CLUCASGRAY

ASSET MANAGEMENT

AM

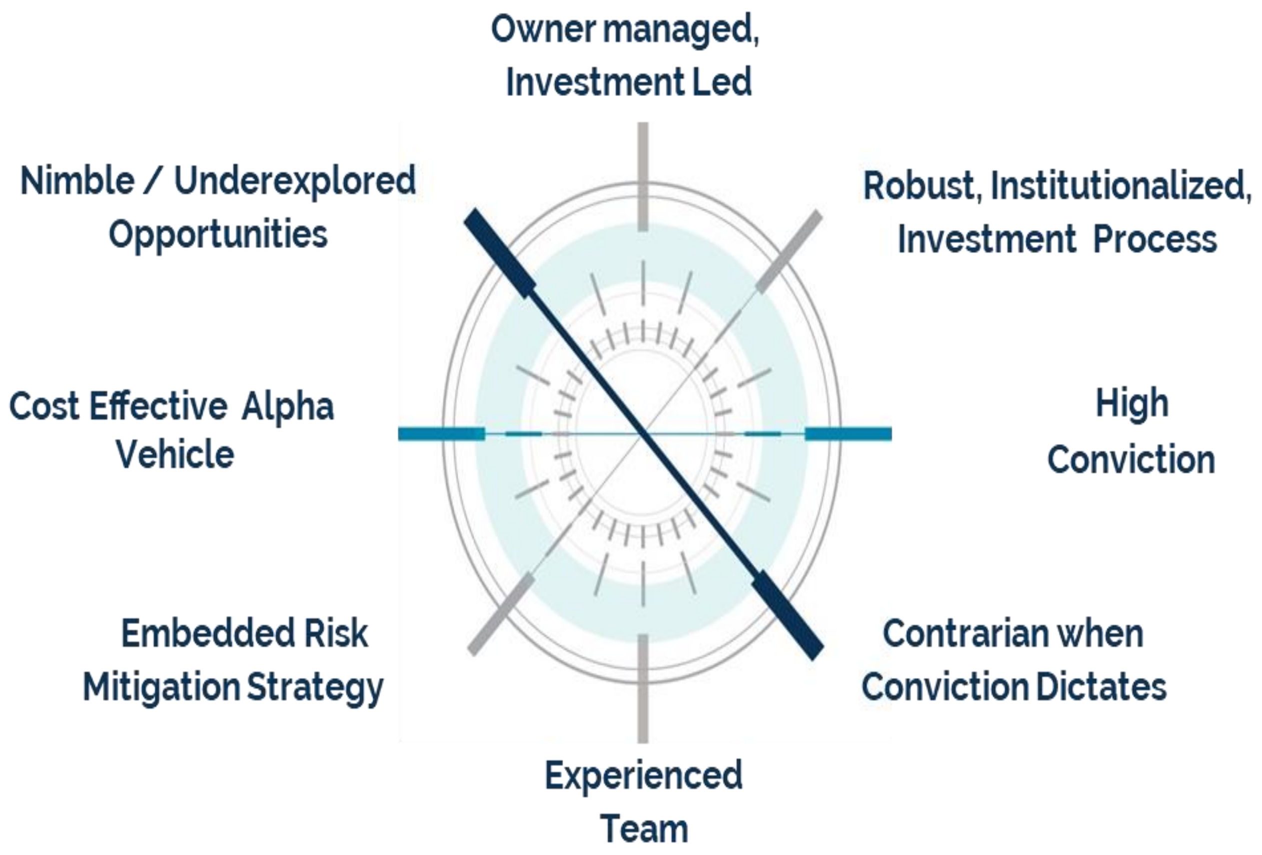
SOUTH AFRICA - DEJA (OR JAMAIS) VU

MEET THE MANAGERS

Andrew Vintcent

AUGUST 2020

INTRODUCTION TO CLUCASGRAY – INDEPENDENT, OWNER MANAGED INVESTMENT BOUTIQUE



AM PC

COMMON RESEARCH AND INVESTMENT PLATFORM

CLUCASGRAY ASSET MANAGEMENT – R2 bn

- Equity Fund & Seg mandates
- Equilibrium Fund (Reg 28 Balanced) & Seg mandates

CLUCASGRAY PRIVATE CLIENTS – R8 bn

- Personal Share Portfolios
- Specialist Private Client Funds

Asset base of around R10bn - Large enough to invest in a well resourced **investment team**; Small enough to take advantage of a more **diverse range of opportunities**

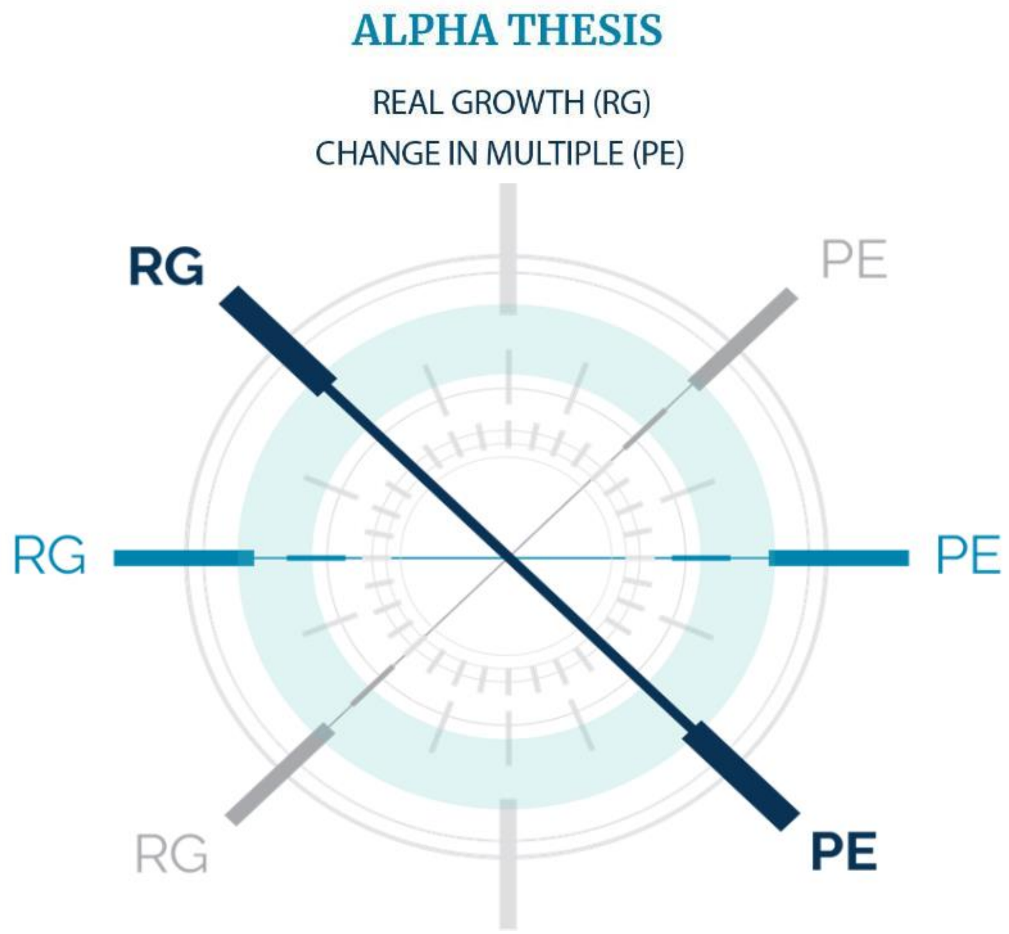
ALPHA THESIS

The key drivers of a share price are:

1. Real growth in earnings, dividends and cash flows;
2. Change in the rating or PE multiple

All investment decisions require comfort around Valuation.

Alpha Thesis relates principally to Stock Selection, but equally applies to Asset Allocation where appropriate.



We believe that by investing in **long term structural earnings outperformers** at an **appropriate multiple** is the best way to generate compound returns

CLUCASGRAY ASSET MANAGEMENT AM

INVESTMENT OVERVIEW

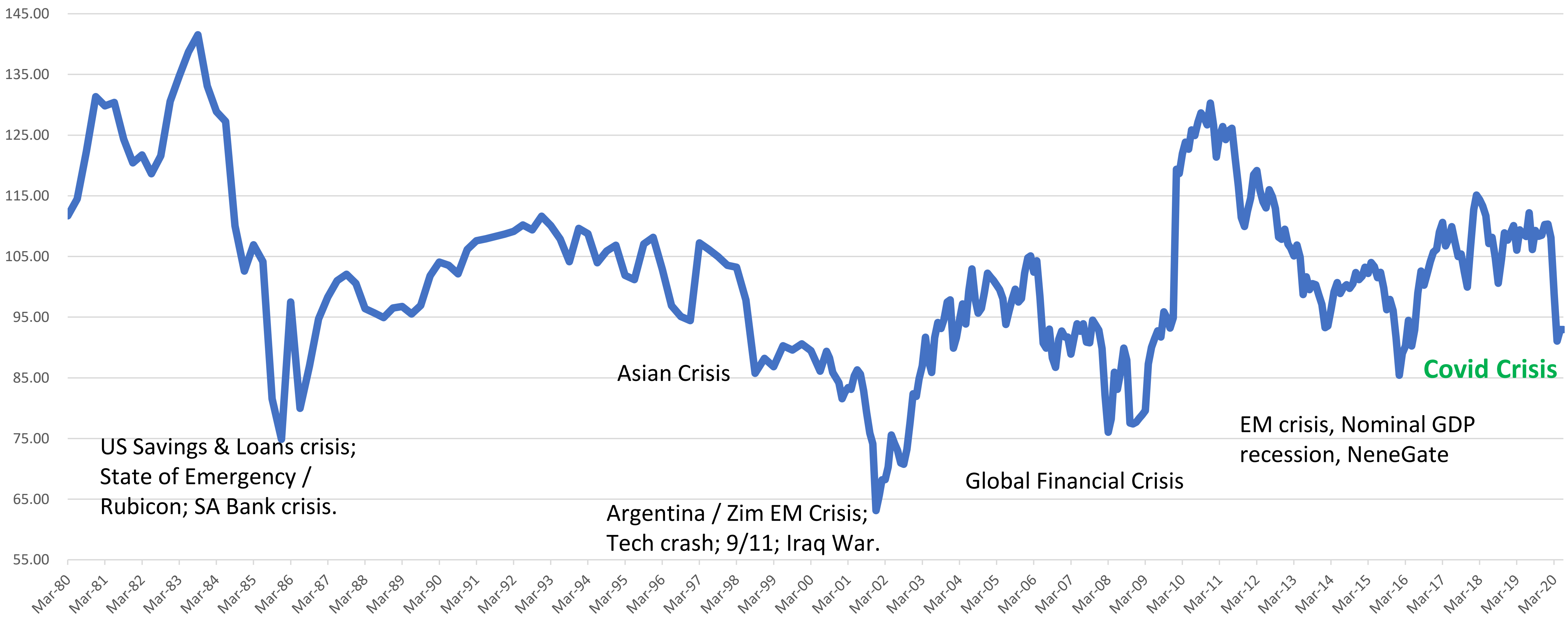
DEJA (OR JAMAIS) VU

"Déjà vu – haven't we met before?" (with apologies to Top Secret)

South African Issues	déjà vu	jamais vu
Growth Rate	Global recovery is constructive for EM & Commodities	Incoherent govt policy undermines business confidence
	Supportive commodity backdrop drives SA recovery, again	Structural impediments to growth prevent a recovery
	Low interest rates & oil stimulate consumer economy	
	Employment recovers	
Government debt levels	Growth & Inflation drives revenue increases	Debt levels and interest burden too high
	Fiscal austerity measures reduce deficits	Debt trap forces sub economic decisions
	Nominal GDP growth rate is higher than interest rates	
Rand / Currency	Global cyclical recovery leads to stronger EM currencies	Rand in structural decline
	Inflation moderates, interest rates lower	Supply side inflation, rising rates
	Lower cost of capital encourage investment	Inability to fund capital projects

The opportunity set appears at odds with the "déjà vu" thesis.

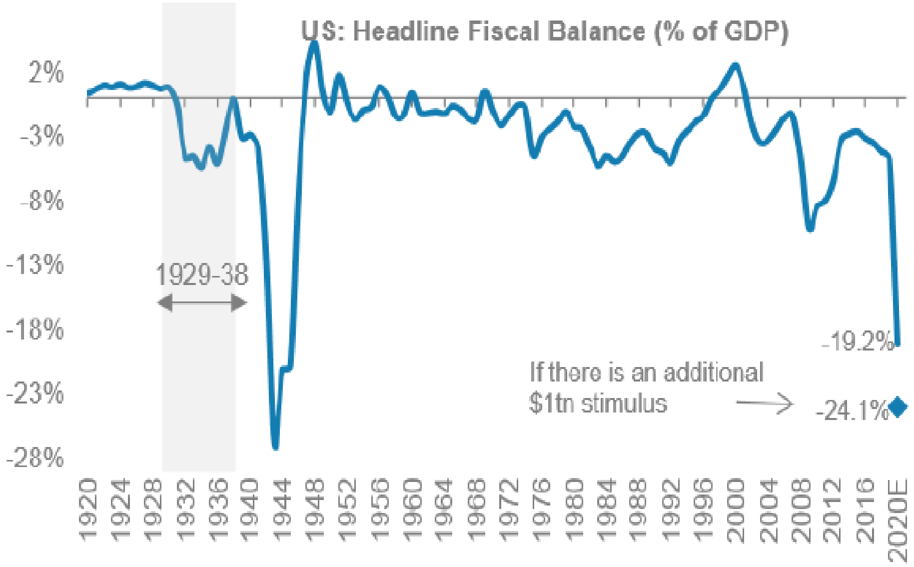
LONG TERM PERSPECTIVE ON THE REAL EFFECTIVE EXCHANGE RATE



The real effective exchange rate provides helpful summary of crises over the decades. SA's gearing to global growth and high relative inflation has typically resulted in the Rand being extremely volatile.

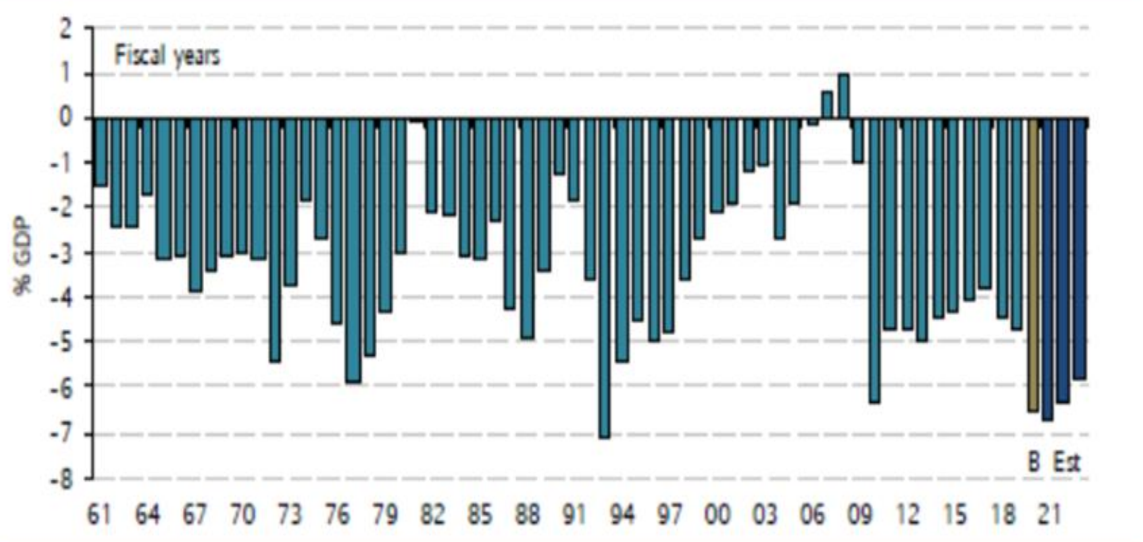
COVID CRISIS RESPONSE UNPARALLED IN PEACE TIME HISTORY

The US deficit is on track to be as big as those recorded in WW2, if Trump gets the extra package through



Source: Thomson Reuters, Morgan Stanley research, RMB Morgan Stanley

Figure 19: SA budget deficit as % GDP



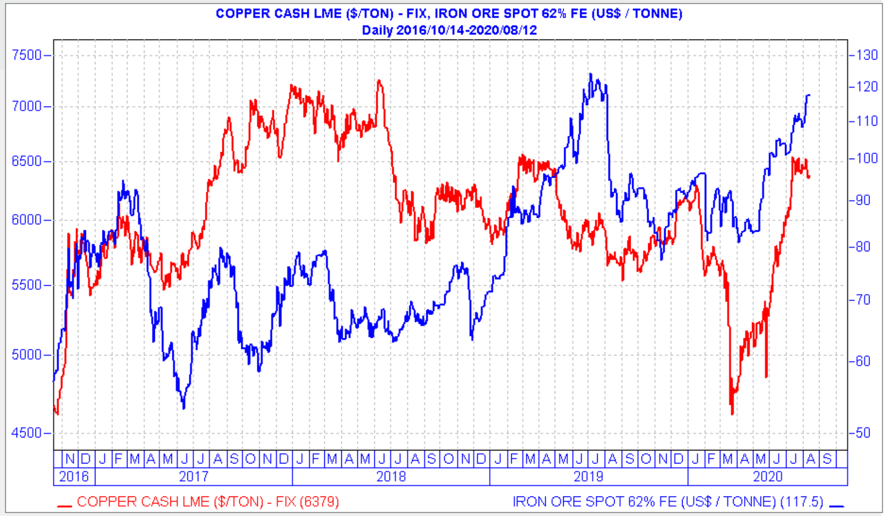
Source: National Treasury, SBG Securities analysis

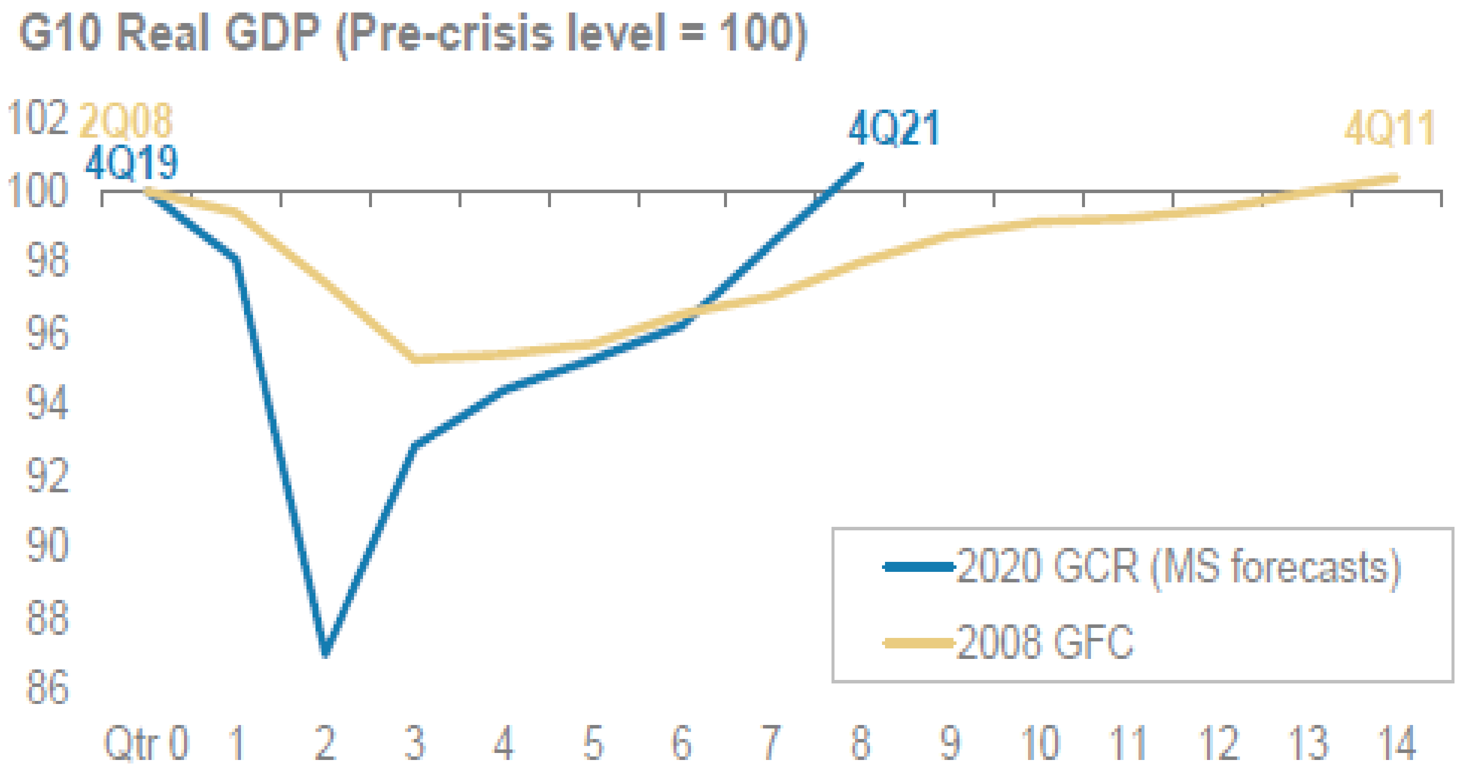
- ❑ US, and others, currently have ability to fund deficits via low interest rates - concerns if rates were to rise
- ❑ South African budget austerity has become critical
- ❑ Political ideologies hampering progress on reducing deficit?

Governments running large deficits to counter impact of Lockdowns. Growing concerns around ability of South Africa to fund it, following years of rising deficits.

THE ECONOMIC BACKDROP – PROSPECTS FOR STRONG RECOVERY OFF 2020 LOWS

- Encouraging improvement in activity in key economies
- Mobility, energy consumption, grocery demand etc all improving
- Commodity prices robust
- Fiscal debt levels require activity levels higher than 2019
- Many company valuations require 2019 earnings by 2021/22



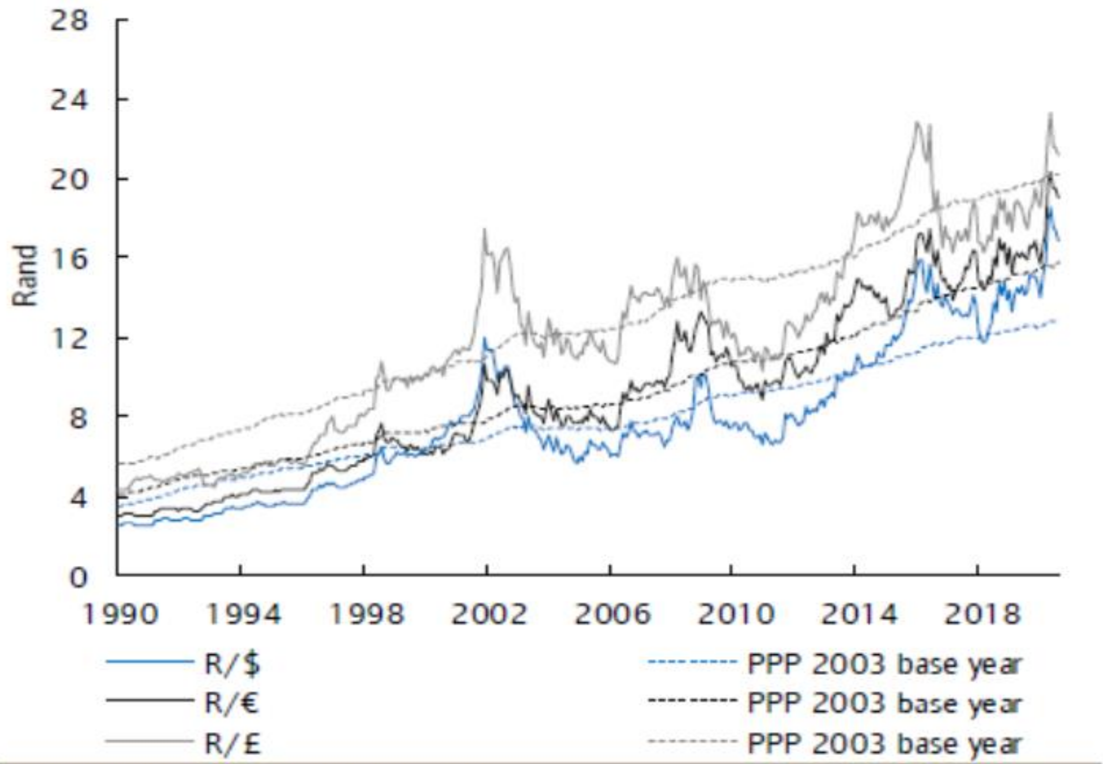


Source: Haver Analytics, Morgan Stanley Research forecasts

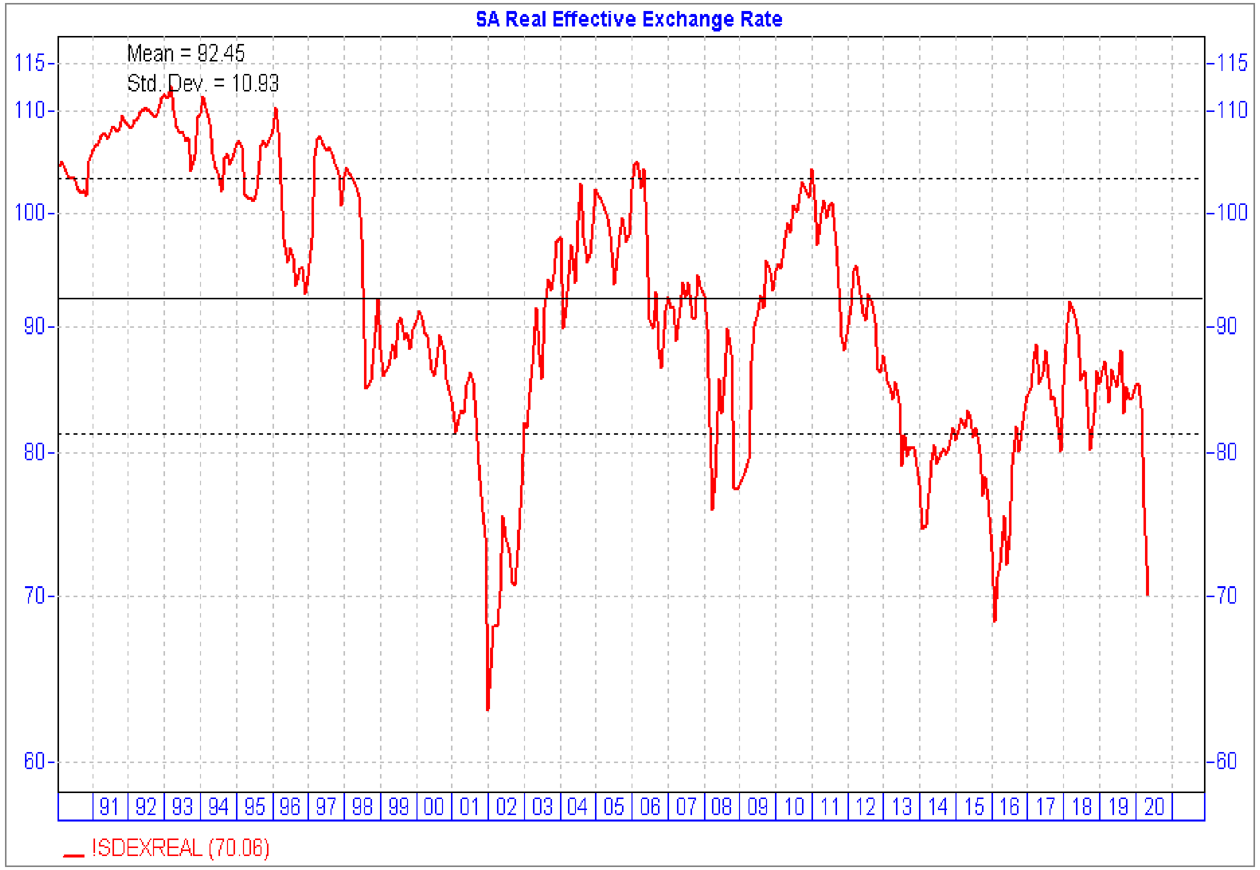
Issue is how quickly economies recover – above forecasts show a deeper slow down than GFC, with a sharper recovery. Encouraging signs of recovery in many economies

RAND WEAKNESS HAS BEEN A THEME FOR MUCH OF THE DECADE

Figure 10: Rand also still quite weak vs PPP estimates



Source: Bloomberg, Standard Bank Research



Real effective exchange rate nearing 2001 and 2015 levels – all previous turning points driven by global economic recovery. The interest rate stimulus as material as any time in history.

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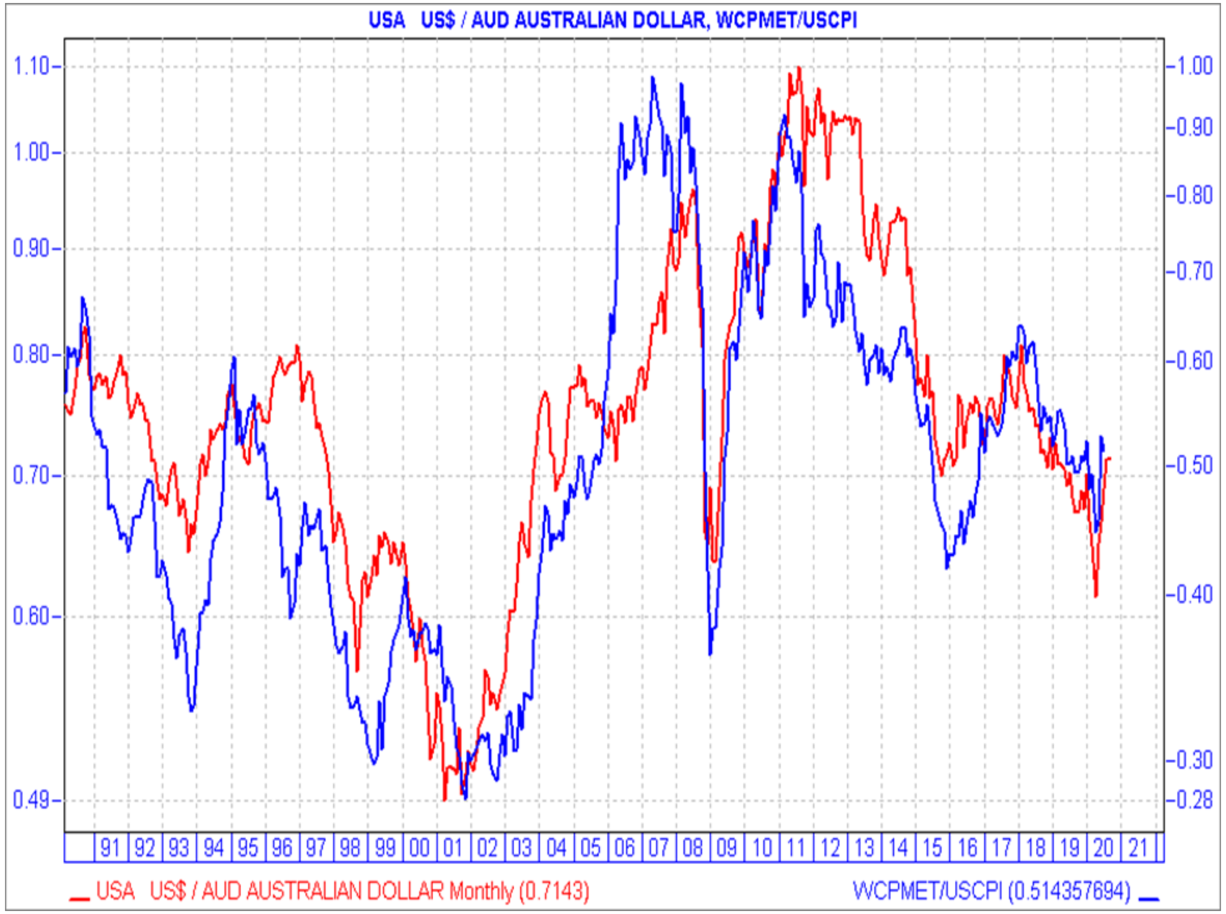
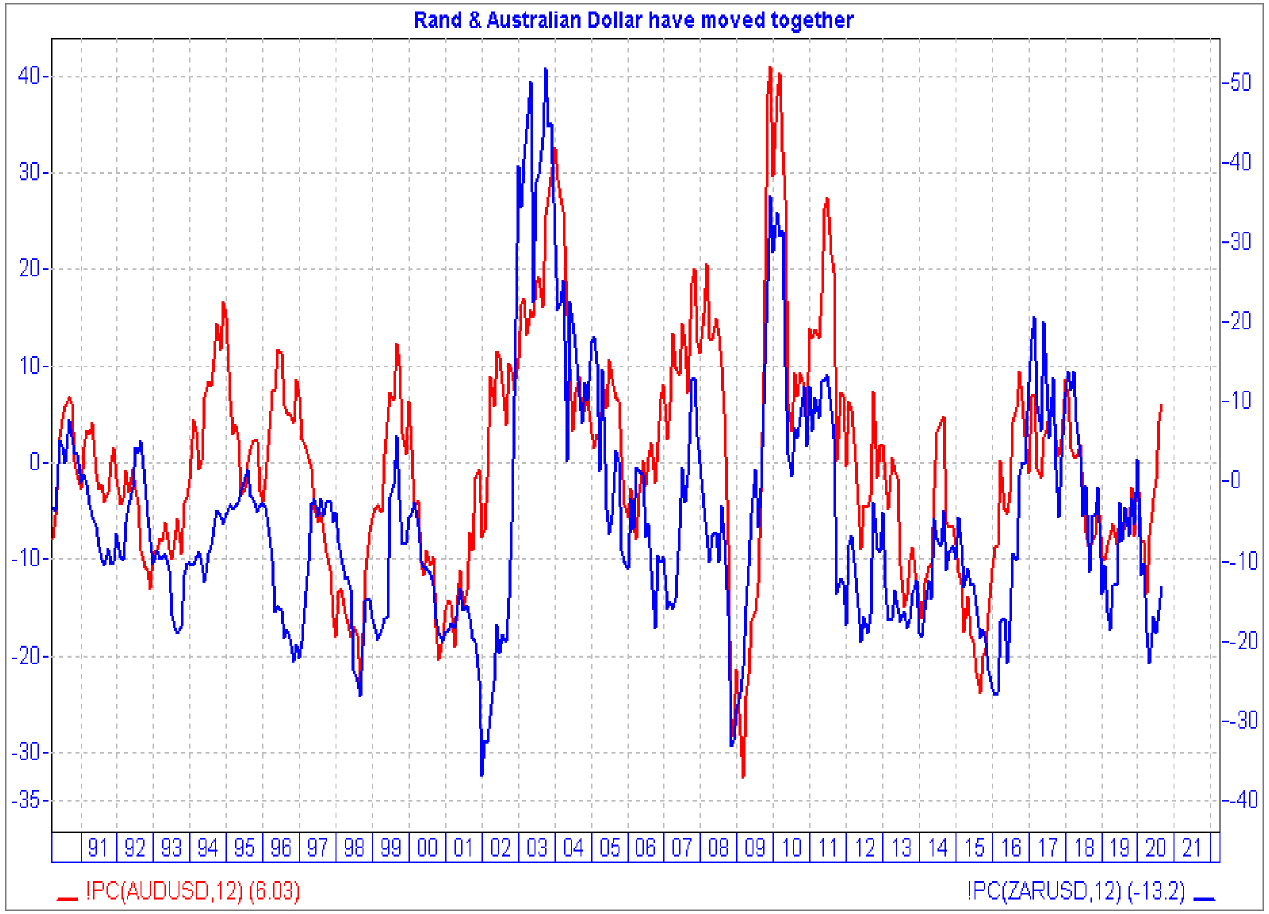
A REMINDER THAT SOUTH AFRICA HAS TRADITIONALLY BEEN COMMODITY LINKED

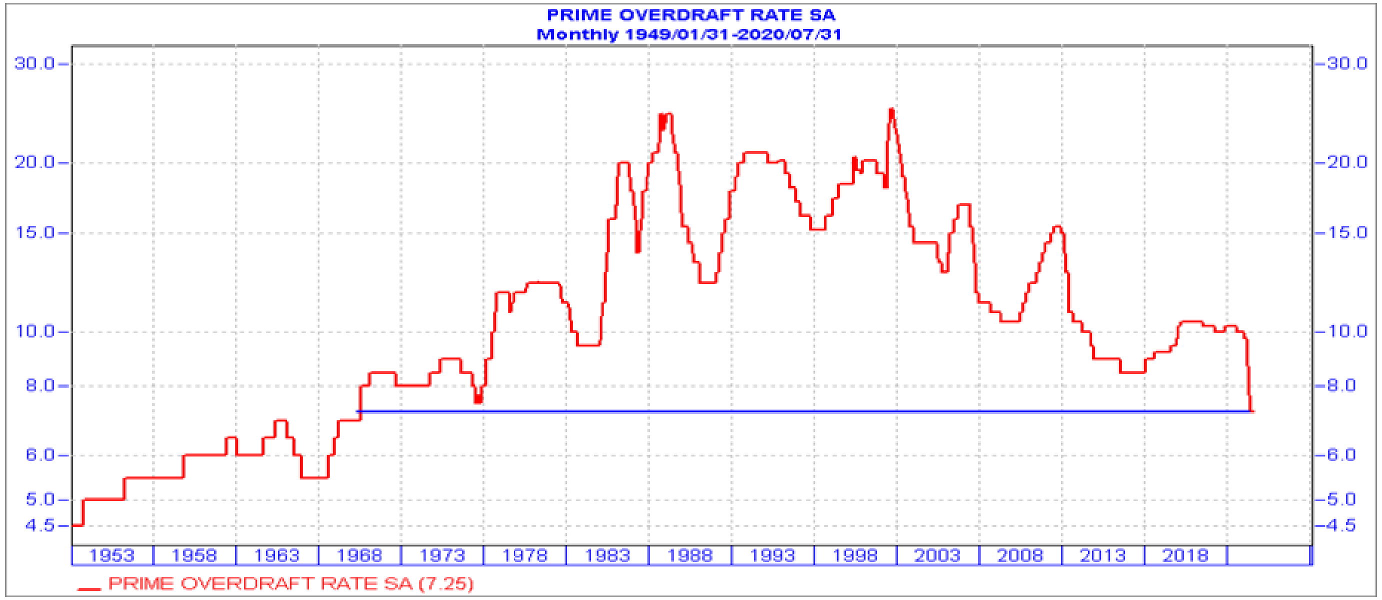




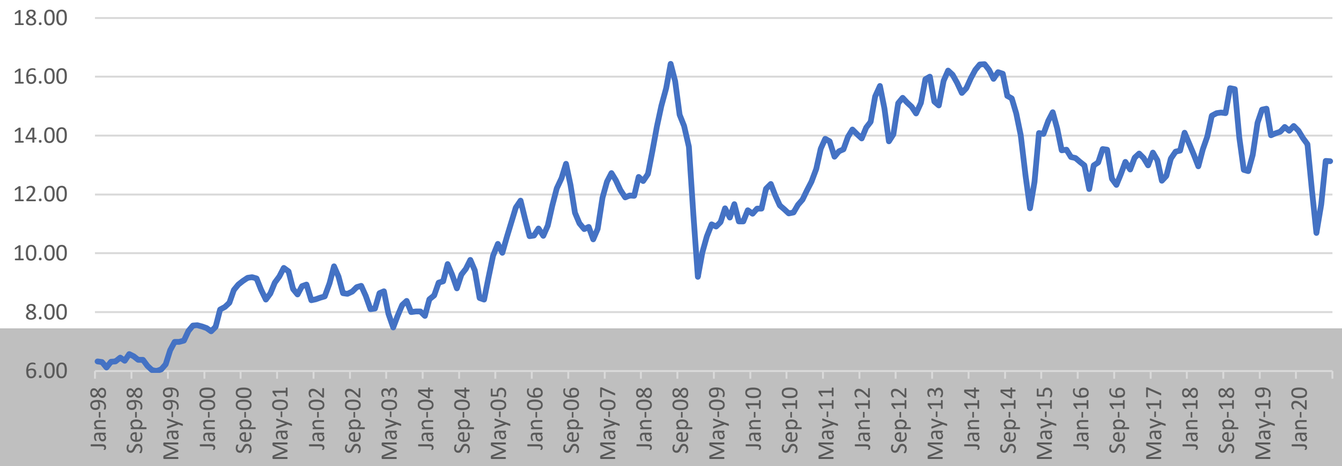
Correlation between Commodity cycle, Australian and South African currencies goes back many years. A constructive global backdrop would traditionally be good for South Africa.

INTEREST RATES & FUEL PRICES

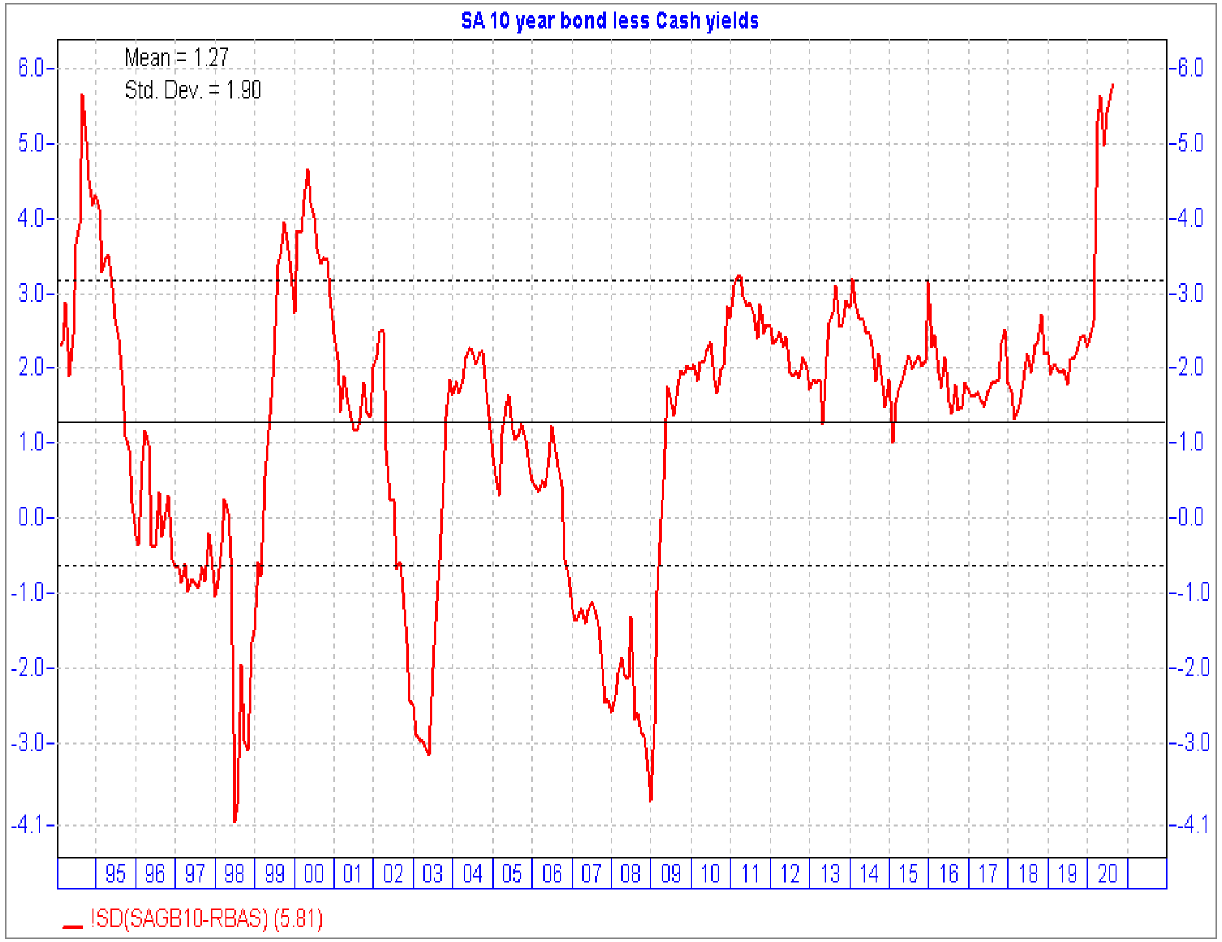
- Significant rate cuts yet to feed through into economy
- Fuel prices in real terms now similair to levels of a decade ago
- Lower fuel prices, coupled with interest rate cuts, would typically prove a stimulus for consumer economy
- The Covid crisis could be different?
- Employment and lack of growth the main counter arguments.

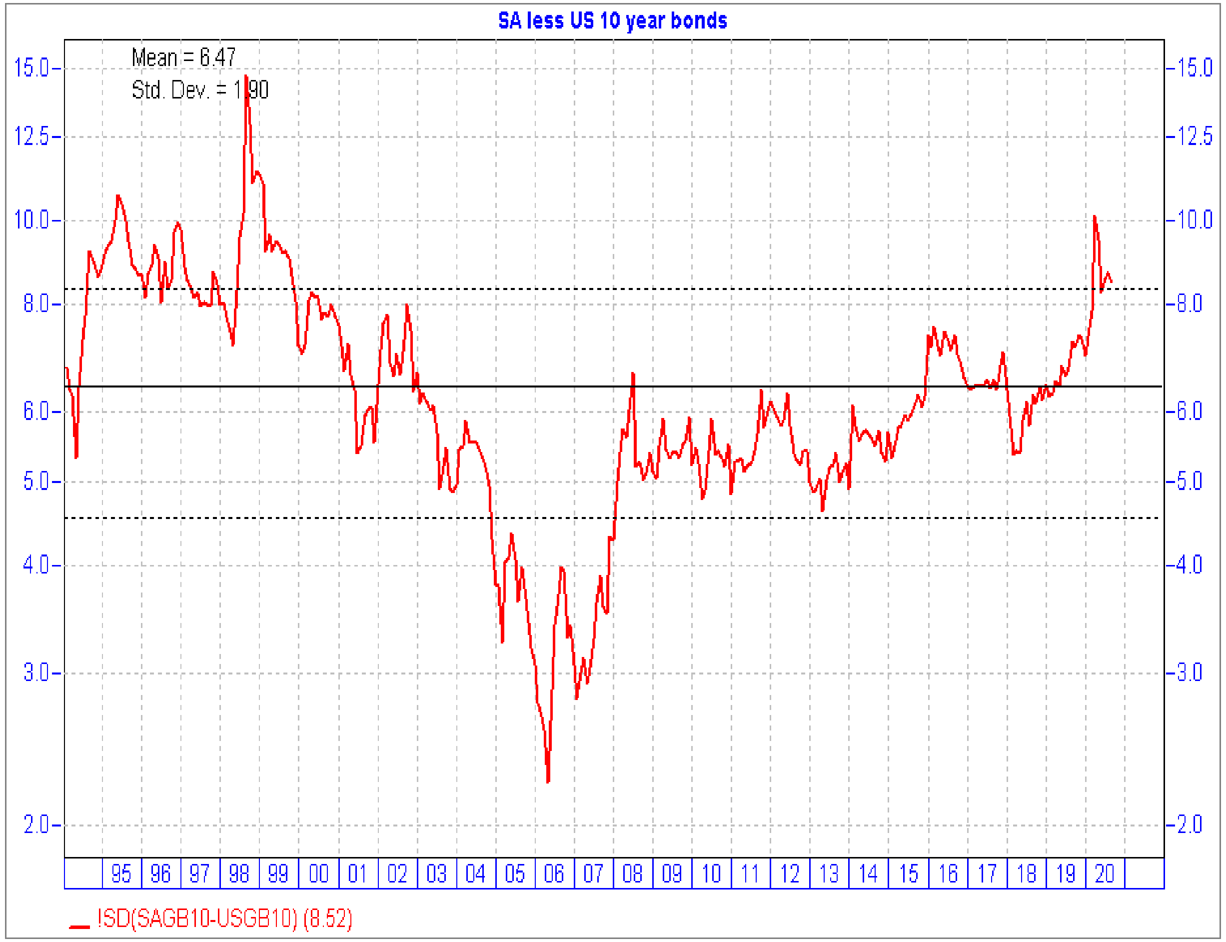


Real fuel prices



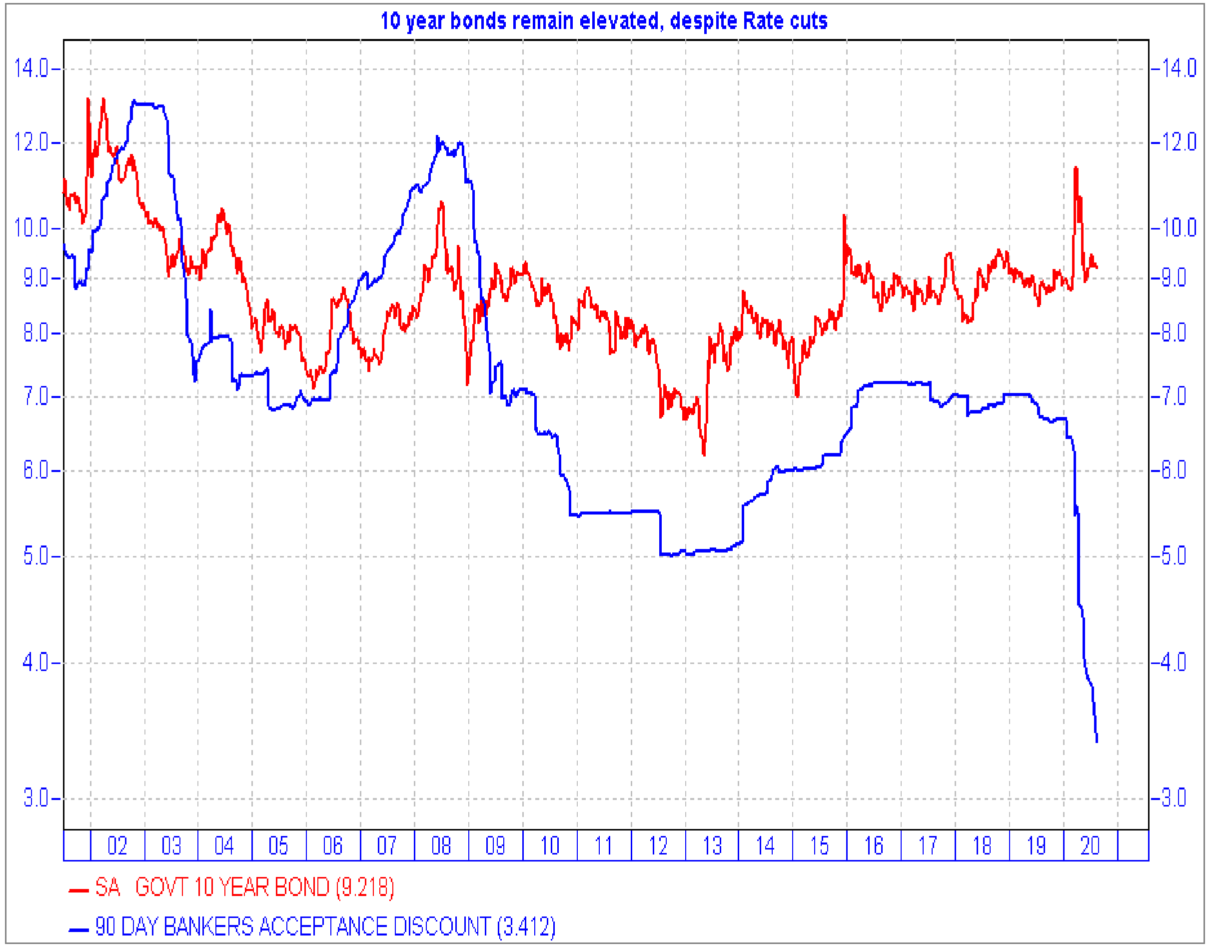
THE SA OPPORTUNITY SET – #1 – FIXED INCOME

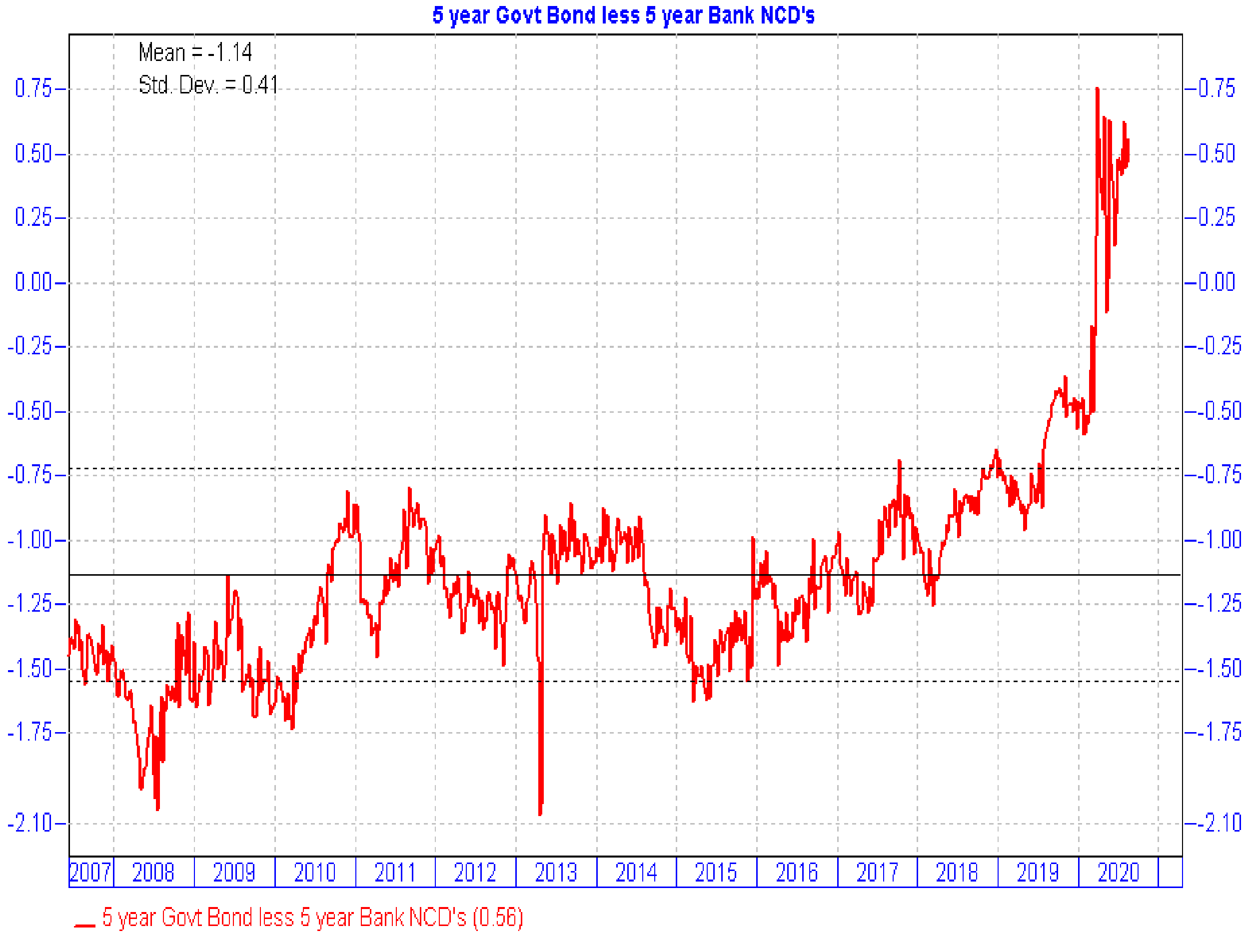




Following years of a relatively flat yield curve, the curve has steepened dramatically in 2020. Similarly, the relative yield gap to global bonds is extreme.

SA COST OF CAPITAL REMAINS STUBBORNLY HIGH – SOVEREIGN RISK ELEVATED

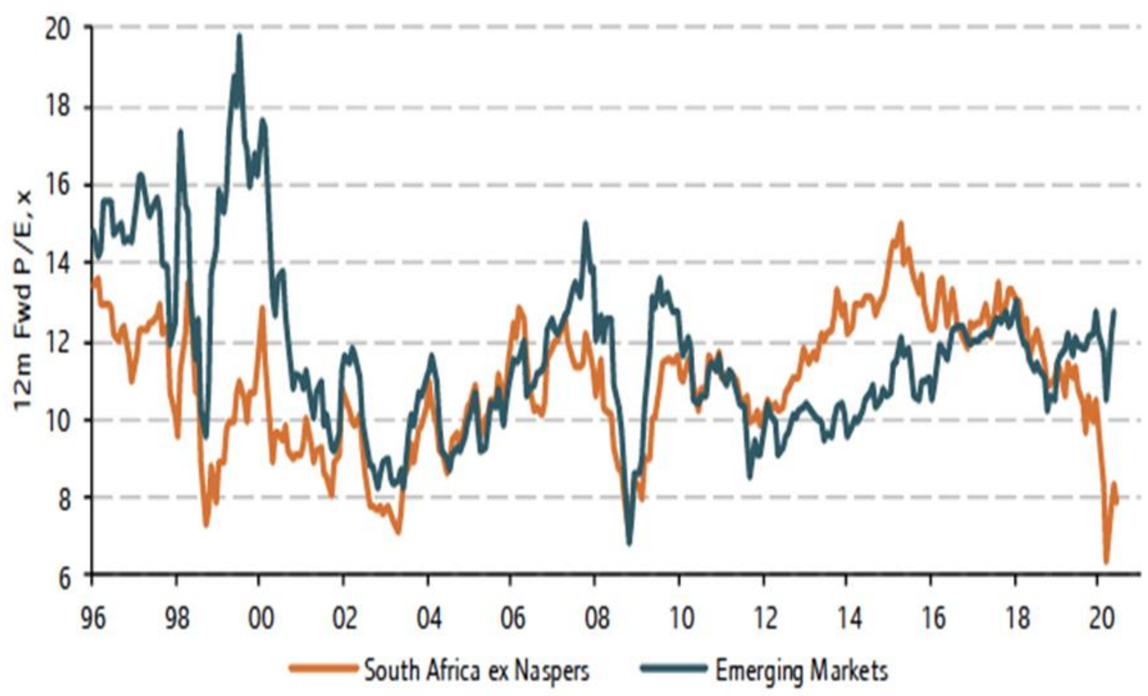




Cash is no longer an attractive real investment in SA. **Post Covid, SA Bank paper now trades at lower yields than Sovereign - clear indication of loss of confidence in Government finances.**

THE SA OPPORTUNITY SET – #2 – DOMESTIC EQUITIES

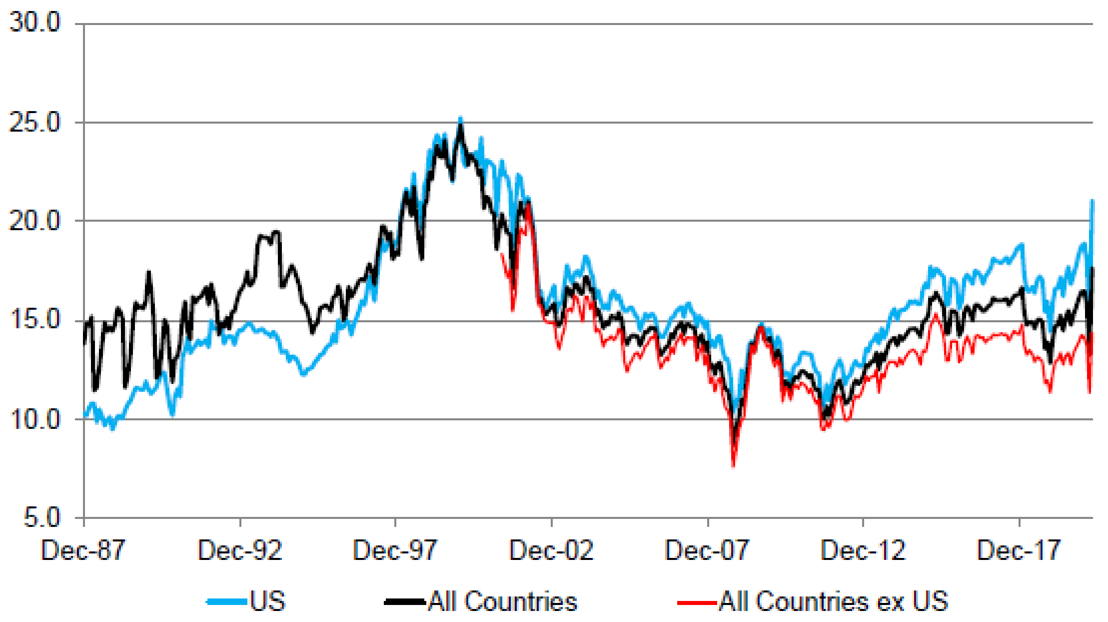
Figure 15: MSCI SA ex Naspers vs MSCI EM 12m fwd P/E ratio



Source: MSCI, FactSet, SBG Securities analysis

- Discount to EM largest on record, prospects for earnings growth similair
- Healthy perspective on South Africa listed companies – solid earnings delivery against EM peers over many years.

12 month forward PEs – equities are pricing in recovery in aggregate



The JSE, excl Naspers, is now as cheap as it was in any prior crises over last 25 years. With global equities re-rating, the SA de-rating has been relatively painful.

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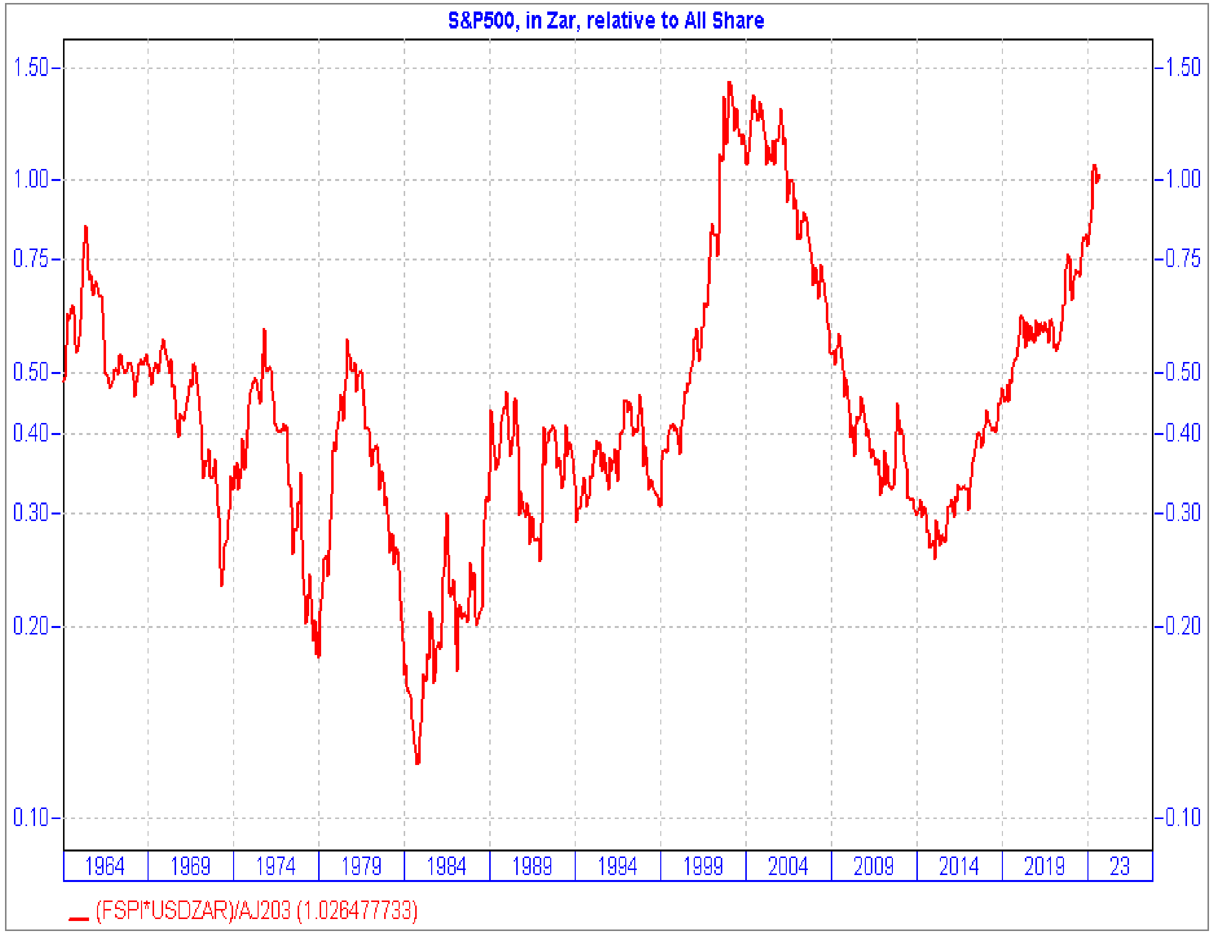
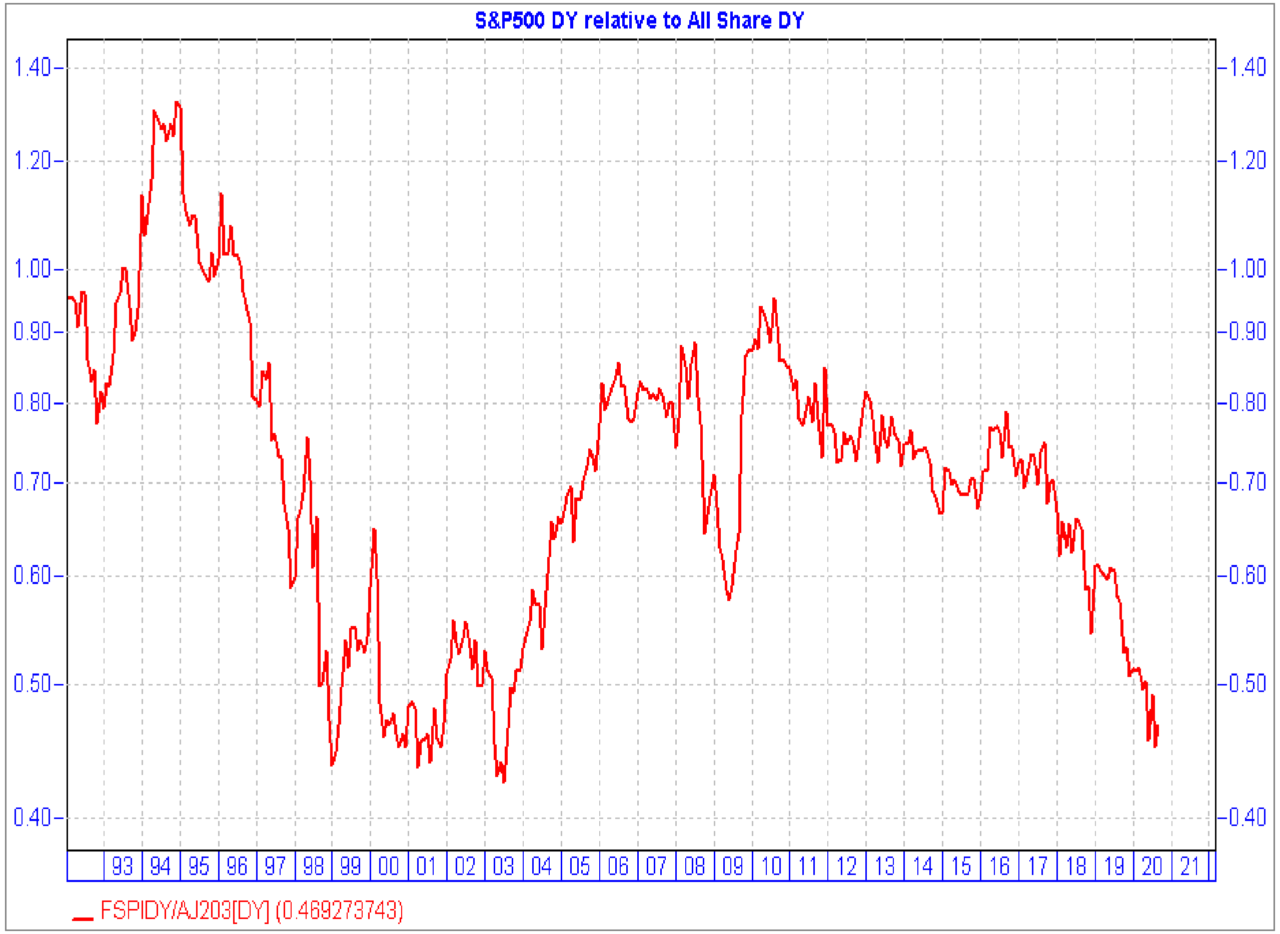
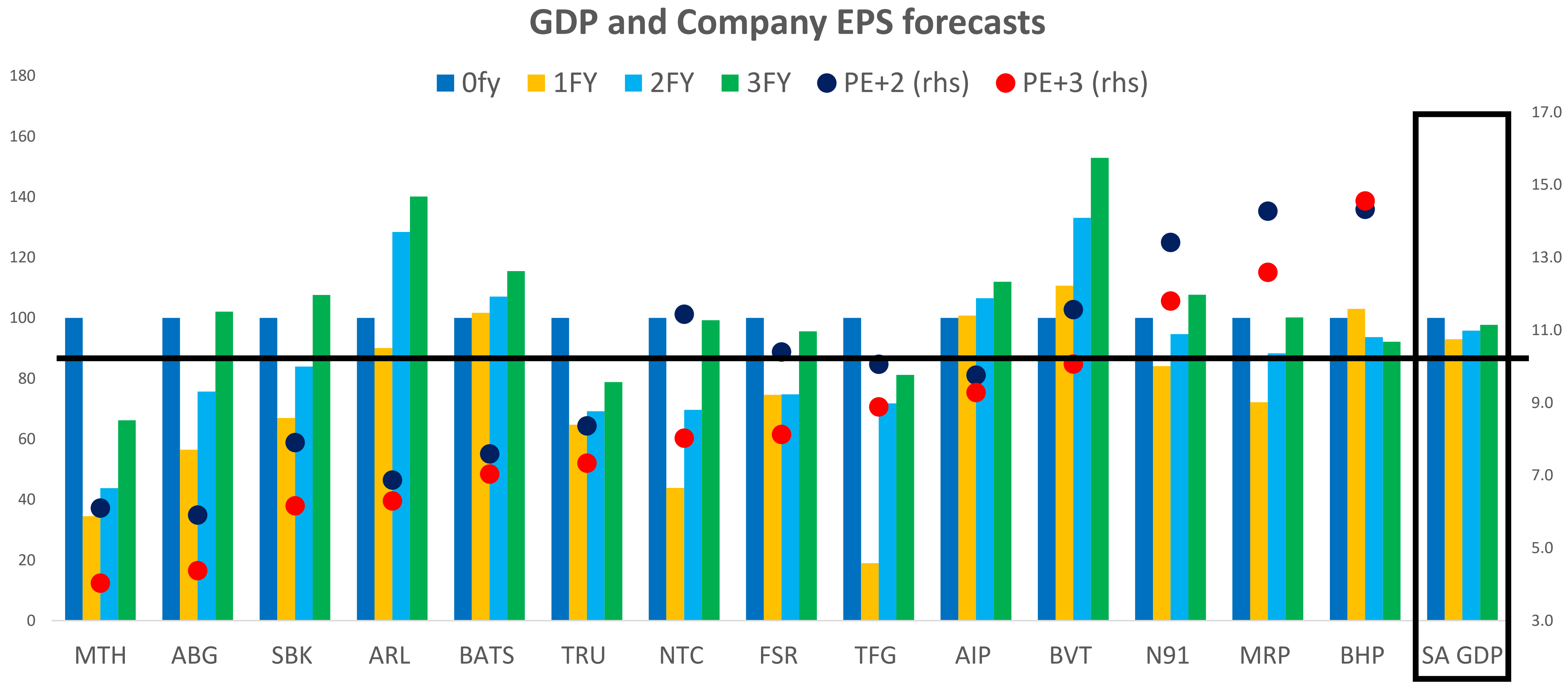
A DECADE LONG PERIOD OF US EQUITY OUTPERFORMANCE vs JSE





Valuation gap extreme, as evidenced by current relative Dividend Yields nearing historic lows.

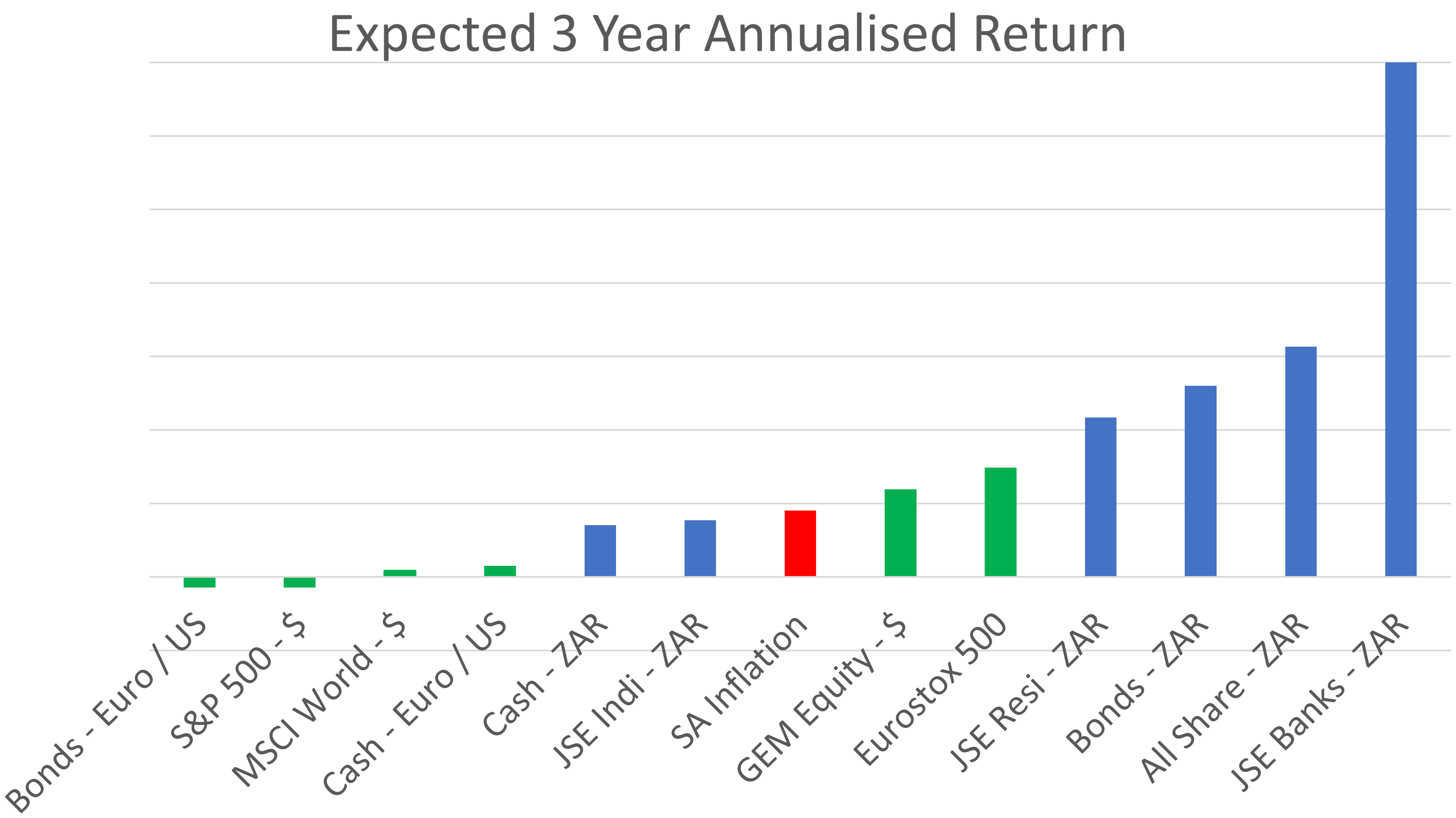
GDP EXPECTED TO RECOVER, AS DO EARNINGS FOR MANY COMPANIES



Numerous companies with single digit PE multiples in years 2 & 3 – clearly forecast risk, but our assessment of appropriate through the cycle PE's is higher for most of these companies

ASSET CLASS RETURN EXPECTATIONS HIGHLIGHT THE COMPLEXITY OF CURRENT ENVIRONMENT

- Various equity indices around the world offering less enticing returns than in March 2020.
- Global returns, in green, appear less interesting – would require a weaker Rand to generate acceptable real returns
- Select regional indices do look more attractive than US equities
- Sovereign risk embedded in both Banks and SA Bonds return potential
- Acknowledge that domestic equities require growth to re-rate.



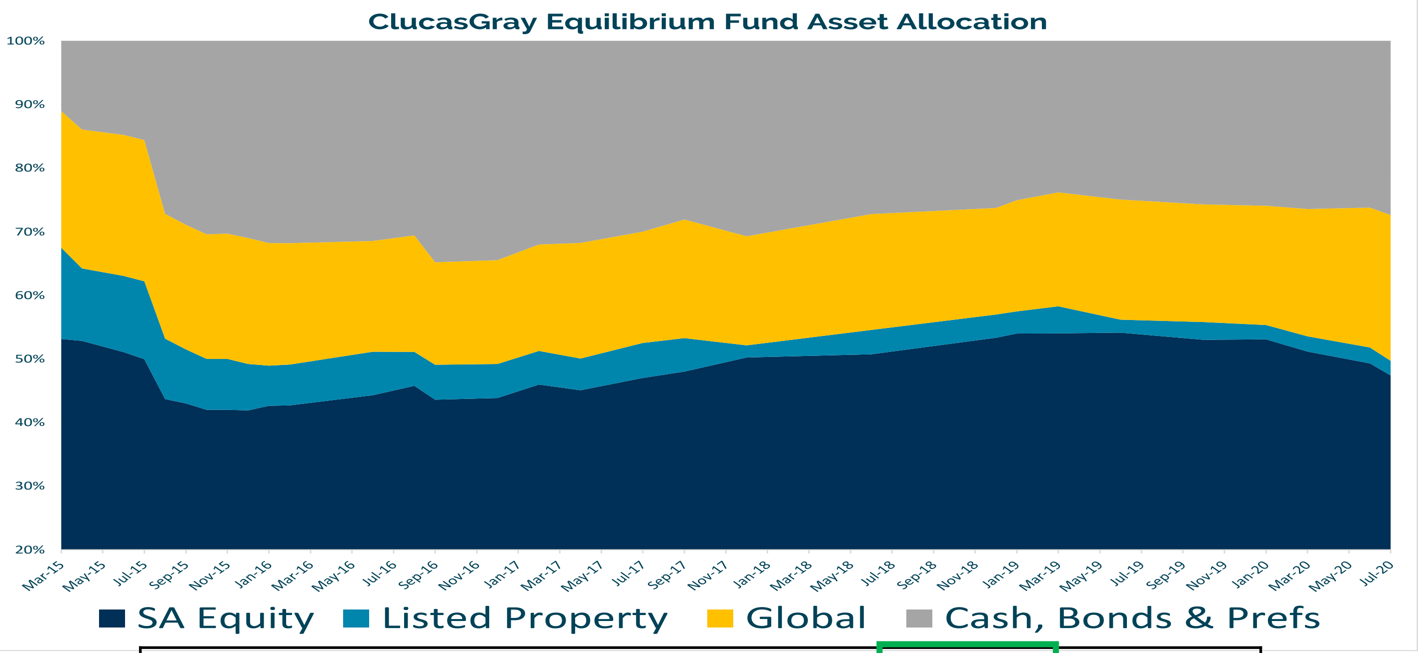
“Safe havens” don’t appear to offer much comfort in expected returns. To generate real Rand returns does currently imply holding South African assets, unless currency depreciation drives offshore returns.

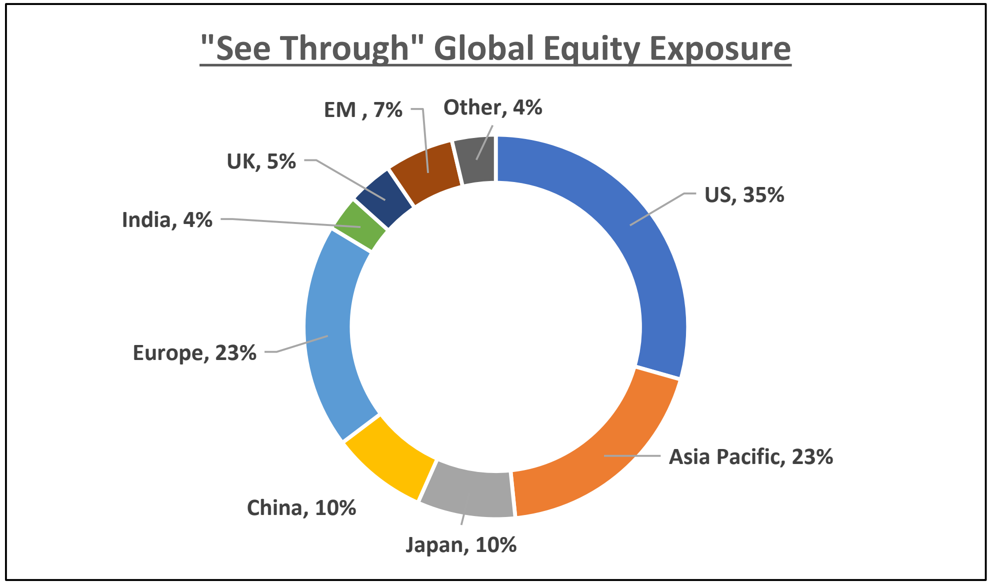
OUR ASSESSMENT OF THE SOUTH AFRICAN INVESTABLE UNIVERSE

Investable universe	déjà vu	jamais vu
Income yield	Global search for yield, carry trade argument	Issuance levels create too much supply - yields rise
	Rand stabilises, yields fall	Sustained elevated cost of capital
	Lower cost of capital, helps equity markets	
Equity market valuation	Valuation discrepancy is extreme	No growth, value trap
	Earnings recovery, coupled with re-rating	Narrowing opportunity set
	Invisible hand, catalysts to unlock value	Continued dominance of Rand Hedges & Global equity
	Broader participation in equity market performance	

We are mindful of the risks, but cognisant of the opportunity set. We do not believe South African assets are priced for a “déjà vu” scenario.

CLUCASGRAY EQUILIBRIUM FUND – ASSET ALLOCATION CHANGES

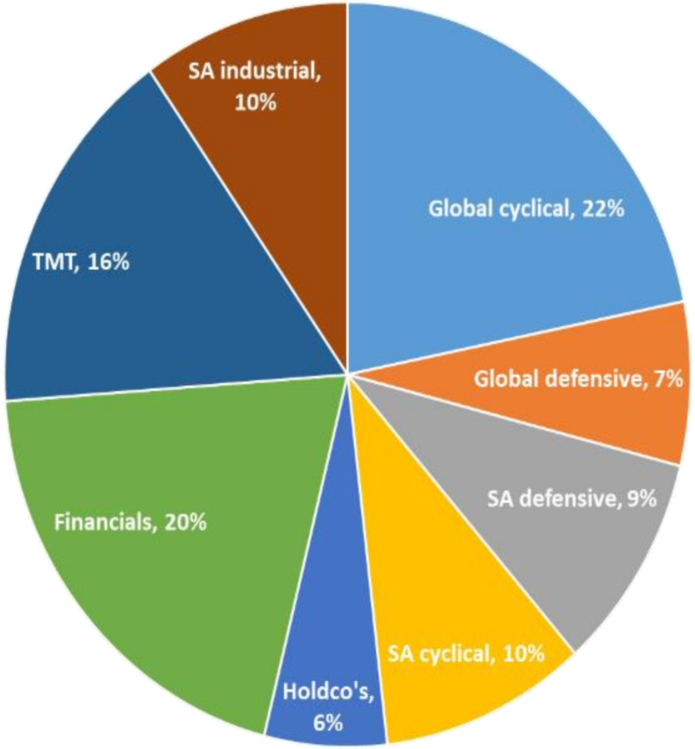




Asset Class	31-Mar-20	Aug-20	Action	Approx move
SA Equity	49.6%	**48%**	reduced	20%
Global Equity	20.9%	**22%**	reduced	20%
Bonds	23.0%	**23%**	dynamic	10%
SA Income	3.1%	**3%**	added	2%
Property	0.9%	**2%**	added	10%
Global Cash	2.5%	**2%**	dynamic	-2%

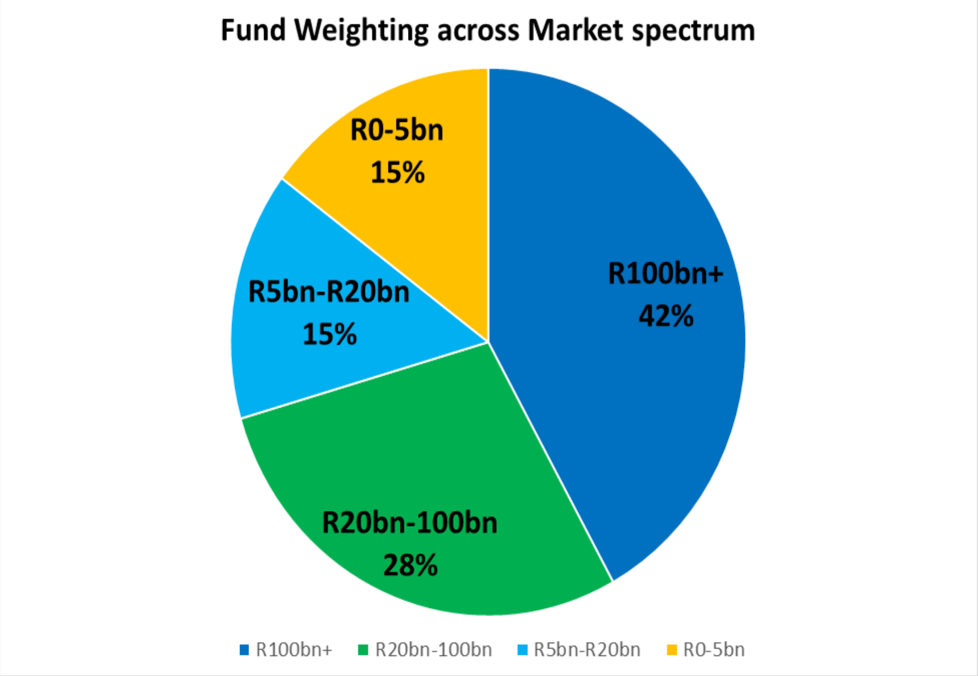
We have continued to be dynamic around both the asset allocation of the portfolio, and the security selection within it.

CLUCASGRAY EQUITY FUND SEGMENTATION



	Weight	PE+2
Global cyclical	22%	9.25
Global defensive	7%	11.18
SA defensive	9%	10.22
SA cyclical	9%	8.46
Holdco's	6%	-52%
Financials	20%	7.96
TMT	16%	14.14
SA industrial	10%	8.49

- We show PE+2 due to 2020 earnings impact from Covid crisis
- With few exceptions, the portfolio holdings valuations are undemanding
- A diverse spread of positions
- Holding company discounts appear extreme.

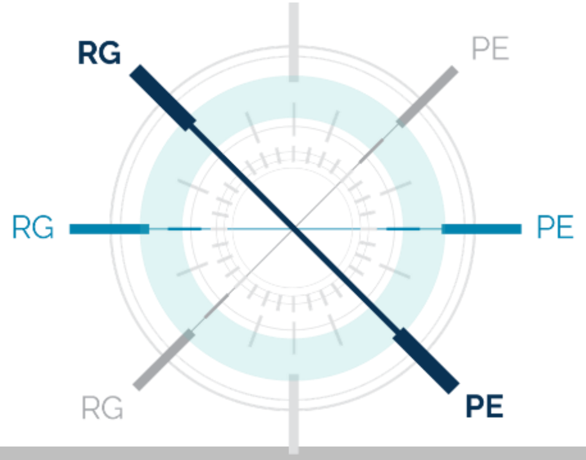


Market Cap	Fund Weight	PE+2
R100bn+	42%	11,85
R20bn-100bn	28%	8,43
R5bn-R20bn	15%	8,58
R0-5bn	15%	7,25 *

With over 70% of the portfolio in large companies, there is exposure across the market cap spectrum – more valuation support further down the market cap spectrum.

PORTFOLIO EQUITY HOLDINGS – POSITIONING & LARGE HOLDINGS

- ❑ Focussed portfolio < 30 stocks in equity block
- ❑ Portfolio Construction guidelines within equity
  - ❑ Minimum weight 1.5%
  - ❑ Maximum weight 10%
- ❑ Don't manage to any benchmarks – divergent at times
- ❑ Opportunity set across market cap spectrum



Portfolio changes / Developments

- Diversified Resource exposure
  - BHP, AGL, EXX, ARI, AMS
- NPN, BTI, ANH
- Adcock, Astral, L4L, Netcare - crisis impacted shorter term performance, yet good businesses and likely to recover
- Banks at generational low valuations – priced for more risks than we foresee
- High cash as % of mkt cap in numerous holdings, large holding company discounts to NAV
- Introduced good companies at better prices: N91, MRP, NTC, BVT, FSR
- Corporate action the catalyst?

Larger holdings	
SBK	EXX
ABG	BHP
NPN	AGL

Notable others	
OMU / MCG	L4L / MTN
AMS / NTC	ARI / BTI
MFL / AIP	BVT / RLO

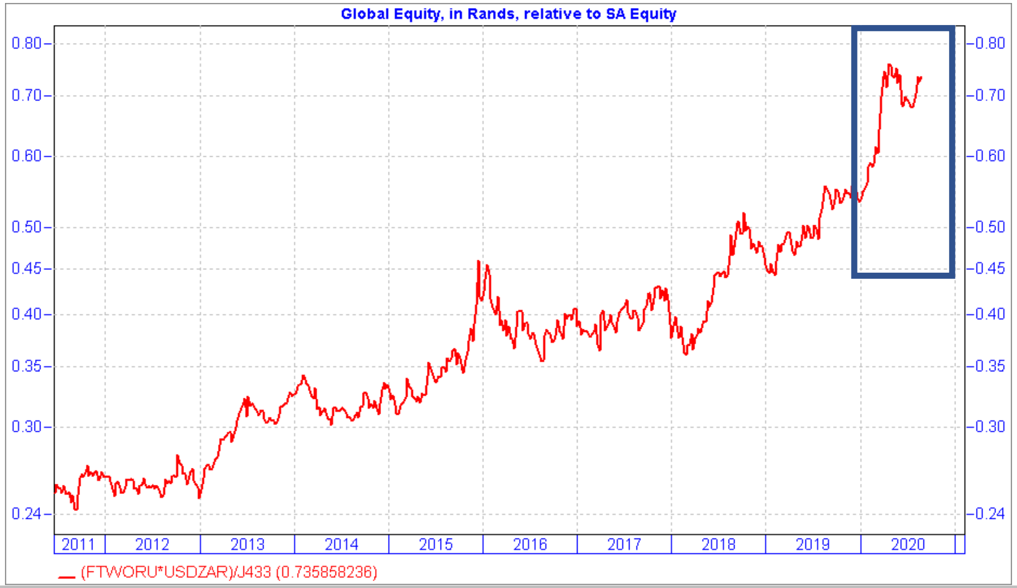
It is years since we have seen the extent of valuation support on offer. The catalyst to unlock these values is, as ever, uncertain. Requires patience, but opportunities are in abundance.

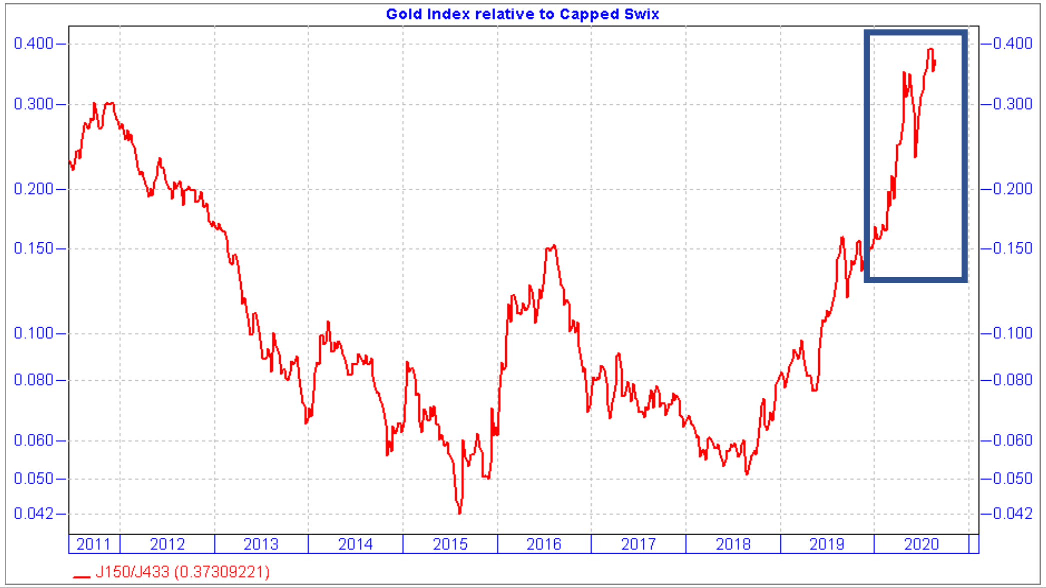
CLUCASGRAY EQUITY & EQUILIBRIUM FUNDS CALENDAR YEAR RETURNS

Equity Fund	YTD	2019	2018	2017	2016	2015	2014	2013	2012
Fund Quartile	4	3	1	1	1	3	2	2	1

Equilibrium Fund	YTD	2019	2018	2017	2016	YTD 2015
Fund Quartile	4	3	1	1	1	1

Source: ProfileData; August 2020





Highlights the impact of the Covid crisis on performance in 2020. Charts shows how materially Gold Index has outperformed over the last 18 months, and the extent of Global equity outperformance of the JSE over last 9 years. 2020 ytd has had material impact on medium term performance figures.

CONCLUSION

Domestic Valuations Compelling	Global Assets Require Careful Navigation	SA Yields Extremely Attractive in Global Context	ClucasGray Asset Management
❑ Valuations compelling across many sectors / companies ❑ 2020 Earnings decline could be worst on record, but many supported by strong balance sheets ❑ Global economic recovery to lead the South African recovery ❑ Believe many good companies not appropriately priced for recovery in earnings in 2021/22.	❑ Non-equity assets remain unappealing ❑ Global equity recovered strongly off the March lows, and key valuations now stretched, even accounting for strong recovery in earnings into 2021/22 ❑ Active managers have performed well ❑ Select markets more attractive than the US, and we have used passive instruments to exploit these opportunities.	❑ Real and Relative yields seldom been higher ❑ Recent fall in interest rates has invited reflection on longer duration yields ❑ Implicit sovereign risk rating as high as we can recall ❑ Cost of Capital elevated, hampering Equity market re-rating.	❑ Skillset in Equity and Asset Allocation ❑ Experienced team & robust process ❑ Ability to be nimble and flexible ❑ Covid-19 crisis impacted shorter term performance, but has provided opportunities ❑ We are guided by Valuation & the mispricing of assets ❑ Funds represented on most major platforms (under Prescient Manco, ClucasGray).

Using history as a guide, the global cycle coupled with lower interest rates, are likely to be supportive of an improving environment for South African investors.

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