REFOCUS

PORTFOLIO MANAGER MONTHLY - FEBRUARY 2020

Piet Viljoen

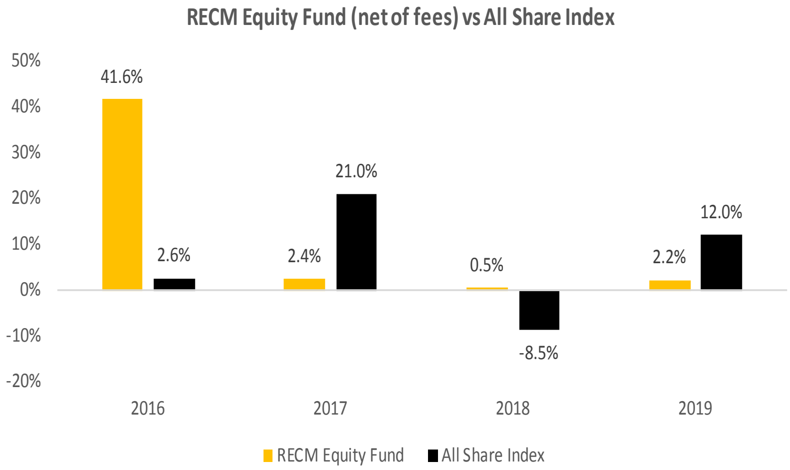
This document describes our thinking behind selected recent portfolio management actions in our portfolios and provides context to their current positioning against the backdrop of their investment opportunity set. Our funds always consist of a diversified portfolio of opportunities and risks; please bear that in mind when evaluating our commentary about individual positions.

Review of 2019

2019 was a tough year for active managers. It was an even tougher year for value managers. And it was an excruciating year for small cap managers. It is no surprise then that your statements for 2019 reflected a disappointing outcome, as RECM is an active manager with a value investment philosophy and a (current) tilt towards investing in smaller companies.

The relatively poor returns of 2019 followed a banner year for our funds' performance in 2016 (when our resource holdings shot the lights out), a more mundane 2017 (when the FANG tech stocks did really well) a good 2018 (when we had almost no exposure to the Steinhoff debacle, and avoided most of the ensuing landmines that destroyed many portfolios here in South Africa)

Our recent performance, net of fees, is presented in graph form below, per calendar year. (This is specifically for our SA equity fund, but our other funds follow a similar pattern.)



So, two winning years and two losing years, in relative terms. Over the full period however, our local equity fund returned almost 50% after fees, while the index was up close to 30%. The key to this outperformance was twofold: making a lot of money in a value rebound in 2016, and not losing money in a tough market in 2018. We chose 2016 as the starting point for a reason, because that is when RECM went back to its roots in terms of our investment process, after our well-documented missteps in 2014/15.

So, what happened in 2019 and could we have done better? To understand the answer, we need to look back on the big trends that defined 2019.

Firstly, value underperformed growth. Interest rates have remained low, which means companies with stable or growing cash flows continue to be valued highly by the market. It's a simple question of maths: Because these stable future cashflows are so "certain", they are extrapolated far into the future, and then discounted back to the present day using currently ultra-low interest rates. Of course, this computes to a very high present value – or share price. If cash flows are considered to be "certain" and interest rates are negative, one could theoretically pay any price for them. On the other side of this looking glass are value stocks with more variable cash flows which, in an environment of low interest rates, are regarded as far less valuable. In today's upside-down world, where Greece can issue bonds at negative interest rates, who cares about cheap stocks? Rather pay (much) more for the "certain" cash flows of glamorous stocks! And this is happening in portfolios worldwide.

Secondly, large cap shares outperformed small cap shares. As index funds have become increasingly popular, "conventional" allocation is incrementally favoring the largest companies. The whole process is one of increasing extremes, where funds are being withdrawn from active managers, forcing them to sell their (predominantly) non-indexed holdings, and allocated to index funds, forcing them to buy more of the biggest companies. Most indices globally have never been more concentrated.

In a recent research report, Verdad research alluded to both the "quality" effect as well as the "index" effect. In the report, they noted that larger cap and higher multiple stocks significantly outperformed in 2019, in sharp contrast to the previous 30 years. You can find their note here.

Finally, in South Africa, global stocks outperformed local stocks. This tied in with a broader phenomenon globally, where developed markets outperformed emerging markets. Quality and growth are mainly found in developed markets – the technology, consumer staple and pharma sectors dominate these markets. Emerging markets have much more exposure to the more cyclical (and cheap) financial, utilities and industrial/manufacturing sectors.

In 2019, as in all other years, our funds were positioned where the value was – smaller companies, industrial and financial companies, and companies operating in emerging markets. Sometimes all in one!

The key unknowable is: How long will these trends carry on? We believe investors in these popular assets are taking on far more risk than they realize. What seems safe and rational now might not feel so good tomorrow. Shareholders of Steinhoff, on the day the news broke of its problems, know this uncomfortable feeling well.

At RECM we have always been prepared to make less money than others in the latter stages of a bull market in order to avoid the inevitable drawdown when it ends. That was the story of our funds' performance in 2017 and 2018. In 2017 we underperformed, as we didn't own the glamorous stocks (Steinhoff, EOH, Fortress etc.). In 2018, when many of these companies started hitting the wall, we still didn't own them, which meant our funds did not lose money, and retained the gains of 2016.

And the silver lining of our lackluster returns in 2019 was that we once again didn't lose money, despite our strong positioning towards small cap value. Applying the lessons from 2014/15, we have been running much more diversified portfolios. We have not only diversified across industries, but also across size and asset class.

Locally, while some of our small cap value positions have done terribly (Stefanutti Stocks, Calgro M3 and HCI), the losses weren't big enough to drag the whole portfolio down. We also owned some big winners like gold and platinum stocks. Our local equity fund also has a dividend yield of over 5%, which helps buffer any drawdowns on specific stocks. Overall, we generated a positive return of just over 2% after fees for the year, which is passable, given the orientation of our value philosophy. However, the All Share Index, driven by a few (expensive) stocks, returned 12%.

Our **Global fund** fared better, returning 14% in US dollar terms. At the start of 2019, when bearishness prevailed, my guess is that most investors offered that return upfront would have taken it. We had some nice winners in our very cheap Russian holdings (Gazprom and Sberbank) as well as platinum and gold stocks. Tesco also added significant value, aided by the strengthening British pound. But the MSCI World Index rose by an astonishing 26% driven by the market's favorite stocks - which we don't own due to their elevated valuation levels.

So, despite not losing money in a tough year for value investing, our funds don't look particularly good in relative terms. And everything's relative isn't it?

As value managers, we think our job is to avoid structural risks the market might not be pricing correctly and to look for mispriced assets outside of those areas. Fortunately, the “outsider” (or contrarian) assets we tend to buy also have high free cash flow yields, and as a result, good dividend yields. We are being paid to wait, so to speak. And, going forward, we think many of the positions we own are pregnant with tremendous upside - under the right conditions, of course.

What are those conditions?

Globally, we would need to see a move away from artificially low interest rates for value to make a comeback. This is not a question of “if”, but “when”. Increasing debt levels at corporate as well as government levels worldwide just about guarantee it. When that happens, many assets that now look safe, won’t be safe at all. This includes ETFs based on the major indices, growth stocks and quality stocks.

Timing remains the issue. Since year end, US bond yields have declined to new lows and index funds continue to rake in assets. So at the moment the trend does not look like it’s ending soon.

Locally, we would need policy certainty and less political noise. We would need prudent fiscal management. We need a less incapable state and we would need some confidence restored to the legal system by seeing some of the public and private sector beneficiaries of state capture sent to jail.

But between the bankrupt SOEs, the populist land policy (EWC), the populist health policy (NHI), cadre deployment, the possible implementation of prescribed assets, constant power blackouts and the emigration of the tax base, it’s almost impossible to make a positive case for investing in South Africa. The only bright spot is that our assets are cheap.

To give you an idea of how cheap stocks are in South Africa, here’s a short precis of some of our holdings:

1. HCI is our biggest holding. It is a diversified investment holding company, with one of the best capital allocators in South Africa at its helm. It owns a wide variety of business – hotel, television, transport and gaming operators. And HCI is trading at less than half of its book value. Apart from that, HCI also owns a stake in the biggest platinum development in the world as well as a stake in a number of very large offshore oil exploration blocks. Both of these assets could be very valuable and are in the books at a nominal value. On top of that, HCI keeps buying back shares – its share count has dropped by a third over the past 7 years from 123 million shares in issue to 85 million. So although the share price has declined over the past few years, the per share value of the business has been increasing.
2. Bowler Metcalf is a 40 year old, family-controlled packaging business. It recently sold a non-core bottling business and paid a special dividend. It retains R380mn net cash on the balance sheet. The operating business will earn around R60mn this year – in a very difficult economic environment. This neat little package is on the market for R550mn - including experienced, committed management. You do the maths.
3. Steinhoff preference shares pay an annual dividend of R8.15 per share. We bought them for R44 per share, for a tax-efficient yield of just over 18% p.a. We bought these in January 2018, just after the bombshell around the business broke. Since then, they have paid their dividend on time every six months, and we have already received 40% of our money back. If the worst were to happen, the downside is 60% - roughly what Sasol shareholders have lost over the past 18 months. It’s important to remember that these preference shares are backed by Steinhoff South Africa, which is solvent, and owns, 71% of Pepkor.

I could go on and on, but the bottom line is that SA assets are dirt cheap.

But, to invest in South African assets one would have to take a view on how probable a positive resolution to our current problems are. If it was a certainty, it would make sense to have all your investments here in South Africa - that is how cheap the market is. But if we have a really negative outcome, many of these cheap assets will be worth nothing. A low valuation will not protect you in a melt-down.

As always, we think diversification makes sense – it's no use trying to predict what will happen. Building a portfolio that is prepared for any possible outcome is a better use of one's time than trying to guess what the future will look like. Diversification is a key step in this preparation.

In our **Global Flexible Fund**, our fund that can invest anywhere in the world in any asset class (and happens to be our most popular fund, as it is a sort of a "one stop shop") we currently have exposure of under 40% to South African assets, and over 60% to global assets. Given current valuations, we think this is a sensible allocation. This fund has generated inflation-beating returns since inception and is set to continue doing so – whatever happens going forward.

2020 and beyond

We recently announced a merger with another like-minded investment firm called Counterpoint Asset Management. This allows us to serve you, our clients, better: we will now have a stronger investment team, a wider range of funds and a more scalable business, which will put us in a position to reduce the fees you pay us to manage your money over time.

The merger is set for 1st March. Until then, nothing changes, and we hope that after that date you will not notice anything different either, apart from the name change. (We've decided to move forward with the brand Counterpoint, which is easier to remember and easier to pronounce!) We will eventually merge our local equity funds, and I will continue to be the portfolio manager there. Sam Houlie will join me in managing these funds, and I look forward to working with him. We will also merge our balanced funds, and here we will have three people looking after the combined funds: myself, Sam and Alex Pestana. Alex is a fixed income specialist, and is bound to add tremendous value. Our Global Flexible Fund will remain as is, with Sam joining me on the management team for that fund. Our Global Fund will eventually be merged with Counterpoint's global fund and here, Sam and I will look after the combined assets.

Counterpoint has other funds with distinct mandates worth mentioning – namely, a dividend income fund, managed by Ray Shapiro as well as an enhanced income fund, managed by Alex Pestana. The management of these funds won't change, but they will be available to all our joint clients. Sam, from Counterpoint, will lead the investment team, with Linda Eedes from RECM leading the business.

We look forward to continuing to serve you in 2020.

Piet Viljoen