Benguela Global Equity 27four Feeder Fund Commentary: 4Q2020

19 February 2021

Portfolio: Benguela Global Equity 27four Feeder Fund

Benchmark: MSCI All Country World Index (MSCI ACWI) – ZAR

Performance Review

Global equity markets continued to rally into the 4Q2020 supported by the news of vaccine approvals and continued fiscal/monetary stimulation that has given investors hope that the global economic stabilisation is within sight. Of course, global economic recovery is never a straight line and a lot of work is still needed in vaccine rollout. As a result, the markets will remain volatile as we move into 2021.

For the three months ended 31 December 2020 the Benguela Global Equity UCITS Fund ("the fund") returned +9.06% (in US$ terms, net of fees) against a benchmark (MSCI ACWI) return of +14.68%. The Benguela Global Feeder Fung, which invests directly into the master Global Equity UCITS Fund, delivered -4.90% (net of fees) in ZAR against a benchmark return of 0.66% – this translates to an underperformance of -5.56% for the quarter.

Investment Strategy Review

From an attribution perspective in the 4Q2020, both stock selection and allocation contributed negatively to performance. Below we discuss the various components of the strategy and how they fared during this volatile quarter.

⇒ Quality Strategy: The MSCI ACWI Quality (hereinafter, “MSCI ACWIQ”) underperformed the MSCI ACWI by 3.04% in 4Q2020. The MSCI ACWIQ returned a thumping 25.38% return for 2020. A key factor behind this substantial outperformance is the 37.9% exposure to the Information Technology sector versus the 21.86% for the MSCI ACWI. Our allocation to the Tech sector was 16% which caused our underperformance of both the MSCI ACWI and MSCI ACWIQ as the technology sector soared 47.5% in 2020.

⇒ Sector Exposure: For the 4Q2020 our sector allocation detracted. The recovery in the underweight sectors of financials (-0.29%) and energy (-0.24%); and the outperformance of equities over cash held for trading (-0.39%) were key detractors.

⇒ Geographic Exposure: On a standalone basis, our underweights in some emerging markets like Brazil, Taiwan and India had a marginally negative attribution effect. These were more than offset by positive contributions from South Korea, Austria and Mexico (as our airport operator in this geography rebounded on the back of Covid-19 vaccine breakthroughs).

Stock Selection Review

Stock selection is a primary source of our value add in our highly concentrated portfolio. As a result, our contributors and detractors for the quarter mostly came from our portfolio holdings (rather than our underweight positions), as some of the cyclical quality businesses in the portfolio suffered.

Key Performance Contributors

⇒ Universal Health Services Inc (UHS.N): O/W
UHS.N provides acute care hospitals, behavioural health, and surgery centres throughout the United States, United Kingdom, and Puerto Rico. UHS.N performance was negatively impacted by cancellations of elective surgery during the 1H2020 as hospitals were required to reserve capacity for Covid-19 patients. The lockdowns eased in the 2H2020 and US hospital capacity utilisations returned to above 72.3% (US HHS data, Jan 2021. UHS rebounded by a considerable 28.5% during the 4Q2020 as the market saw the emergency approvals of vaccines in October 2020 as an early indicator of a possible recovery in admissions for elective surgery.

⇒ Grupo Aeroportuario Del Centro Norte SAB DE CV (OMAB.MX): O/W
MX.OMA, an operator of the biggest airports in Mexico, was caught in the eye of the coronavirus storm as air travel was grounded. In the 1Q2020 when the stock was down 43.5%, we said the following: “*We remain holders of the stock as it has a net debt to equity of less than 13% and available cash to cover one full year of 100% of all operating expenses at zero revenues”.* Indeed, the stock rebounded 40.1% during the 4Q2020. We believe that the recovery will continue as the vaccine rollout becomes widespread.

⇒ Alibaba Group Holding (BABA.K): U/W
Alibaba provides internet infrastructure, electronic commerce, online financial, and internet content services through its worldwide subsidiaries.

During the last quarter to 31 December 2020 BABA.K fell victim to a Chinese government clamp down on outspoken dissatisfaction with Chinese government policies. Uncertainty began in November when regulators first torpedoed the record initial public offering of Ant Group – an affiliate of Alibaba – which was then followed by an investigation into the online retailer. Alibaba's stock has dropped more than 14% since. This was despite a stronger-than-expected earnings report in which BABA.K increased sales by 37% on the back of the Covid-19 driven acceleration in e-commerce trends.

⇒ Krungthai Card PCL (KTC.BK): O/W
KTC.BK provides credit and debit card services, offering both VISA and MasterCard associated cards, as well as other card-related services. KTC.BK has done relatively well in an economic environment that is generally unfavourable for lenders (falling interest rates and rising impairments). Non-Performing-Loans (NPL) have been on a gradual downward trend (improving). In 3Q2020, its net interest margin (NIM) dropped 0.30% despite local interest rates declining 0.75%. The cost-to-income remains globally admirable at 32.9%. The stock is up 54.9% in US$ terms. Despite its very high-quality profile, KTC.BK is trading at an extremely high valuation now. We believe that it is time to take our profits on this stock.

Key Performance Detractors

⇒ China Overseas Property Holdings Ltd (2669.HK): O/W
2669.HK operates as a property management firm, managing residential, commercial and government properties in China. For over half a decade, 2669.HK has grown its earnings per share at 37% a year. This was a story of a great business whose resilient business model became over-appreciated during the uncertainty of 2020 resulting in an extremely flattering valuation multiple of over 50x earnings. 2669. By year end, the share price had fallen significantly from its May peak. 2699.HK has rebounded by 30% in the new year.

⇒ Polyus PAO (PLZ.L): O/W
PLZ.L is Russia's largest gold producer. After reporting a net profit increase of 63% due to a 31% increase in the gold price during the 3Q2020, the stock deflated by -3.0% in the 4Q2020. The stock was up 82.7% in 2020. As expected, the pullback in the price of gold from over US$2 000 to hover around US$1 800 (on the back of the vaccine breakthrough) led to a pullback in gold stocks across the board. PLZ.L remains one of our preferred gold counters due to its low cost of production (±US$571/oz), however it is probably fairly valued, and we will take some profits here too.

⇒ Northrop Grumman Corporation (NOC): O/W
Northrop Grumman is a global defence company that supplies systems, products, and solutions in aerospace, electronics, information systems, and technical services. Northrop Grumman serves government and commercial customers worldwide. After a strong rally in 2019, fuelled by US/Middle East geopolitics, NOC begun deflating from January 2020 all the way to year end despite strong 4Q2020 and full-year earnings released on 28 January 2021. For the quarter, revenue grew 17.1% to $10.21 billion, easily beating Wall Street analysts' estimates by almost $1 billion. The book-to-bill ratio is sitting at 1.5x indicating NOC has scope to maintain and growth from the current profit/cash flow base. NOC is currently trading at a PE ratio of 15.7x compared to the US Aerospace & Defence industry average of 34.9x. While this is not a high growth business, it has a very stable clientele that

enables it to keep churning out consistent improvements in profits. Defence companies serve as a portfolio diversifier against the effects of global geopolitics.

⇒ Lockheed Martin Corporation (LMT): O/W

LMT is another of our global defence companies. It offers products/services that span space, telecommunications, electronics, information and services, aeronautics, energy, and systems integration. LMT declined by -6.7% against a 14.68% rally in the market despite posting a better-than-expected first quarter earnings in 2021 and a better-than-expected sales outlook for the rest of the year. The world is not growing any safer, and the US Pentagon has committed to a multiyear arsenal transformation to better prepare itself for potential conflicts. This bodes well for LMT's order book.

⇒ China Maple Leaf Education Systems (1317.HK): O/W

1317.HK is a Chinese international private school operator. The Company operates high schools, middle schools and elementary schools across various Chinese cities.1317.HK has been a terrible disappointment for our portfolios. While the stock is high quality with strong cash generation, it has been buffeted between rising regulatory pressures from the Chinese government on private schools and more recently, the inability to deliver their services due to Covid-19 lockdowns. The stock dropped by 34.3% to reach a low point last seen in 2016 of HK$2.00. Although we believe that the original investment case still has merit given a huge tailwind of the rising middle class in China that seeks to provide their children with internationally accredited basic education, Covid-19 is likely to change the pricing dynamics going forward (both from an affordability in a tight economic environment perspective and the shift towards contactless education).

Market Environment: Economic Outlook

The Covid-19 crisis is one of the worst health emergencies the world has witnessed for a century and its economic impact in 2020 was steep and likely to be protracted. The collapse in global economic activity in 2020 is estimated to have been slightly less severe than previously projected, mainly due to shallower contractions in advanced economies and a more robust recovery in China. In contrast, disruptions to activity in the majority of other developing economies were more acute than expected. Although global economic output is recovering from the collapse triggered by Covid-19, it is expected to remain below pre-pandemic levels for a prolonged period. Despite a vaccine breakthrough in October 2020, a second wave of rising infections prompted new restrictions around the world. The emergence of new coronavirus strains in Brazil, South Africa and the United Kingdom further complicated the easing of cross-country travel restrictions. New strains also presented challenges around the rollout of vaccines as some drugs showed low efficacy. The pandemic has not only affected peoples' health and free movement, but also their ability to earn a living as businesses closed and workers were furloughed. Job market statistics have shown severe deterioration in 2020 especially in western countries and emerging markets outside of China.

World Bank Group President David Malpass recently said the following: "*While the global economy appears to have entered a subdued recovery, policymakers face formidable challenges—in public health, debt management, budget policies, central banking and structural reforms—as they try to ensure that this still fragile global recovery gains traction and sets a foundation for robust growth. Making the right investments*

now is vital both to support the recovery when it is urgently needed and foster resilience. Our response to the pandemic crisis today will shape our common future for years to come. We should seize the opportunity to lay the foundations for a durable, equitable, and sustainable global economy. To overcome the impacts of the pandemic and counter the investment headwind, there needs to be a major push to improve business environments, increase labor and product market flexibility, and strengthen transparency and governance."

Given the humongous economic challenges presented to communities across world by Covid-19, monetary and fiscal policy responses have been unprecedented both in terms quantum and speed of reaction. When compared to 2008, for example, some large economies have spent as much as ten times in fiscal response relative to GDP – please see figure 1 below. On the other hand, key central banks executed a breakneck acceleration of money supply as depicted in Figure 2.

Our own estimates, based on data from 114 countries, suggest that a total of US$13.5 trillion in new money was supplied in 2020. This equates to 15.4% of world GDP as calculated by the World Bank. The majority of this came from advanced economies in the form of cash payments, wages/salaries subsistence, secondary market bond purchases, new loan purchases and debt relief for corporates.

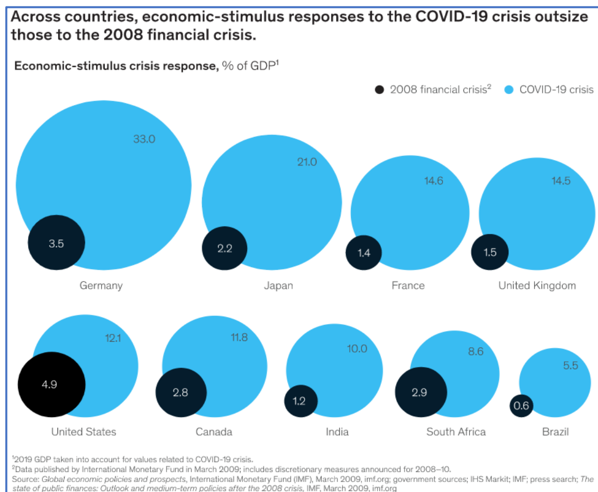

Figure 1

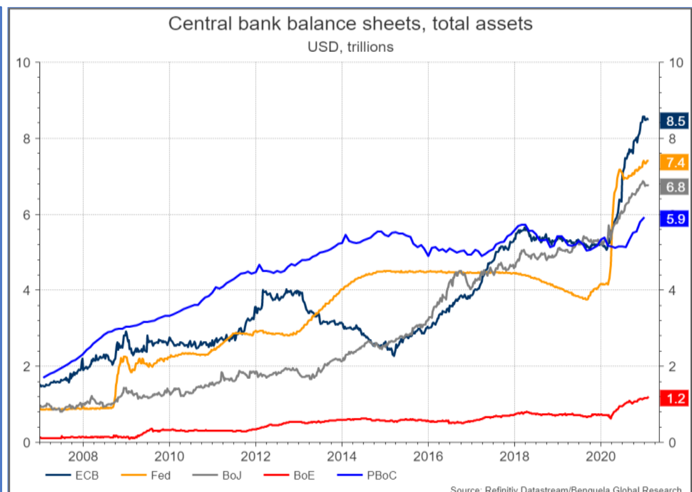

Figure 2

The near-term outlook remains highly uncertain and different growth outcomes are still possible. A downside scenario, in which infections continue to rise and the rollout of vaccines is delayed, could limit the global expansion to 1.6% in 2021. In contrast, an optimistic scenario based on successful control of the pandemic and a faster vaccination process, sees global growth accelerating by nearly 5% in 2021. Nonetheless, as a result of the expected acceleration in vaccinations around the world and the continuation of both monetary and fiscal stimulation, our base case scenario is for the economic recovery seen in most economies during the 3Q2020 to solidify by 3Q2021. The World Bank expects the global economy to expand by at least 4% in 2021, assuming an initial Covid-19 vaccine rollout becomes widespread throughout the year.

In advanced economies, a nascent rebound stalled in the fourth quarter following a resurgence of infections, pointing to a slow and challenging recovery. US GDP is forecasted to expand 3.5% in 2021, after an estimated 3.6% contraction in 2020. In the Euro area, output is anticipated to grow 3.6% this year, following a 7.4% decline in 2020. Activity in Japan, which shrank by an estimated 5.3% in 2020, is forecast to grow by 2.5% in 2021. Aggregate GDP in emerging market and developing economies, including China, is expected to grow 5% in 2021, after an estimated contraction of 2.6% in 2020. China's economy is expected to expand by 7.9% this year following 2% growth last year. Excluding China, emerging market and developing economies are forecast to expand by 3.4% in 2021 after an estimated contraction of 5% in 2020. Among low-income economies, activity is projected to increase 3.3% in 2021, after a contraction of 0.9% in 2020.

With economies expected to recover in 2021, questions around inflation and interest rates start to be raised. Despite a humongous increase in money supply across economies, there have not been accompanying increases in productivity. In our view, we are unlikely to see meaningful inflation increases until 4Q2021 and when it does come through, EMs will be the first in line. In general, for inflation to rise meaningfully we need to see rapid increases in private consumption without a matching increase in production – this often occurs when people have free movement and generous social grants. We believe that in the next two quarters the vaccine rollout is likely to face some logistical hiccups so movement restrictions may continue to hamper the rate of economic acceleration needed to drive inflation meaningfully higher. The upside risk in inflation for most countries comes from the supply chain disruptions that occurred in 2020 which left some key raw materials in short supply.

On the interest rate side, we believe that central banks will likely remain accommodative until such time that the economic recovery has solidified and inflation has moved to higher levels. Following the 2008 financial crises, the US Fed only began tapering its quantitative easing in January 2014 (more than 5.5 years after the crises began) and only completely halted it on 29 October 2014 after accumulating $4.5 trillion in assets. Indeed, our forecasting tools suggest that we will have no rate hikes in developed markets possibly until 2023. Against this backdrop and our views of inflation in emerging markets, it is likely that some emerging market countries may hike policy rates ahead of the Fed to protect their currencies and stem the rise of inflation.

In summary, we believe that the economic recovery will continue steadily into 2021 as economic stimulation supports private consumption momentum until such a time when an adequate proportion of the global population has been vaccinated and the job market normalises. We expect developed market inflation to start slowly creeping up from, at the earliest, 4Q2021. In turn, emerging market interest rates are likely to start ticking up from 2Q2022 if early inflation persists. In the US, rate hikes can be safely expected from 1Q2023 onwards.

Market Environment: Investment Outlook

The pandemic has exacerbated the risks associated with a decade-long wave of global debt accumulation by both sovereign and corporate borrowers. Central banks have expanded their balance sheets on an unprecedented scale in response to the global coronavirus pandemic. The scale of the 2020 asset purchase programme levels, compared to the 2008 Global Financial Crisis, naturally gives rise to concerns about the impact on free market functioning. In particular, yields on some sovereign bonds are now negative. From our perspective this is unsustainable. We therefore believe that in the next five years, bond yields are more likely to rise than decline further for the following reasons:

a) There is an excess supply of both sovereign and corporate bonds that need to be refinanced between 2021 and 2025. The current low yields and the attempt by the issuers to lengthen the tenor of the bonds may shift the bargaining power away from the bond issuers and towards the bond purchasers (lenders); and
b) The prospect of rising inflation may lead bond buyers to demand more inflation protection in their investments.

Given the aggressive rate of easing in 2020, equity markets rallied quite strongly especially the technology-rich US market. For the twelve months to 31 December the US market produced a total return of 22.7%. In contrast, Emerging Markets for example, returned a mere 4.1% (USD) over the same period. Over the past five years the US returned a total of 102.5%, outperforming all the other developed markets and emerging markets with total returns of 77.6% and 56.9%, respectively. However, when we strip out the contribution of the Technology, Media and Telecom sector, the US market returned 79.7% in the five years to 31 December 2020. What is of major concern is that the US achieved this stellar outperformance on the back of a rapid expansion in valuation multiples led by the technology sector. While the technology sector of today is in much better shape operationally and financially than that of the early 2000s, the market seems to be extrapolating recent growth into the future. It is possible that the rotation away from technology stocks will continue into 2021. Since the pandemic brought a lot of the technology investment forward, the super-profits earned by tech sector stocks from the lockdowns has probably reached a peak. For current valuations to hold, their earnings have to meet or exceed expectations.

While tech stocks benefited from the accelerated trend to online as a result of Covid, the 2020 base is very low for most non-tech sectors. This base is likely to be easily beaten in 2021.

Portfolio Strategy

Despite our cautious stance on the near-term outlook for the global economy and rapid recovery in stock markets, we believe that elevated levels of market volatility often bring uncertainty for short-term investors, but great opportunities for long-term investors. Figure 3 below shows, through the lens of the US market, that despite deep declines in stock prices at the beginning of financial crises, the recoveries tend to be sharp twelve months out. In other words, investors who remain fully invested will be rewarded over time.

S&P 500 declines and year-after returns, 1987-2020

S&P 500's largest drops	Black Monday 8/25/87-12/4/87	Gulf War 7/16/90-10/11/90	Asia Monetary Crisis 7/17/98-8/31/98	Tech Bubble 3/27/00-10/9/02	Financial Crisis 10/9/07-3/9/09	U.S. Credit Downgrade 3/10/11-10/3/11	Trade War 10/3/18-12/24/18	Global COVID-19 Outbreak 2/19/20-to date
Decline	-33.5%	-19.9%	-19.3%	-49.0%	-56.8%	-19.0%	-19.6%	-29.4%
Next 12 months	**+21.4%**	**+29.1%**	**+37.9%**	**+33.7%**	**+68.6%**	**+32.0%**	**+37.1%**	**?**

Figure 3 - Source: BlackRock and Morningstar, March 2020. Data for the "Global COVID-19 Outbreak" is through March 16, 2020. Returns are principal only and do not include dividends. The S&P 500 is an unmanaged index of 500 large-cap U.S. stocks. Past performance is not a reliable indicator of current or future results. Index performance is for illustrative purposes only. It is not possible to invest directly in an index.

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 businesses 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 are confident that we will keep our promise to our clients regardless of how the future looks for equity markets.

Kind regards,

Zwelakhe Mnguni | Chief Investment Officer

Email | zwelakhe@benguelaglobal.com

Mobile | 082 408 5106

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