position of Delivery Hero and their ability to service the coupons and settle these bonds as they mature. We continue to hold South African government bonds that now represent 4.2% of Fund, which is lower than the prior quarter as some of this bond exposure was switched into the Delivery Hero convertibles. While South Africa has fiscal risks, the bonds should yield a positive return even in a scenario whereby bond holders take a capital haircut, which provides a level of downside protection whilst providing a ~11% return in a non-haircut scenario. We also continue to hold a 4.6% position in short-dated US Treasuries, yielding ~4%, as a higher yield alternative to holding USD cash.

We continue to have a 2% holding in AngloGold Ashanti due to fundamental attractiveness of the business which trades on ~11x earnings and continues to benefit from operational improvements. The gold price was up 9% in the quarter with AngloGold up 26% due to operational leverage implicit in gold producers. This is a position that also acts as an important portfolio diversifier due to the uncorrelated performance of gold compared to financial markets. The balance of the Fund is invested in cash, largely offshore.

Notable increases in position sizes (or new buys) during the quarter were Phillip Morris (global tobacco), JD.com (China ecommerce) and Haleon (consumer healthcare).

Phillip Morris is a global tobacco business that is furthest along their journey to transitioning their combustible business to reduced risk non-combustible alternatives, which now represent just under 30% of their revenues. This non-combustible revenue should be margin accretive and their market positioning in this market is stronger than their legacy combustible business. Phillip Morris is also in the early stages of growing their non-combustible business in the US where they have no legacy business and thus this is a material incremental profit pool to attack over time. Due to the high growth nature of the non-combustible business, which is now a material portion of group revenue, Phillip Morris should grow quicker than its peers (with improving margins) trading at what we deem an attractive valuation of ~15x forward earnings and a ~5% dividend yield.

We have written extensively in the past on JD.com, which is now the biggest position in the Fund. The share has sold off on growth concerns due to increased competition and a lacklustre consumer spending environment within China. In response, JD.com has renewed its focus on offering everyday low prices to compete more effectively. The business is also focused on expanding its product assortment by growing third-party merchants selling on their platform. We think JD.com will successfully execute these strategies with the growth slowdown proving to be cyclical as opposed to structural. JD.com remains an extremely compelling investment in our view and even with slower topline growth they are continuing to achieve margin improvements in the retail business leading to increasing free cash flow generation. When you consider the business has ~35% 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 ~4x current earnings which embeds an EBIT margin of 3.7%, which we feel should normalise closer to 7% due to business mix changes, and continued operational leverage. In our view, this is an incredibly attractive investment notwithstanding the short-term headwinds facing the business.

Haleon is a consumer healthcare business spun out from its parent GSK in July 2022. The business owns iconic brands such as Sensodyne, Tums and Chapstick, with these products generally exhibiting resilient demand regardless of the economic environment. The business trades on a lower multiple compared to its peers mainly due to higher debt levels and ongoing legal cases. Regarding the former, Haleon is a highly cash generative business and thus we expect it to quickly de-leverage from its current 3.6x net debt to EBITDA to below 2.5x – a level more in line with peers. The ongoing legal cases and the risk associated to this has largely dissipated post favourable court rulings. The business trades on 16x forward earnings and should grow earnings at a high single-digit rate for the next few years, which combined with a ~2% starting dividend yield should deliver a double-digit IRR in hard currency, with what we deem a narrow range of future outcomes due to the predictability of their revenue stream.

Outlook

There remains an elevated number of unknowns today versus the past due to a potential structural change in interest 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, but 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 to provide diversification with which to achieve the best risk-adjusted returns going forward in a variety of future scenarios.

Portfolio managers
Gavin Joubert and Marc Talpert
as at 31 March 2023