Benguela Global Equity UCITS Fund Commentary

Review of Q3 2020

Portfolio: Benguela Global Equity UCITS Fund

Benchmark: MSCI All Country World Index (MSCI ACWI)

Performance Review

The strong rebound in global equity markets, following a Covid-19-induced correction, has continued into 3Q2020 albeit at a moderated pace of +8.13% compared to a breath-taking +18.23% experienced in 2Q2020.

For the three months ended 30 September 2020, the Benguela Global Equity UCITS Fund ("the fund") returned +2.59% (net of fees, in US$ terms). This translates to an underperformance of -5.66% for the quarter, which is quite disappointing. Despite the short-term pain, we remain disciplined around our quality and valuation metrics that stood us well in the crisis period. For the twelve-month period to 30 September 2020, the MSCI ACWI was firmly in the positive territory with a net return of +11.00% in contrast to a return of only +5.09% for the Benguela Global Equity UCITS Fund. It is therefore quite evident that the bulk of our underperformance materialised in the past quarter. Most of this underperformance resulted from stock selection (a combination of underweight positions that outperformed and/or overweight positions that underperformed). While periods of underperformance are painful, we take solace in the fact that they are often short-lived.

Investment Strategy Review

For the 3Q2020, stock selection accounts for almost all the underperformance. The various components of our stock selection strategy contributed as follows to the performance outcome:

⇒ Quality Strategy: For the 3Q2020 the MSCI ACWI Quality Index ("MSCI ACWQI") outperformed the MSCI ACWI by 1.8%. A key driver of the performance divergence between the MSCI ACWQI and the Benguela UCITS fund lies in the MSCI ACWQI's high concentration in the US (64.9%) and Technology sector (36.9%). In contrast, the Fund had a relatively smaller allocation to both the US and the global technology sector. Moreover, the Fund's global technology sector allocations are spread across several countries while the MSCI Quality Index has a high technology concentration in the US.

⇒ Geographic Exposure: Relative to the benchmark the fund allocation benefited (+0.41%) from the geographic exposure to South Korea (O/W:3.56%), France (U/W:2.80%) and the Netherlands (U/W:1.58%). However, our allocations to Russia (O/W:2.73%, via London), Hong Kong (0/W:2.69%) and Austria (O/W: 0.98%) detracted a combined 0.72%.

⇒ Sector Exposure: Our underweights in Energy (U/W: 2.94%) and Financials (U/W: 2.94%), as well as overweight in Industrials gave the fund a combined allocation benefit of 1.00%. Nonetheless, our Information Technology underweight (U/W: 5.06%), as well our overweight positions in Cash (O/W: 3.99%) and Real Estate (O/W: 4.23%), detracted heavily from our performance, not only in 3Q2020, but also the 2Q2020. In hindsight, our conservative position in the Tech sector was a significant mistake especially given that our Technology holdings did just as well as, if not better than, the sector aggregates. Finding the right balance between the risk of overvaluation on the basis of prospective performance and extremely conservative assumptions is something that needs to improve going forward.

Stock Selection Review

As a firm that prides itself in a clearly defined investment philosophy and in-house rigorous research, it is to be expected that both our outperformance and underperformance would derive predominantly from our stock selection. The acuteness of our active approach can be observed from the fact that our active share hovers around 87%, with a realised tracking error of 4.8%. Out of the 69 stocks in the portfolio (vs. 2 995 for MSCI ACWI), only 68% of the portfolio weight is reflective of the benchmark content. Being different is one thing but being risk-conscious is a hallmark of true investment discipline. From an active risk contribution perspective, there are two major drivers: (i) pure stock specific risk which amounts to 60.15% of portfolio risk and (ii) quality investment style contributes another 24.40% of our active risk. Stock selection is a primary source of our value add.

3Q2020: Key Performance Contributors and Detractors

Top Contributor	% Change	Bottom Contributor	% Change
Public Joint Stock Polyus (O/W)	+26.95%	China Overseas Property Ltd (O/W)	-22.7%
Twitter (O/W)	+49.4%	Cisco Systems (O/W)	-14.9%
Huhtamaki (O/W)	+29.3%	ZTO Express (Cayman) Inc (O/W)	-18.5%
Schouw & Co (O/W)	+21.8%	Intel Corp (O/W)	12.9%
Shimamura (O/W)	20.9%	Cash	0.0%

We review our top and bottom-most contributors in more detail below:

⇒ Polyus PAO (O/W): PLZ.L was up +26.95% for the quarter. Polyus is amongst the lowest-cost gold producers globally (US$600 AISC). We highlight the continued rally in the gold price during this quarter, which touched an all-time high of US$2 053 on the 6th of August 2020 but quickly deflated to settle around US$1 900 at the end of 3Q2020. We remain long-term holders of PLZ.L as a high-quality gold producer that also serves as a portfolio risk reduction allocation.

⇒ China Overseas Property Holdings Ltd (O/W): After a massive rally in the past 18 months that enabled us to take profits, 2669.HK had a sharp pullback of 22.7% alongside the rest of the Chinese market as investors weighed up the possibility of Trump being re-elected. Prior to this pullback we were able to cut our overweight position by 2.5%.

Market Environment Review

The Covid-19 pandemic continued to dominate the news flow and everyday life in the third quarter of 2020. The crisis is one of the worst health emergencies the world has witnessed for a century and its economic impact could be just as steep. Epidemiological estimates of cases suggest that the second wave has had, on several occasions, greater than affirmed cases in the initial phase of the pandemic, as countries used lockdowns to suppress the spread of the virus (while fiscal support measures were introduced to help businesses and households keep their heads above water). Nonetheless as of the end of the 3Q2020, some of the most severe lockdowns were being relaxed in several jurisdictions. The freer movement of people within countries (and later outside) should enable a stronger recovery into 4Q2020 unless we get wave two of the pandemic. The recent uptick in caseloads in Europe and United States have raised the sceptre of wave two by 4Q2020 or 1Q2021. While the discovery and approval of a vaccine will go a long way to settle the nerves of society, especially capital market participants, the logistics around mass production and distribution of a vaccine worldwide may prolong the duration of the pandemic on the global economy.

During the first half of 2020 governments and central banks introduced solutions to counter the negative effects of Covid-19 on the economy. As confirmed by McKinsey, governments' economic responses to the crisis was unprecedented: $10 trillion announced just in the first two months, which is three times more than the response to the 2008–09 financial crisis. Most of this money came from monetary policy packages like loan guarantees and reduction in reserve requirements. This was accompanied by, on the fiscal side, direct household social assistance. Corporates have also been hard at work to extend the tenure of their corporate bonds as there is hardly adequate cash flows to settle existing debt and to tide them over the period of uncertainty.

To enable sustainable economic recovery, not only do we need a vaccine for Covid-19, but also proper fiscal stimulation programmes like infrastructure spend. We expect monetary policy to remain accommodative well into the first half of 2021. However, with most governments having maxed out their short-term budget capacity, new capital raising proposals are needed to supplement the fiscal shortfalls. Given their relatively small tax bases and low coverage of social assistance programmes, lower-income countries face greater constraints on how to implement fiscal stimulus measures as the effectiveness of fiscal policy responses could be undermined by weaknesses in the political/fiscal governance frameworks. For most countries, this capital raising will come in the form of sovereign bond (debt) issuances.

The fresh capital raising is where economic reality intersects with capital markets. We believe that the need by corporates and national treasuries to borrow more is likely to overwhelm debt markets and start to push rates higher twelve to twenty-four months out. We believe that in the short term, demand pull inflation is unlikely as both consumption and investment are subdued, but in the next twelve months we are likely to see some cost push inflation rearing its ugly head as the broken supply chains start to have an effect on the economy. As such, we believe that the big rally in bonds may essentially fizzle out and in its place cash allocations could shift to equities, particularly emerging market equities that have lagged.

Despite our positive outlook on the broader equity asset class, there are two types of risks that lurk in this capital market:

(a) Companies that are so overindebted that they are unable to raise cheap debt funding. These companies may carry a substantial dilutionary risk to value as they may need to do deeply discounted rights issues – broadly speaking these are companies in the energy and real estate sectors that have been battered by the rapid decline in the global economy.

(b) Companies that are discounting either a rapid economic recovery despite a hazy process to vaccine approval or an unrealistic growth in earnings/free cash flows – we see this in many technology companies. In addition, as we get closer to the vaccine, some high cost gold producers look vulnerable to the downside of operating leverage that boosted their coffers over the past twelve months as the gold price rallied on the back of global economic uncertainty.

On the upside, we expect the discovery of a vaccine to support improvement in sentiment and provide impetus to investment and large-scale hiring in developed markets. Emerging markets may lag slightly as the fiscal safety net has not been wide enough. Needless to say, global equity markets will likely start to discount the improved outlook well before actual earnings materialise.

Portfolio Activity and Investment Strategy

Despite disappointing short-term outcomes that were caused by our under-allocation to the tech sector, we believe that our disciplined implementation of the quality strategy would pay off for our clients. Irrespective of the tough market environment, we remain focused on stock selection from the purview of our investment philosophy which emphasises: *(a) the quality of the business we invest in AND (b) a healthy discount to conservative free cash flow valuations*. In this tough economic environment, we are acutely focused on the ESG risk and Financial risk components of the six Benguela Quality Score (BQS) factors.

We continue to take more profits from China Overseas Properties while upping cyclical quality counters like Eiken Chemical, a company founded in 1939 (longevity) which is focused on the manufacturing and sales of clinical diagnostics reagents (±80% of revenue) and equipment. The business is in a net cash position with a ROIC of 8.6% (5Y AVG: 9.1%) in a market where the risk-free rate is negative. This business is one of the few direct and low risk beneficiaries of the Covid-19 pandemic.

While some companies have screened well on most of the six BQS factors, many of these are trading at valuations that leave extraordinarily little room for error, protracted Covid-19 economic effects or adverse US election outcomes. The high-quality defensive sectors are looking mostly fully priced while cyclical quality companies with strong balance sheets look quite appealing. The blend of these two sector characteristics within the high-quality segment of the market is driven by our risk-conscious portfolio construction that monitors our risk allocations both from a statistical and fundamental perspective. We are confident that we will keep our promise to our clients regardless on how the future looks for equity markets.

Kind regards,

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