REFOCUS

PORTFOLIO MANAGER MONTHLY - MARCH 2018

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.

BORING IS BETTER

Clients of RECM would know that as an investment firm we have gone back to basics over the past year. Subsequent to our missteps in 2014/15 we have gone through a period of introspection, and have emerged with a renewed commitment to the principles that made us successful in protecting and growing our clients' wealth during our first decade. To recap, they are: an unwavering commitment to value investing, applying a sensible investment process based on what works in investing over the long term and working for a group of clients that understands what we are trying to do for them.

In the past, our investment philosophy and process typically led to what many people described as "a boring outcome". Our funds never seemed to be invested in the exciting stocks. When the market was strong, our funds tended to do relatively poorly - not losing money, just not making as much as the high flyers. But when markets turned down – as they inevitably do from time to time - our clients did relatively well. Sometimes spectacularly so. We lost a lot less – and sometimes even made money - during these periods of strain in the market. And in the early bull markets that followed, we were able to put our excess cash to use to capitalize on the opportunities presented by falling prices.

Many factors played a role in this outcome, but the most important of these is that we concentrated on building a diversified portfolio of assets priced well below their intrinsic value. This discount to intrinsic value, or "margin of safety", is our primary risk management tool. Warren Buffett famously quipped, when someone commented on Berkshire Hathaway's significant lack of analyst manpower and disregard for conventional due diligences, "Price is our due diligence". At RECM, we concur.

For the past 12 months to end February, our local equity fund returned 0.7% after fees, compare to the 17.4% generated by the All Share Index. At face value, our equity fund performed relatively poorly. Looking under the hood however, almost half of the return of the ALSI came from Naspers, with another 5 stocks - Richemont, Anglos, BHP Billiton, Standard Bank and FirstRand contributing most of the remainder. Excluding these stocks, the market returned 3.9%. It's clear that the market has become increasingly narrow over the past few years with one stock (Naspers) dominating everything else. Investors do not seem to care about its poor corporate governance, or management's poor capital allocation and they certainly don't seem to care too much about the concentration risk it brings to the table. Today, Naspers makes up almost 20% of the All Share index. Effectively, diversity has broken down, and the rush to indexing has accelerated this process.

As a result, at RECM we think the underlying riskiness of the market has increased dramatically, with big components like Naspers preventing investors from getting a clear view of the risks that are bubbling under the surface. During good times, it's more difficult to ascertain whether risk controls are adequate. The absence of loss does not necessarily mean a portfolio is safely constructed. The cost of risk control – in the form of return foregone – can seem excessive during the good years, but ultimately these controls pay off when risk collides with negative events and portfolios are protected against permanent capital losses.

So, the past 12 months are familiar ground for longstanding clients of RECM. During so-called good times, RECM may underperform. We are comfortable with this, because we are consciously managing risk that many investors may unwittingly be exposed to.

However, over the three months ending February the market (and Naspers) has stopped going up in a linear fashion, and there have been some significant negative surprises. The hand grenades included popular stocks like Steinhoff (-90%), Fortress REIT (-60%), Resilient REIT (-52%), NEPI Rockcastle (-44%), EOH holdings (-38%), Brait (-33%), Ascendis Health (-33%), PSG (-25%), Reinet (-21%) and the very popular new listing African Rainbow Capital (-18%).

Our "boring" portfolio has been a relatively comfortable place for our investors during this time. For the three month period our equity fund returned 3.4%, while the ALSI returned -2.2%. Volatility in the market has been our friend, allowing us to make unemotional decisions as to whether to increase or decrease exposure, depending on price movements relative to our calculations of underlying value.

Putting everything together, since early 2016, when we re-committed ourselves to our brand of value investing, our funds have done well in absolute and relative terms. Our local equity fund has returned 48.1% after fees since the start of 2016 to the end of February this year - compared to the All Share Index which returned 21.8%. This time period is of course far too short to draw too many conclusions from, but it contains good and bad times, and importantly, our funds have performed as expected in both types of times, as well as over the whole period. We are happy with this pattern of returns – it signifies to us that we are back to protecting and growing our client's wealth, and we hope this serves as a source of comfort for those who entrust their wealth to us.