Bateleur Flexible Prescient Fund—

First half 2020 commentary

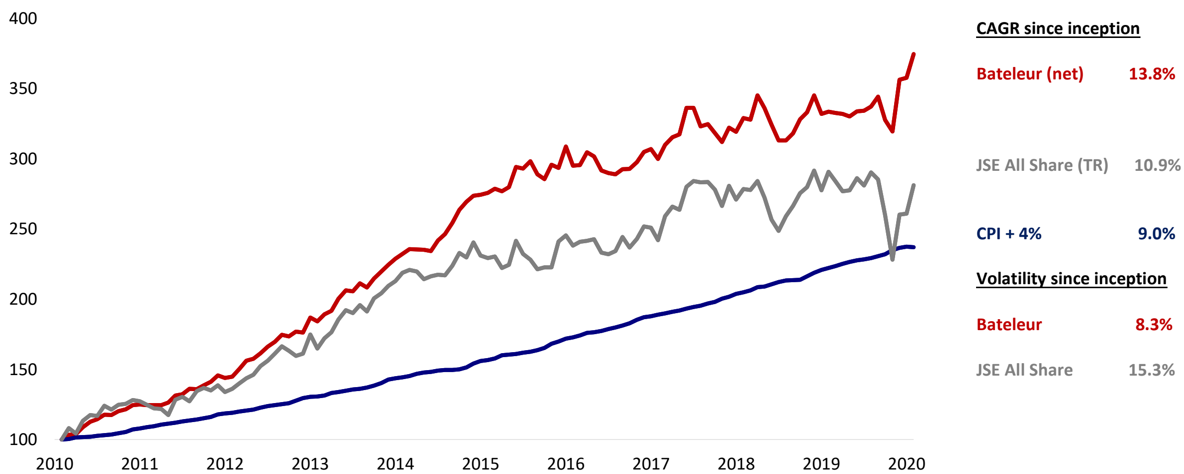
bateleur capital

Bateleur Flexible Prescient Fund – 2020 first half report back to unitholders

The fund's NAV per unit increased 10.9% for the first half of 2020. Over the same period, SA equities (JSE All Share Index) declined 3.2%, SA bonds (ALBI) increased 0.4%, while cash (STeFI) returned 2.7%.

The fund celebrated its 10-year anniversary on the 30th of June 2020, an important milestone. In the 10-year period since inception the fund has compounded at 13.8% p.a. net of fees, ahead of its benchmark (CPI + 4%) of 9.0%, the JSE All Share Index of 10.9% (inclusive of dividends reinvested), SA bonds of 8.3% and cash of 5.9%. Returns have been achieved at significantly lower risk than the equity market, emphasising sound capital preservation attributes (chart 1).

Chart 1: Bateleur Flexible Prescient Fund – returns since inception vs. the JSE and benchmark



Source: Bateleur

In the period under review, the fund benefited from increased equity exposure as cash was deployed into the market sell-off, a healthy weighting in physical gold, and solid share selection. A summary of the attribution by strategy and top contributors and detractors are shown below.

Table 1: Flexible Fund H1 2020 - attribution by strategy and top individual contributors and detractors

Attribution by strategy	H1 2020
JSE listed equities	+1.3%
Foreign listed equities	+10.6%
Costs (and other)	-1.0%
Total	10.9%

Top contributors	Top detractors
Naspers/Prosus	Tsogo Gaming
Dollar General	Sasol
PayPal	Supergroup
African Rainbow Minerals	Anglo American
Amazon	Hospitality Group
Microsoft	Mpact

Source: Bateleur

The top contributors were predominantly global shares, unsurprising given the Rand's sharp depreciation against the US Dollar. However, offshore stock picking was also sound with PayPal (+61%), Amazon (+49%), Microsoft (+29%) and Dollar General (+22%) all registering notable gains in US Dollars.

These companies delivered impressive revenue growth in recent quarterly results and are prospering in the current COVID environment, either through increased digitisation or shifting consumer habits.

Microsoft CEO Satya Nadella made the following comment when reporting recent quarterly results *"As Covid-19 impacts every aspect of our work and life, we've seen two years' worth of digital transformation in two months."* They are clear winners in the shift to a work from home environment and increasing cloud adoption by both corporates and individuals.

Amazon's online shopping business has expanded rapidly during the pandemic necessitating the company recruiting an additional 175,000 employees. The growth runway for Amazon remains long, with US E-commerce still small as a percentage of total retail spend compared to China, while tech productivity continues to improve (charts 2 and 3.)

Chart 2: US E-commerce – long growth runway

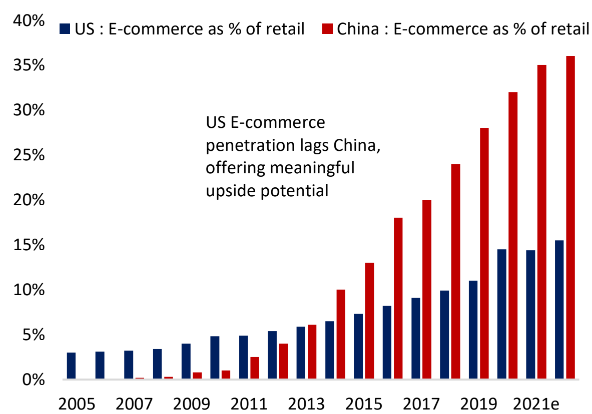
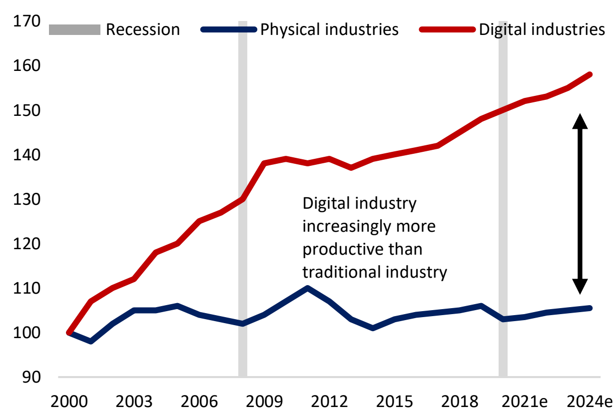


Chart 3: The tech industry productivity boom



Source: Epoch Partners, Bank of America, Bernstein, Bloomberg – sourced from Epoch partners presentation.

Detractors were largely domestic focused shares whose earnings are expected to decline sharply in 2020 due to the indirect impact from the virus. These include companies exposed to the travel and leisure segments (Tsogo Gaming and The Hospitality Group), logistics and motor vehicle retail (Supergroup) and those exposed to lower economic activity (Mpact). The fund has retained its exposure to these companies as they trade at material discounts to our assessment of fair value in a normalised environment.

Current fund positioning.

During the sell-off in February and March 2020, the fund increased its equity exposure by reducing its money market holdings. From an allocation of 26% in late February, the money market weighting has reduced to 15%. Equity exposure is currently 80% with physical gold making up the remaining 5%.

Equity exposure was increased into both SA listed and global equities via individual stocks (i.e. no indices were bought). However, our ability to further invest in global equities was curtailed to 30% of the fund's NAV, the maximum allowed mandate weight.

In adding equity exposure, we focused on companies with strong balance sheets, earnings resilience, entrenched business models and attractive valuations.

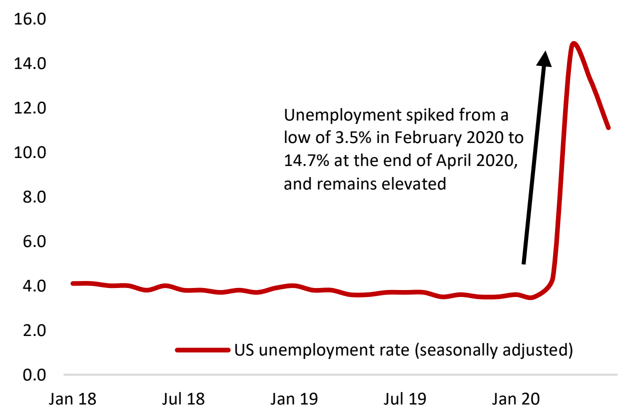
Local holdings added to include the JSE, Multichoice, Shoprite, Adcock Ingram, African Rainbow Minerals and RMI. Offshore additions include Dollar General, Alibaba, Lundin Energy, PayPal and Swedish Match.

Risk assets have rebounded strongly from the March lows. The S&P 500 is up 45% since the low reached on the 23rd of March and is now only 4% below its all-time high (chart 4). Similarly, the JSE All Share Index is up 50% in Rands off its March low and is currently only 3% off its all-time high.

Announced stimulus packages by major developed market central banks have clearly supported capital markets notwithstanding dire economic conditions on the ground. This is the only plausible explanation for the disconnect between elevated asset prices and record unemployment levels (chart 5).

Chart 4: S&P 500 index price performance

Chart 5: US unemployment rate (%)



Source: Bloomberg, Bateleur, US Dept. of Labour

The sheer magnitude of the policy response by the G4 countries (US, UK, Europe and Japan) is difficult to comprehend (Chart 6). These countries are cumulatively expected to expand their balance sheets by $11.9 trillion in the short-term, implying an additional increase in debt to GDP of 28%.

Fund manager Blackrock performed an interesting exercise by comparing the size of the stimulus response by the G4 to the estimated negative GDP impact from the virus. In the case of the US and the Euro Area, the monetary and fiscal stimulus exceeds the negative impact from the virus (chart 7).

Chart 6: G4 Central Banks B/S as a % of GDP

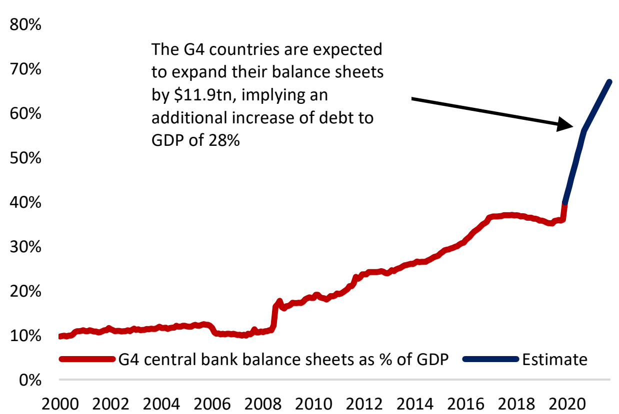
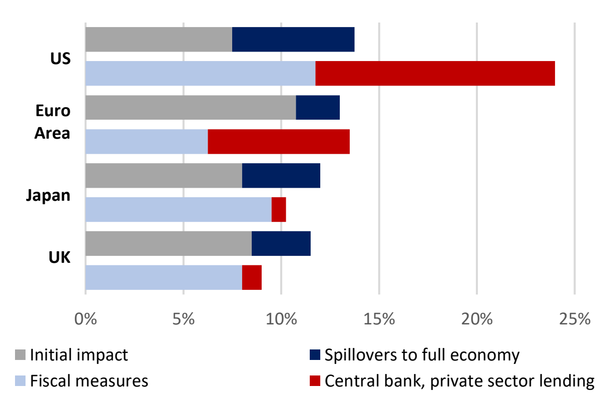


Chart 7: Estimated virus impact vs response



Source: Bloomberg, Morgan Stanley, Bateleur, Blackrock, Federal Reserve, ECB, BOJ, BOE and Haver Analytics

Although this seems bizarre, it can be supported when reviewing the US CARES Act. This program provides an income grant to individuals who recently lost their jobs or were placed on furlough as a result of the pandemic. The median US worker is earning substantially more (35% more) under the CARES program (while unemployed) than they did while working (chart 8).

Contrast this to SA, who does not have the ability to undertake large monetary policy stimulus without dramatically impacting the currency. People who have lost their job as a result of the pandemic can apply for TERS benefits which on average amount to 31% of what they previously earned (chart 9). The result is that SA will likely face a deeper and longer recession than many of its global peers.

Chart 8: US weekly wage replacement rate %

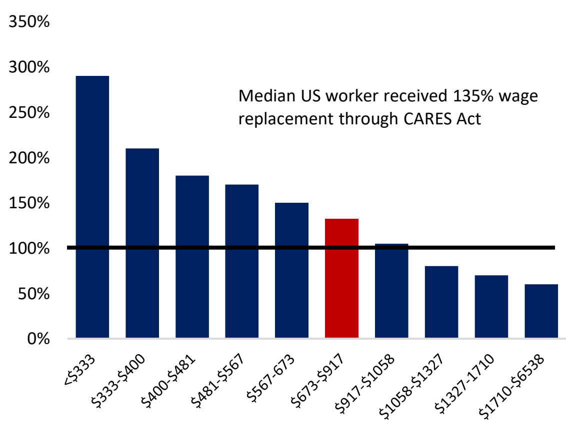
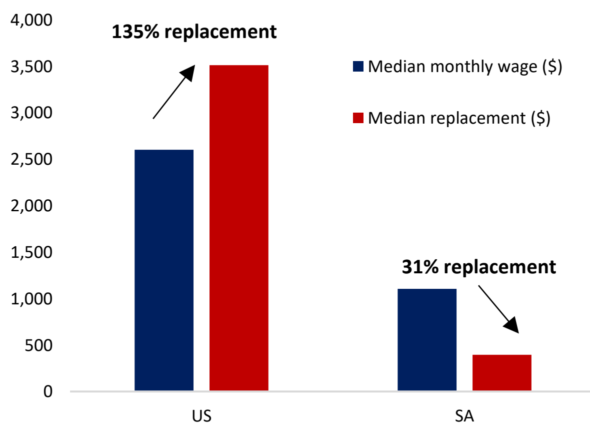


Chart 9: US vs SA wage replacement ($)



Source: Bateleur, University of Chicago, Stats SA

The sharp rebound in risk assets has resulted in equity valuations trading above their long-term average on a historic basis (chart 10). Similarly, corporate debt yields which initially spiked in February and March have retreated to previous low levels – despite corporate debt levels being at all-time highs with poor corporate earnings prospects (chart 11).

Chart 10: S&P 500 trailing P/E

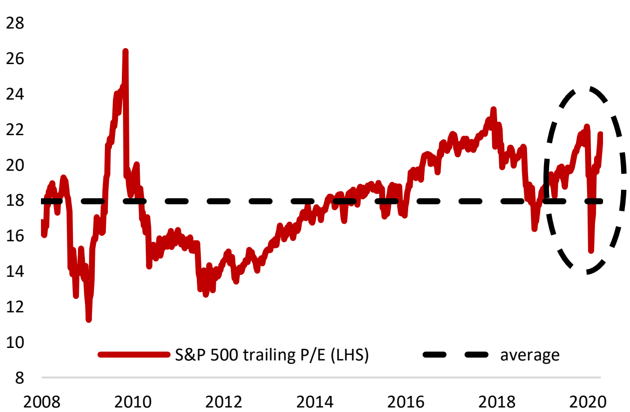
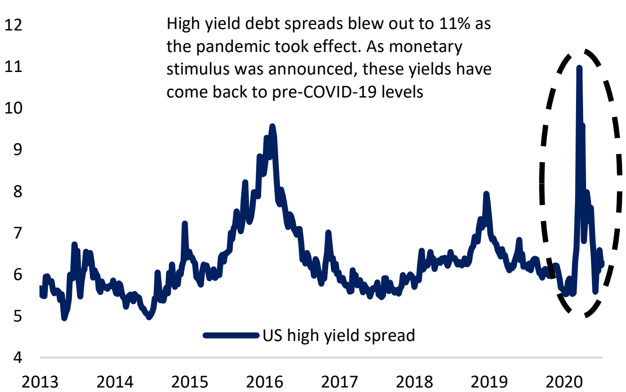


Chart 11: US high yield debt spread



Source: Bloomberg, Bateleur

While not betting against central banks, given the sharp rebound in risk assets, we remain cautious on the near-term outlook for equities and are therefore not adding to the fund's current equity exposure. We continue to realise certain holdings that have performed strongly in the current risk on environment and rotate into lower risk opportunities.

In terms of themes – on global equities we remain cautious on cyclicals, financials and companies with elevated debt levels. Our preference has been to be invest in 1) select technology companies that are showing strong organic growth in the current environment and trade at reasonable valuations; and 2) defensive/staple companies that have proven business models over multiple economic cycles, generate strong free cash flow, and have dividend yields above the risk-free rate currently on offer.

Domestically, the fund's bias is to companies that are listed on the JSE but are global companies – including Naspers/Prosus, British American Tobacco, AB InBev and select miners. Holdings that are directly associated with the SA economy are relatively small as a percentage of the overall portfolio and are stock specific.

A summary of the current fund positioning is shown below.

Current fund positioning by strategy	**%**
JSE listed equities	49.0%
Domestic facing holdings	*22.2%*
Dual listed/ Rand hedge	*26.8%*
Foreign listed equities	31.0%
Total equity exposure	**80.0%**
Gold	**5.0%**
Cash & money market	**15.0%**

Sincerely,

Kevin Williams

Fund Manager

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Head: Distribution

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