ASHBURTON INVESTMENTS

APRIL 2023

# QUARTERLY INVESTMENT COMMENTARY

ASHBURTON EQUITY FUND

## OVERVIEW

The first quarter of 2023 lived up to the volatile precedent set during the previous year. There was no shortage of drama for global financial market participants as rapidly tightening financial conditions claimed several well-known casualties.

The most prominent being Switzerland's second-largest bank, Credit Suisse, which was bought out by its largest Swiss competitor, UBS just before its collapse.

Banking is a confidence game, given the inherent mismatch between short-dated liabilities (cash deposits) and long-duration lending assets (customer loans). Banking executives are expected to manage this fundamental mismatch by limiting credit risk, managing market risk via the appropriate use of conservative financial assets and protection strategies, as well as ensuring that they maintain appropriate liquidity levels to provide customers with the confidence that their solvency is never in doubt. Failure to provide confidence regarding your bank's solvency can very quickly result in a depositor stampede for the exit. In today's electronic world, this no longer entails queuing in the sun outside one's local branch to make a withdrawal but can be actioned instantaneously via a click of a button. This significantly accelerates the speed at which a banking crisis can unfold in the modern era. In this regard, the life of a banking executive can perhaps be compared to that of an airline pilot where 99% of one's working life is associated with long periods of boredom punctuated by brief moments of sheer terror.

In all these recent bank failures, the rapidly increasing interest rates regime required to tame runaway inflation caused significant unrealised mark-to-market losses in bank asset portfolios that hadn't managed market risk appropriately. Once depositor confidence evaporated in several of the more precariously positioned banks, the game was up. Banking regulators have been forced to step in and provide depositor guarantees, backstops, or managed buyouts to ensure that a regional banking crisis does not morph into a broader systemic financial crisis. There is inevitably an element of 'moral hazard' in these regulator interventions, as the management of banks such as Silicon Valley Bank (SVB) ignored many of the fundamental risks (principles) associated with running a sound banking enterprise. One can only hope that these banking executives become subject to clawback provisions that are now typical in financial sector employee remuneration policies to discourage similar future risk-taking by peers.

**Given the above elevated global risk environment, one may have expected to see global equity returns underperform during the quarter, this was not the case as the MSCI All World Index increased by + 6.8% in dollar terms.**


As we have become accustomed to it of late, liquidity trumped fundamentals as the Federal Reserve (Fed) was forced to temporarily abandon its quantitative tightening program as the regional banking crisis unfolded. It once again injected capital (liquidity) into the system to try and stabilise the market. Up until mid-March the Fed had sold $580 billion of securities and contracted its balance sheet by approximately $620 billion. By the end of the quarter, their balance sheet rebounded by $364 billion. This liquidity injection had the usual positive effect on many asset prices late in the quarter. It was particularly evident in the rebound of the tech-heavy Nasdaq Index as investors believed that the current banking crisis would force a 'pivot' in the interest rates which would be supportive of long-duration growth assets.

At present there appears to be a stand-off between bond investors and equity investors. The record inversion of the yield curve leaves no uncertainty that bond investors are banking on the macro deteriorating as we enter recessionary conditions, while US equity market ratings are not reflecting this same negative outcome. Only time will tell who is 'on the money' in this regard.

Looking east, the Chinese post-Covid re-opening was the central theme for the quarter. With the commodity cycle running out of steam last year, many thematic-led investors looking for exposure to the Chinese re-opening trade pushed the valuations of several consumer facing companies with material Chinese exposure to elevated levels. As was the case in Western markets, there is an expectation that the release of Covid related consumer savings will drive near-term consumer spending. While this is true, these assumptions are now embedded in current equity prices for companies under our coverage. Despite positive momentum from a weak Covid lockdown base, there still appears to be a mixed medium-term outlook in China as the weaker-than-usual property market will weigh on earnings and sentiment.

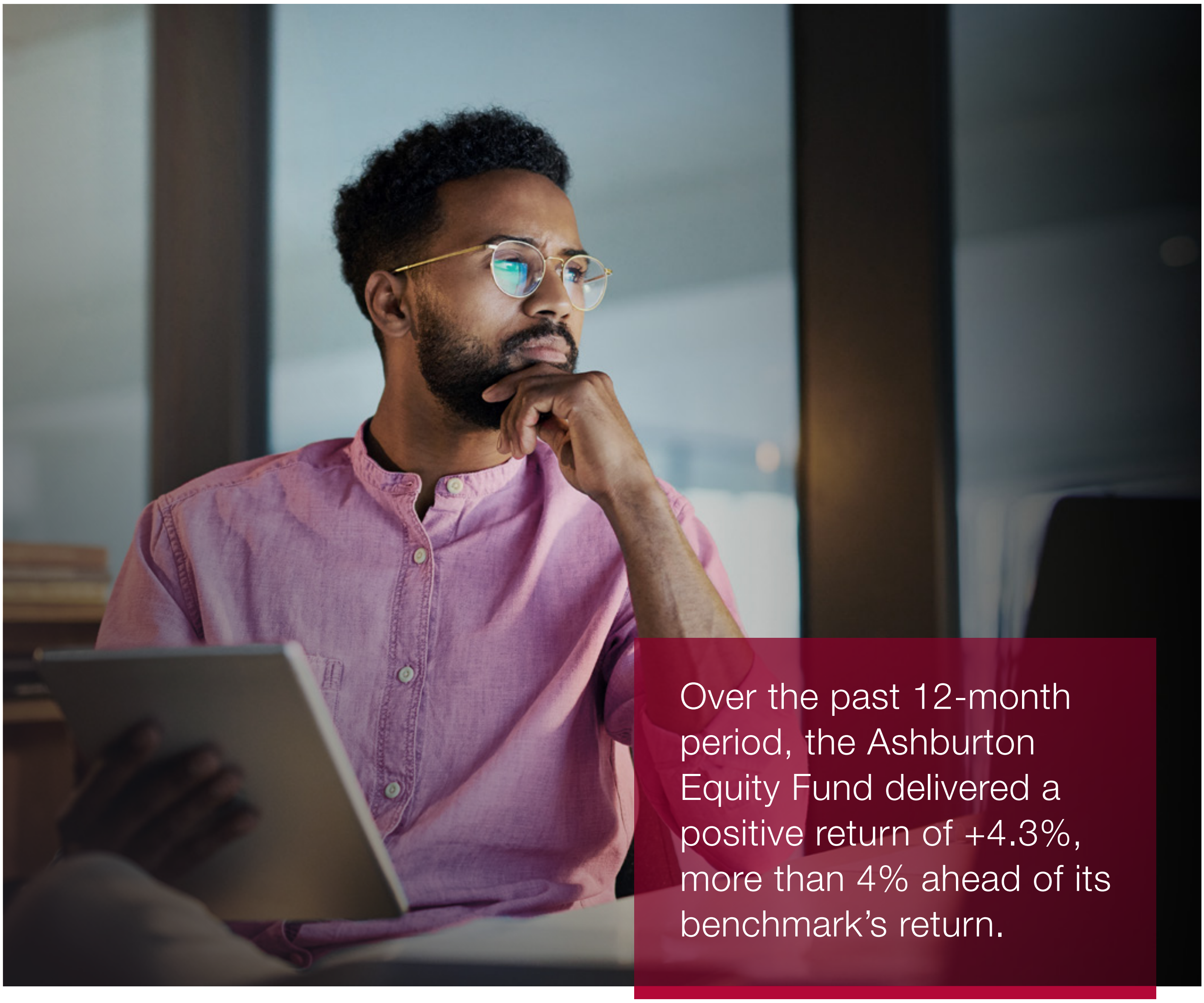
South African assets had a tougher quarter due to the impact of severe load-shedding on confidence and company operating performance weighed on local equity returns. This weakness was particularly evident for companies with more South African exposure. Direct and indirect load-shedding costs are weighing on these companies' earnings, forcing downgrades to earnings estimates. The load-shedding burden will likely be with us for most of 2023. There is some light at the end of the tunnel as load-shedding is likely to ease into early 2024 as repairs to some key Eskom-generating assets are completed and private sector generation gains momentum. An end to severe load-shedding together with the potential for declining interest rates into next year will set up South African equities to start growing earnings and cash flows again off a very weak base.

The JSE All-share Index returned just under +1% in dollar terms. But this positive index return was dragged higher by a select number of large companies with significant offshore exposure, particularly non-resource companies exposed to the Chinese reopening theme such as Naspers, Prosus and Richemont. The balance of the local market did not perform as well due to the local headwinds we just discussed.

## PORTFOLIO PERFORMANCE

Post a very strong 2022 performance, the Ashburton Equity Fund had a tougher first quarter of 2023 returning +1.4% total return in rands. The portfolio's benchmark, the JSE Capped Swix Index returned +2.4% for the three-month period, implying we underperformed the benchmark by approximately 1% for the three months.

However, over the past 12-month period, the portfolio has delivered a positive return of 4.3%, more than 4% ahead of its JSE Capped Swix benchmark's return of +0.2% for the same period.



Over the past 12-month period, the Ashburton Equity Fund delivered a positive return of +4.3%, more than 4% ahead of its benchmark's return.

## OUTLOOK AND STRATEGY

Our equity research process relies heavily on bottom-up valuation. We need to be disciplined and comfortable in not owning companies whose valuations are above our internal assessment of fair value, even if in the short term we understand that their share prices are likely to be supported by the prevailing global macro conditions. This long-term mindset when it comes to portfolio construction, may mean that we may suffer from short-term underperformance of our benchmark from time to time. We firmly believe our clients' long-term interests are best served by us never overpaying for assets.

There are many well-known problems within the local context, on the back of this sentiment, local asset prices have de-rated to levels that now reflect many of these issues. In some select instances, we believe that share prices have de-rated to levels that more than compensate investors for risks embedded in the prevailing market conditions. Our local banking sector remains relatively isolated from the ructions seen in many developed markets' banking sectors. Our banks are well-capitalised, well-run and well-prepared for the deteriorating credit cycle in South Africa. They also provide an attractive cash yield for investors and currently trade at a deeply discounted rating relative to their long-term histories.

The share prices of many of our local consumer-facing companies, which are likely to be at the forefront of the increasing pressure on consumers due to higher interest rates and inflation, as well as load-shedding costs, have also sold off significantly. Among this cohort, there are several good-quality companies which are trading at valuations well below our assessment of fair value.

However, given the prevailing context, investors in these companies will require patience to see out the current cycle. Unfortunately, experience teaches us that no one 'rings a bell' at the bottom of a sector cycle and investors need to have the stomach to position themselves ahead of the turn in the market, provided valuations are attractive enough to adequately reward investors for their long-term view. Similarly, there are a handful of South African listed companies with low exposure to the local market, whose valuations and ratings have been sold off in sympathy with their local peers. We are happy to take advantage of these selective opportunities in the portfolio.

As always, our focus remains on the consistent implementation of our investment process. In this volatile environment, this remains the one thing that is completely within our control. As we consistently communicate, our process relies heavily on having the right people and investing with a long-term mindset. In this regard, we are also happy to report our equity team has grown during the quarter. Garth Barry, a commodities specialist joined Ashburton Investments at the beginning of March. Garth will add new energy to the team and increase the number of companies under our coverage which in turn will improve the pool of available investment opportunities for our clients.

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