ASHBURTON INVESTMENTS

JANUARY 2023

QUARTERLY INVESTMENT COMMENTARY

ASHBURTON EQUITY FUND

OVERVIEW

As a tumultuous and painful year closed, the final quarter's positive returns provided a welcome respite for weary investors.

Emerging markets did particularly well, outperforming developed market peers during the fourth quarter as concerns grew that various developed market economies would tip into recession. When considering a theme for the past year, the US Federal Reserve (Fed) and the US economy were certainly at the epicenter of shaping prevailing global market sentiment as the Fed aggressively hiked interest rates to slow rampant inflation. The combination of aggressively raising interest rates while shifting from quantitative easing to quantitative tightening was always going to be a powerful downdraft that asset prices would struggle to overcome. As such, the paradigm of 'bad news is good news' was central over the year, supporting a situation where market participants perversely yearned for negative economic data points they believed would break the Fed's resolve to continue hiking interest rates in a weakening economy.

As if the above factors were not enough, the ongoing war in Ukraine, and the subsequent human suffering and disruptions to global energy and commodity flows fueled global inflation and has introduced significant anxiety and friction into the global economy. The conflict has laid bare the fault lines between the major economic and military superpowers, and it seems that after decades of relatively benign geopolitical tensions, we are entering a more precarious period. One can't help but draw parallels between the situation in Ukraine and that of Taiwan, and we can only hope that cool heads ultimately prevail.

On a more positive note, the latter half of 2023 saw many companies (with the exception of China) finally operating free of direct Covid-19 impacts. That said, there is no doubt that global supply chains have still not fully recovered as many companies are still having to manage the indirect impact of supply chain disruptions that originated during the pandemic. These disruptions typically manifest in increased working capital requirements and longer lead times which increase capital requirements and delay sales, profits, and cash earnings.

China's zero-Covid policy had a significant influence on the global economy in 2022.

The country's hard lockdown policy slammed the brakes on commodity demand and the supply chains of many downstream industries were negatively affected by factory closures. Inevitably, the wheels fell off China's zero-Covid policy as domestic social unrest gained momentum and the authoritarian government realised they could no longer keep a lid on growing social unrest, particularly as the rest of the world had visibly moved on from the outbreak.

As South Africans, we have become accustomed to dealing with high inflation, uncertainty, a lack of service delivery (particularly power), and a generally higher-risk operating environment. The disruptions to the global energy balance, as a result of the Russian and Ukrainian conflict, has meant that very few countries are able to escape many of the pressures to which we have become so accustomed. While local inflation has no doubt increased, the scale of our increase versus our long-term inflation rate has been significantly less than increases seen across many developed markets. This has, to a certain degree, insulated us from the full effect of the inflation crisis we have witnessed in many developed markets over the past six months. Notably, inflation appears to have peaked late in 2022 and is forecast to continue to fall over the coming year. Currently, the risk treasury officials are trying to snuff out is that second-round inflation effects don't increase long-term inflation expectations and cause inflation and interest rates to remain higher for longer.

Closer to home, it would be remiss of me not to flag the growing Eskom risk to the broader economy. The catastrophic failure of a significant portion of Eskom's generating capacity beggars belief. South Africans have become so punch-drunk on the power supply front that we are now at the point where stage three load shedding is regarded as a victory. It would be ignorant not to expect second-round effects of the power crisis not to filter through to the financial performance of our companies, their employees and broader society. There are no short-term solutions, which means that 2023 will no doubt be a tougher year on both the power supply and consumer front. In the midst of the crisis, government continues to make several own goals. Both the latest bid rounds of renewables could not be brought to financial closure, further delaying efforts to add much-needed new generating assets to the grid. As is normal for South Africa, it now appears that the private sector will have to save itself on the power front. Encouragingly, companies are investing in power generation at a speed and unprecedented scale. This backup power is likely to be brought to the grid long before we see any progress from the government in getting their renewables projects over the line. Many of these private projects yielded very attractive investment returns even before the latest round of power price increases were awarded to Eskom.

These corporate and private residential power generation investments will provide **new funding opportunities for the local financial sector.**

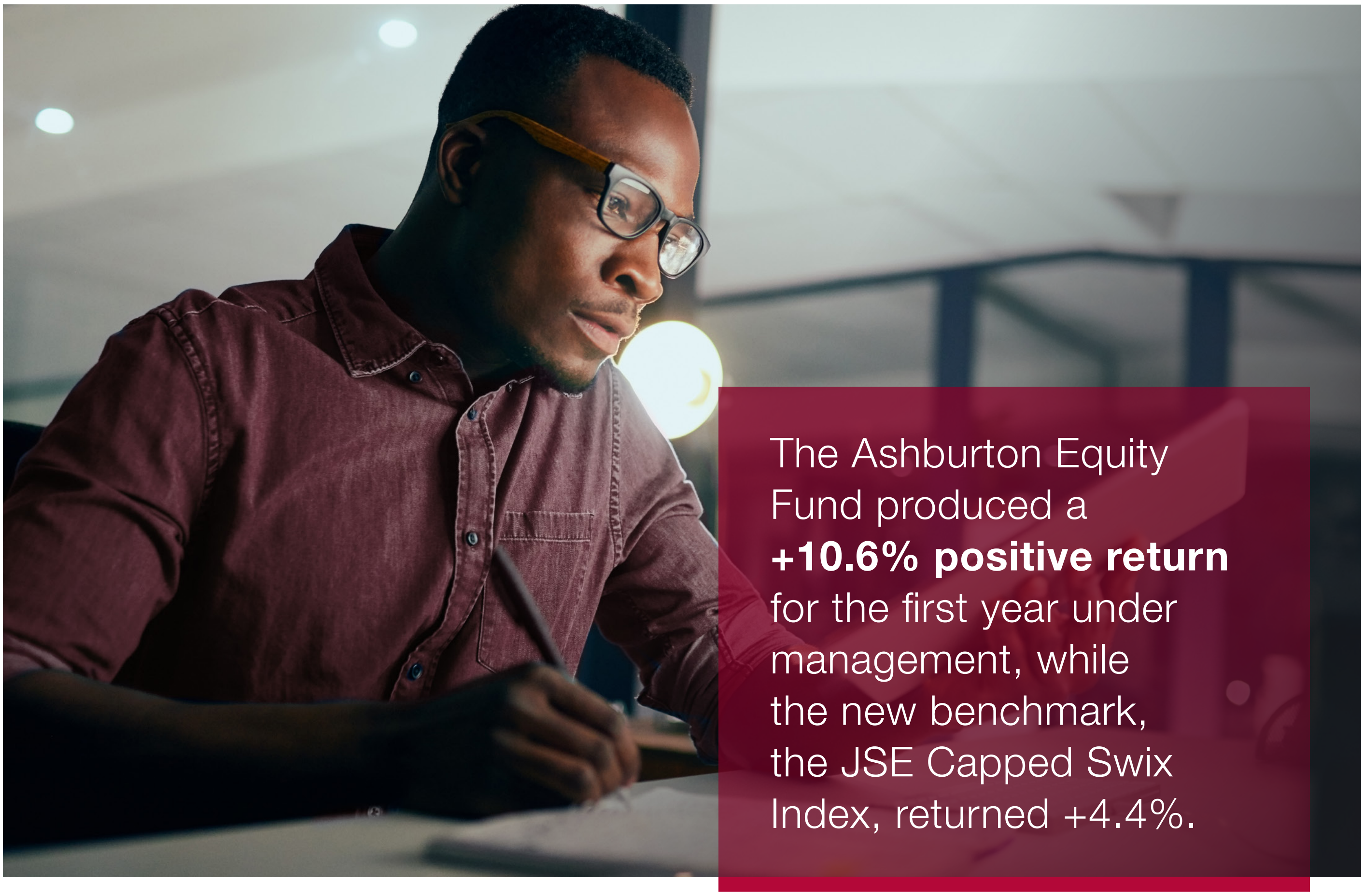
PORTFOLIO PERFORMANCE

Last year marked a shift for Ashburton Investments, being the first time that the Ashburton Equity Fund was managed by a new team. While it was a baptism of fire in terms of market conditions, the team applied itself well and focused on what was within its realm of influence, namely detailed company research and analysis. We remain of the firm belief that valuations matter. Overpaying for assets, no matter what the prevailing context, is seldom the source of long-term equity outperformance. Investing in South African equities at the beginning of 2022 was not the most popular course of action. However, a year ago we saw local valuations as being significantly more attractive versus developed market comparisons. This view proved to be correct, as South African equities handsomely outperformed most developed market peers.

The Ashburton Equity Fund produced a +10.6% positive return for the first year under management, while the new benchmark, the JSE Capped Swix Index, returned +4.4% - implying that we added approximately +6.2% of positive alpha for investors during 2022. This fund performance places us well within the top quartile of peer performance for the year, a very pleasing start to our management of the portfolio.

Looking at the Ashburton Equity Fund's performance for the 2022 year in USD or hard currency, the portfolio delivered a positive annual return of +3.7% during a very tough year. The fund's performance was significantly better than the negative -19.4% for the S&P 500 or negative -19.8% for the MSCI All World Index and offered a just reward for those clients who remained invested in the fund during this challenging period.

For the final quarter, the JSE Capped Swix Index ended the final three months of the year with a strong positive return of +12.2%. Our portfolio lagged this quarterly return slightly, with a return of +11.1%.



The Ashburton Equity Fund produced a **+10.6% positive return** for the first year under management, while the new benchmark, the JSE Capped Swix Index, returned +4.4%.

OUTLOOK AND STRATEGY

Looking ahead, we are always going to be guided by valuation and valuation differentials across markets and sectors. In the wake of the de-rating, we have seen across many markets and sectors over the past year, the outlook for 2023 is more balanced than it was 12 months ago. There are fewer sectors and markets showing significant value dislocation than was the case early last year.

We still believe that the US market valuations are, on average, not attractive enough. While prices and ratings have improved materially, we still feel that the market is too optimistic when it comes to corporate earnings forecasts and that current ratings don't yet fully reflect the downside potential that still exists.

Following the significant de-rating in Asia equities during 2022 we saw good value in that market.

Some of the upside already played out in the last quarter of the year, as we saw equities rally hard off the 2022 lows. Our portfolio benefited through our positions in Naspers and Prosus.

Looking closer to home, we still feel that South African equities are attractively priced relative to their own long-term histories, as well as in comparison to other global markets. However, we do need to be mindful of the growing risk that Eskom is having on corporate South Africa and the consumer. This means that the potential for value unlock is more than likely going to be pushed out until a such time that we see improvement on the power front. Within this context, one needs to carefully manage position sizes and risk.

As before, we continue to own some exciting opportunities in the South African mid-cap space. Companies with strong business models and strong balance sheets are under-researched and under-owned. We don't know when the catalysts for value unlock will come, but we are patient investors and are willing to wait until the market eventually rewards tangible cash flows and undervalued assets. Over the past year, the portfolio benefited from the re-rating of several of our mid-cap positions. In some cases, we used the proceeds of these re-ratings to cycle capital into new positions where we see better risk-return potential.

From a local sector point of view, we also feel that the outlook for the year ahead is more balanced. The resource sector was more attractive after the sell-down in 2022 and had a strong run into the final quarter. Pockets within the financials and industrial sectors remain attractive and the property outlook has improved as companies learn to deal with new post-Covid work-from-home models.

For the year ahead, we understand that there is no substitute for hard work. We are excited about the opportunity to continue to build the team, which will expand our research base. Our focus, as always, will remain on the consistent implementation and execution of the Ashburton investment process.

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