Kagiso Equity Alpha Fund
June 2021

KAGISO Asset Management

The fund was down 2.4% this quarter, underperforming other general equity funds (up 0.6% on average). It has returned 13.2% pa over the last three years, well ahead of the competitor fund average (5.8% pa), and 40.0% over the last year (versus 25.3% from competitors). Over the last ten years, the fund has returned 10.5% pa and is ranked third since inception in 2004, having delivered 16.0% pa since then.

With the unexpected pandemic market shock now more than a year behind us and materially changed economic prospects for the companies and economies in which we invest, we are pleased with the extent of our fund's rebound and outperformance.

Economic backdrop

Rapid rollout programs of (very effective) vaccines have substantially progressed in many developed markets, with laggard countries (like Germany and Japan) rapidly catching up. This is allowing a faster return to more normal activity in those regions, limiting further scarring in services sectors (particularly tourism and leisure). Unfortunately, several less wealthy nations are enduring continued heavy Covid-19 impacts, accompanied by slow vaccine rollouts. This is delaying their economic recoveries. It currently appears that the rate of vaccine rollouts is insufficient to contain the virus worldwide and, with mutations occurring where the virus is raging, it is likely that negative economic effects will endure for an extended period of time.

Developed market consumer and corporate health appears to have been largely preserved through extensive and ongoing fiscal and monetary support. Labour markets are reasonably healthy and are thus far showing resilience where government sponsored furlough schemes are ending. In the USA, the level of fiscal support has increased further this year and is currently providing a positive and enduring boost for the global economy. In the near-term it seems that many developed economies are growing at above trend levels post their pandemic recoveries. Nevertheless, sustainable economic conditions may be visible only when fiscal support and monetary stimulus meaningfully tapers off more meaningfully and the reality of permanent job losses manifests.

Following a rapid resumption of economic activity back to pre-crisis levels, the Chinese economy is once again growing strongly. This is largely due to the successful early containment of the pandemic, government stimulus (which boosted infrastructure and residential investment in particular) and surprisingly strong exports and manufacturing activity. Initially exports were buoyed by temporary Covid-19-related goods demand and thereafter sustained by improving global activity. Consumer spending has recovered (showing reasonable growth off pre-crisis levels) but confidence remains lackluster. Pre-crisis risks, however, remain - a disruptive moderation and rebalancing of economic growth (away from fixed asset investments and towards consumption) and potential further deterioration in geopolitical relations.

The local economy has continued to recover, with consistently high commodity prices (particularly platinum group metals and iron ore) significantly supporting economic outcomes and the agricultural sector remaining buoyant. However, with an ineffective vaccine rollout, recurring Covid-19 variant surges continue to hamper the recovery of our services sectors. South Africa is lagging the global recovery considerably, showing signs of permanent economic damage from the lockdown and years of state mismanagement. We suffer from a very depressed labour market, unstable electricity supply, weakened and tax-hungry municipalities and chronically low business and investment confidence. For these reasons, we remain pessimistic regarding the structural growth rate for the local economy (which we believe has severely weakened in recent years) and have been wary of extrapolating a short-term cyclical growth rebound too far into the future when valuing cash flows.

While economic revival plans are well articulated, they still rely too heavily on implementation from weakened state institutions and do not draw sufficiently on private sector participation. However, recent actions to liberalise private sector electricity production are a step in the right direction. In addition, actions to rebuild crime fighting and tax collection capabilities are advancing, although still far from sufficient and far too slowly. A full post-crisis economic recovery will take meaningfully longer than the rest of the world due to the inherent structural weaknesses of the South African economy, with increased risk due to unsustainably high sovereign debt.

The shocking and tragic recent looting unrest and resultant sapping of business confidence and economic damage (particularly in KwaZulu-Natal) are another reminder of the long-term structural growth impediments we face. Recurrent social instability and unrest is an unfortunate inevitability given very high levels of unemployment and inequality.

The medium-term outlook for developing economies varies widely at present, with differing exposures to volatile energy prices (importers versus exporters), strong other commodity prices, decimated tourism industries and differing impacts from the management of the pandemic and progress of vaccine rollouts. Due to recovering domestic demand and some signs of increased inflation, policy interest rates have started normalising higher in these economies from the extraordinarily low crisis levels.

Market review

Global markets were once again strong this quarter (up 7.9% in US dollars), with France up 10.0%, the UK up 5.7% and the USA up 8.5%. Within emerging markets (up 5.1% in dollar terms), Brazil (up 23.8%) and Russia (up 14.4%) outperformed, while South Africa (down 1.3%) lagged. Over the last 15 months global equity markets have recovered very strongly from the March 2020 lows (up 67% overall).

In rand terms, the local equity market was flat this quarter, with mid-caps (up 5.9% for the quarter versus large-caps that were down 0.8%) still underperforming since the start of 2020 (down 0.9% versus large-caps up 18.8%).

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Resources shares underperformed this quarter (down 5.2%) following an extended period of outperformance. Anglo Platinum (down 23.4%), Anglogold (down 17.5%) and Northam Platinum (down 15.7%) underperformed, while Glencore (up 6.8%), Anglo American (down 0.7%) and BHP Group (down 1.2%) outperformed within this sector.

Industrials were flat (up 0.1%) – heavily influenced by weakness in Naspers (down 15.1%). Standout positive performers included Richemont (up 21.9%) and retailers (Dis-Chem up 41.4%, Foschini up 30.0%, Pepkor up 24.6% and Truworths up 20.6%). Telecommunication stocks were also strong, with MTN up 18.9% and Telkom up 9.5%. MultiChoice (down 9%) and British American Tobacco (down 1.3%) were other laggards.

Financials outperformed (up 8.1%), with listed property (up 12.1%), banks (up 9.6%) and life insurance (up 5.8%). Investec Plc (up 26.4%), Nedbank (up 22.1%) and Capitec (up 20.0%) outperformed, while Ninety One (down 10.9%), Coronation (down 7%) and Quilter (down 6.8%) underperformed.

Extremely high developed market fiscal and monetary stimulus measures are providing a powerful support for financial markets and have led to dramatic increases in general asset prices. We expect increased volatility and weakness in many now buoyant areas when fiscal stimulus inevitably wanes, if sustained inflation emerges at last and when interest rates rise from their extremely low levels.

Fund performance and positioning

The key detractors this quarter were Naspers and to a lesser extent our PGM miner holdings (Northam Platinum, Royal Bafokeng Platinum and Anglo Platinum). Meaningful positive contributors included Omnia, MTN, PPC and Curro.

Our global equity holdings contributed negatively to performance. Detractors included Siemens Energy, Prudential and Fiserv, whereas Spire Healthcare, Nisshinbo, Kinder Morgan and M&G positively contributed.

It is evident that companies with stronger balance sheets, better business models and flexible, more adaptable management teams are outperforming in the recovery period and we believe the outperformance will be even more pronounced in the weaker economy in the years ahead. We are maintaining exposure to such companies, at the right price.

Our portfolios contain a diverse selection of local mid-cap holdings offering very attractive upside.

Metair is one of these. It is a manufacturing business producing automotive components and batteries. Production facilities are based in South Africa, Turkey and Romania. Metair's production is sold directly to vehicle manufacturers (OEMs), as well as into the aftermarket. Having endured production disruptions in 2020, Metair is well positioned to deliver strong earnings growth as production recovers and then ramps up further on the back of significant new project wins. Given South Africa's generously incentivised automotive manufacturing policy, OEMs remain committed to growing their local production as evidenced by the large capital expenditure programs they have announced recently. Although globally we are seeing a transition to electric vehicles, given limited local charging infrastructure and incentives to support this transition in the markets Metair services, the vehicle parc in Metair's main local markets will continue to use the lead acid batteries produced by the company. The Romanian and Turkish operations offer a price competitive offering for both their local and broader European vehicle markets. Increasing aftermarket volumes to serve the ageing vehicle parcs and the progression to start stop lead acid technology support the expansion of operating margins within Metair's battery business. We believe the investment case is compelling given the low price at which the business trades relative to its cashflow prospects.

Within equities, we maintain our high exposure to low-cost, growing PGM miners. We expect a sustained acute shortage in PGM metals when global economic activity normalises, due to structural supply impediments, demand from tightened emission regulations, increased jewellery demand and a rapidly growing hydrogen energy sector. Current share prices offer very attractive near-term free cash flow yields, even if commodity prices are lower.

We maintain a very high weighting in Naspers, where the group balance sheet is strong and the underlying exposure to online Chinese economic activity (via Tencent) has a bright, long-term future. The company is thriving in the current crisis, as evidenced by recent results and there is considerable upside at the current share price.

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Invest with us **Website** www.kagisoam.com **Client service** 0800 864 418 **Email** clientservice@kagisoam.com **Fax** 088 021 671 3112