Benguela Global Equity ACI Feeder Fund Commentary: Q2 2020

30 July 2020

Portfolio: Benguela Global Equity ACI Feeder Fund

Benchmark: MSCI All Country World Index (MSCI ACWI)

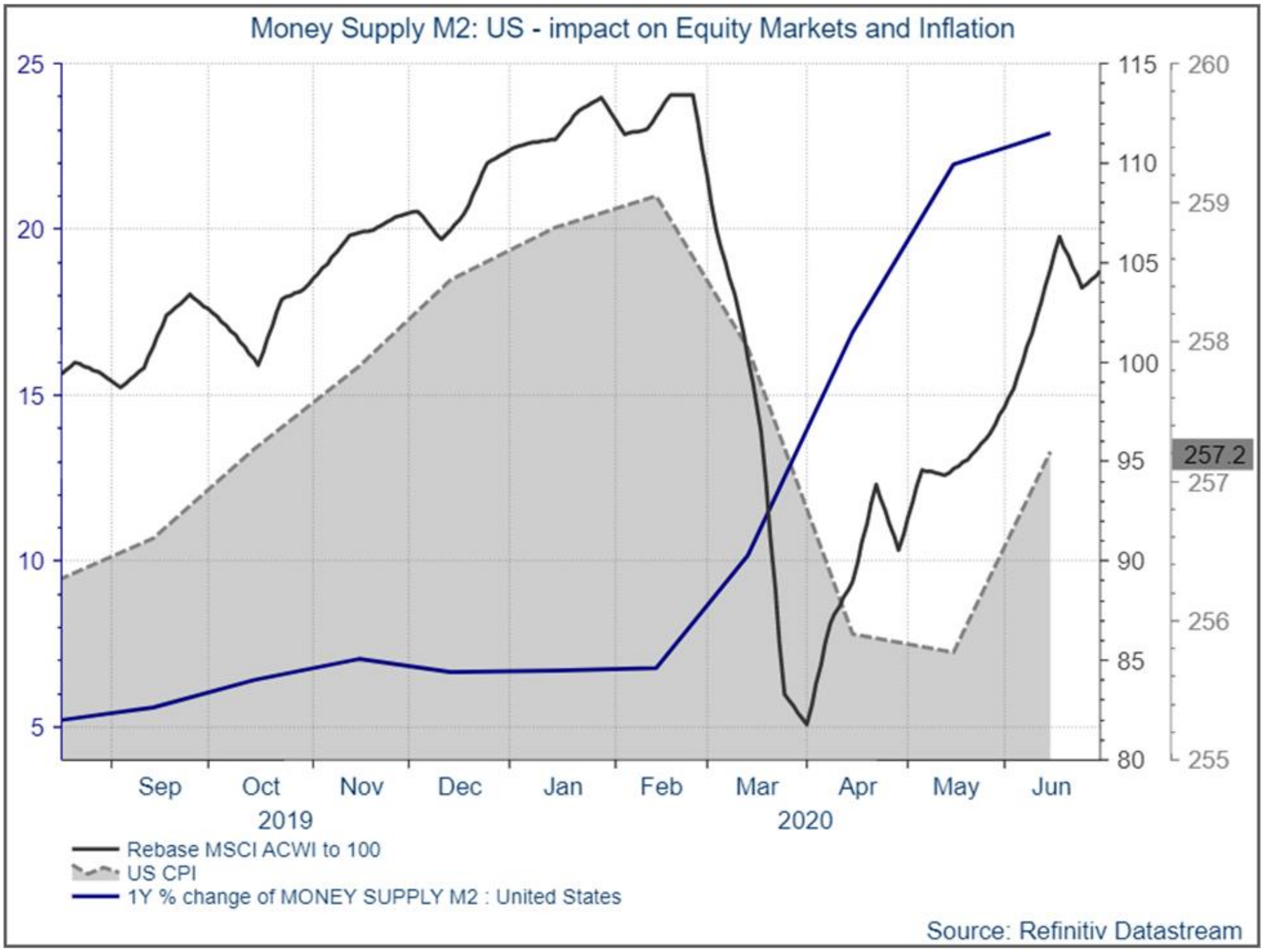
Performance Review

Global equity markets have staged an extraordinary recovery, with the MSCI ACWI up 19.2% over the quarter, to end the quarter just 6.3% below where it started the year, and 37% above its 23 March 2020 trough. This, despite the global economy still in the early stages of recovery from the depths of the largest economic setback in modern economic history.

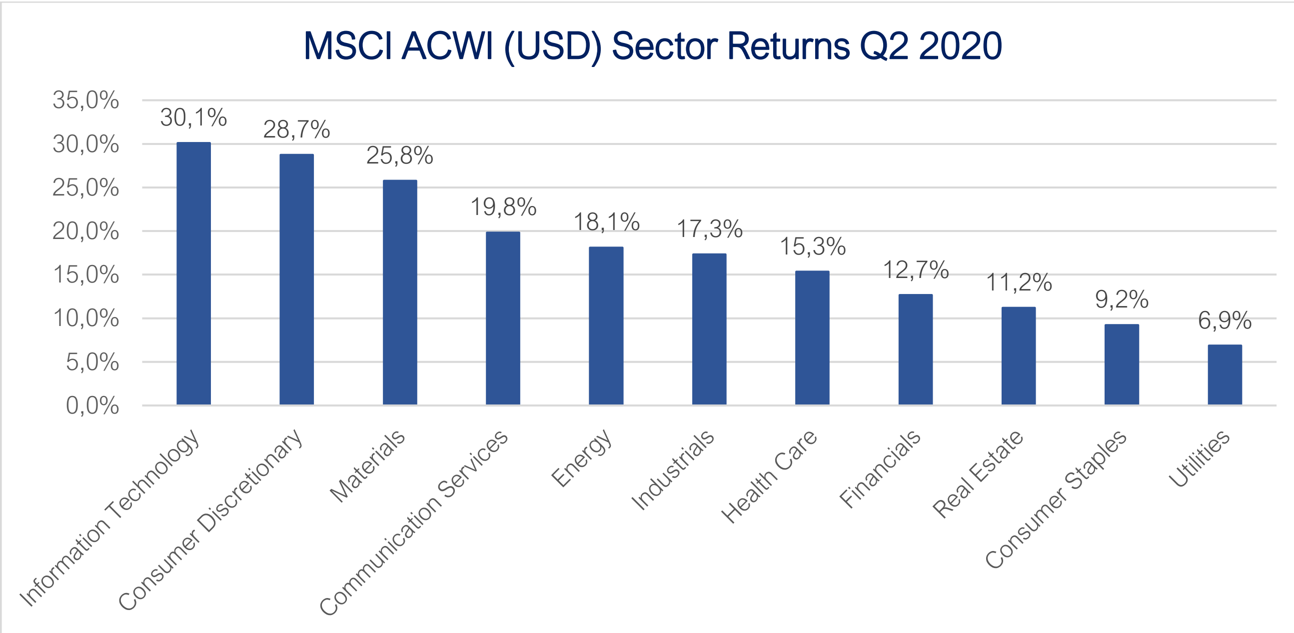
The Benguela Global Equity ACI Feeder Fund ("the Fund") returned strong double-digit growth of 13.5% versus a Benchmark of 15.8% (both in ZAR terms, net of fees), lagging the benchmark by 2.3 % for the quarter. This slight lag in performance by the fund is not out of character for the quality strategy we follow, which provides upside participation, but may lag the market slightly during sharp rallies. Important is that the strategy provides significant downside protection as it did in the previous quarter.

While economic activity around the world is slowly starting to pick up, the swift rebound of the stock market can best be attributed to initiatives by governments and central banks around the world to backstop the collapse in economic activity as a result of the Covid-related lockdowns. In short, central banks and governments have created a significant increase in the amount of money outstanding in the economy. In the US alone, M2 money supply was up 23% year-on-year in June, at a time when economic output was collapsing.

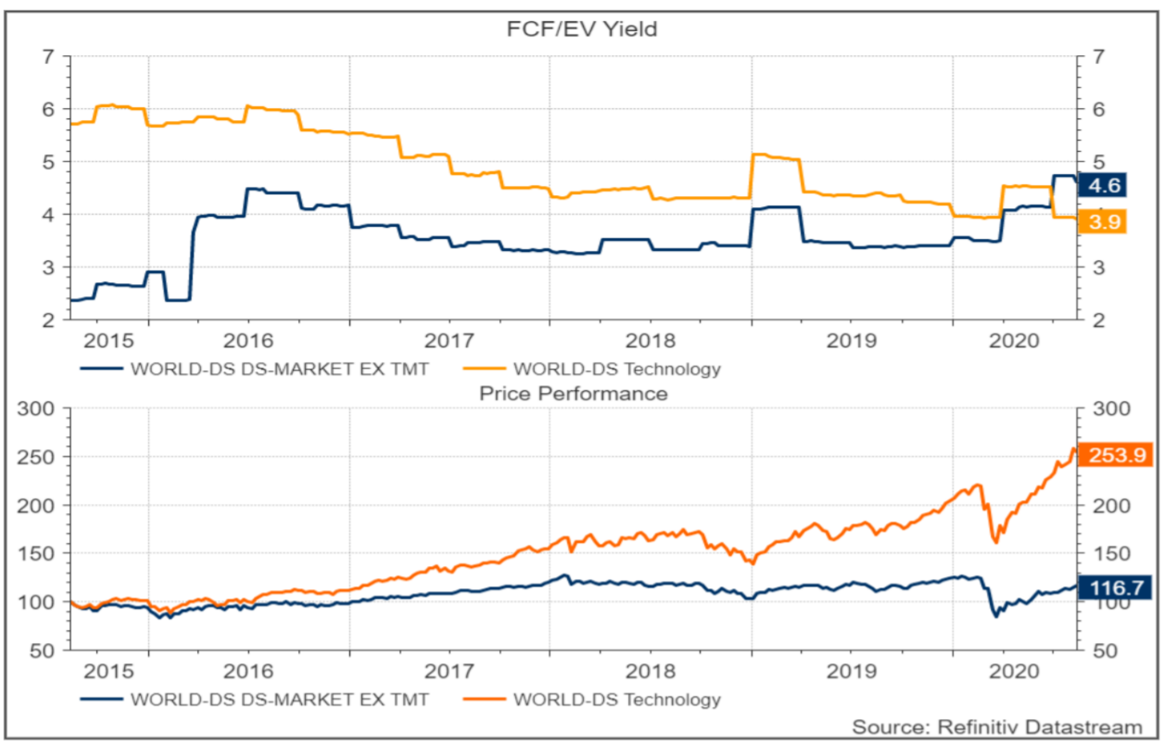
While this money supply has hardly affected the price of goods and services (i.e. inflation), it has certainly supported the price of assets such as bonds and equities.



Within equities, investors at a time of significant uncertainty have further increased their preference for ownership of businesses that are fast growing or defensive in nature, which is a reasonable response but for the already high valuations of these companies. This has led to a significant divergence in performance across sectors. Below we highlight the disparity in sector performance, with Information Technology, Consumer Discretionary and Materials having each returned over 25% in the last quarter vs 12.7% and below for Financials, Real Estate, Consumer Staples and Utilities, quite a large differential over such a short period.



The tech sector has been the go-to sector for investors looking for growth, particularly the so called FANGAM stocks (Facebook, Amazon, Netflix, Google, Apple, Microsoft), leading to record valuations. However, with 10-year government bond yields below 1% across the developed world, higher valuations may be justified. In terms of free cash flows (as opposed to PE ratio), the tech sector has certainly justified its performance and valuations over the past number of years, with Free Cash Flows to Enterprise Value being more attractive than the rest of the market until the latest rally.



Allocation and Stock Selection Review

From an attribution perspective, both stock selection and sector allocation detracted in Q2 2020.

⇒ Sector Exposure: From a sector perspective, our underweight in the Information Technology sector detracted on the back of its sharp recovery and continued rally. Even though we added to our technology positions at attractive prices in March, the continued underweight in the sector is still predominantly influenced by the Fund's underweight in hardware and semiconductor businesses that are generally highly susceptible to the global economic cycle deterioration. Our allocations to the better performing software and internet segments of the tech sector were inadequate to give us a meaningful relative benefit.

Our underweight allocation to Financials contributed positively, and even though the sector added a reasonable 12.7% for the quarter, it still lagged the index by a significant 6.7%.

⇒ Geographic Exposure: Relative to the benchmark, our geographic exposure to China (O/W: +8%) and USA (U/W: 9.1%) detracted. The positive geographic contributors included our underweight in Hong Kong and overweight in Austria.

⇒ Stock Selection Review: The Fund's stock selection detracted over the quarter as follows:

Among the best contributors to performance were Tractor Supply Co (operator of rural lifestyle retail stores in the USA, O/W, up 56%), NCSoft Corp (Korea-based gaming company, O/W, up 39%) and Grupo Aeroportuario Del Centro Norte SAB DE CV (Mexican Airport company, O/W, up 37%).

Interestingly, two of the biggest contributors in this quarter were some of the largest detractors in the prior quarter, highlighting the extreme volatility of markets recently.

Some of the biggest detractors were Biogen Inc (a biopharmaceutical company, O/W, down 15.4%), China Maple Leaf Educational Systems (operator of international schools in China, O/W, down 1.7%) and Universal Health Services Inc (owner and operator of acute care hospitals and outpatient facilities in the USA, O/W, down 6.2%).

Changes to the Portfolio

During the quarter we introduced some new positions to the fund. We added Eiken Chemical Co (a Japan-based company principally engaged in the manufacture and sale of test drugs), Amdocs Ltd (a provider of software and services for communications, pay television, entertainment and media industries) and Intel Corp (design and manufacture of products and technologies), while trimming positions where the stocks had performed very well, such as China Overseas Property Holdings Ltd and Tractor Supply Co.

We continue to look for new high-quality opportunities. While certain sectors such as the hospitality and travel sectors have been severely negatively impacted by Covid-19, there may be selected opportunities in these sectors with a long-term outlook, however we are cautious of the speed of recovery for these sectors, in particular business travel. The advent of an effective vaccine will certainly facilitate a faster recovery. For now, however, we are comfortable with exposure to the airports companies as well as indirect exposure to the aerospace industry through Hexcel Corp, a supplier of lightweight construction materials – like carbon fibre – to the industry.

Investment Outlook

When considering the collapse in the global economy, very low interest rates, massive stimulus packages by central banks, rapidly rising government debt, together with stock markets having recovered close to all-time highs, we are certainly in uncharted waters for financial markets and there are likely to be some surprises. Despite our cautious stance on the near-term outlook for the global economy and rapid recovery in stock markets, we believe that while elevated levels of market volatility often bring uncertainty for short-term investors, they offer great opportunities for long-term investors.

Irrespective of the market environment, our philosophy and process ensure that we remain focused on investing in high quality companies that are attractively priced compared to our conservative free cash flow valuations.

Kind regards,

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