ASHBURTON INVESTMENTS

JUNE 2022

QUARTERLY INVESTMENT COMMENTARY

ASHBURTON EQUITY FUND

OVERVIEW

As has become the norm of late, volatility remained the only constant during the second quarter of the year. Given the context of rising global interest rates and the withdrawal of treasury sponsored quantitative easing programmes, these market convulsions can be likened to an addict foregoing their daily fix. There have been few places to hide as asset classes which usually provide diversification benefits sold off in unison.

Global imbalances due to geopolitics and Covid lockdowns continue to impact supply chains across a multitude of sectors and commodities. These imbalances are taking time to dissipate and have been a driver of developed market inflation rates that we only thought possible in an emerging market context. Second round inflation effects appear to be gaining momentum, providing a sobering dose of realism to the central bankers that had previously been anchored in the mindset that inflation was transitory. They are now realising that they are behind the curve in terms of raising interest rates to put a brake on building inflation. Higher interest rates, combined with slowing global growth, point to stagflation taking hold.

Energy prices remain stubbornly high. We are now paying the price for the lack of investment in replacement hydrocarbon supply to offset the natural production declines of producing assets, mainly due to the environmental, social and governance (ESG) pressure. This lack of new production as well as the withdrawal of Russian energy flows to the western market due to the Ukraine conflict has created a 'perfect storm'. It has resulted in surging coal, gas and oil prices, adding fuel to the inflation fire. Perversely, the current tight energy market has pushed some developed countries to bring mothballed 'dirty' coal-fired generation assets back into production. Nuclear energy, which was not too long ago seen as a pariah in terms of a green solution to future energy needs, appears to be seeing somewhat of a resurgence as the potential solution to future base load power generation.

This cocktail of higher interest rates and increasing inflation has driven many market participants towards hard assets or commodities. These have typically provided refuge for investors during past inflationary cycles. However, this crowded trade was derailed early in the quarter by China's hard lockdown zero Covid policies. With China being the world's largest consumer of commodities, these hard lockdown policies put a spanner in the works in terms of commodity demand. China lockdowns, together with more recent concerns around slowing global growth, have resulted in commodity prices and equities taking a breather over the last few months after a sustained period of very strong returns. Given the question marks around forward-looking global commodity demand, and the rising probability of a recession, investors are faced with more questions than answers in terms of where to next.

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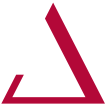
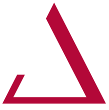


It is during uncertain times like these we rely heavily on a tried and tested investment process and a long-term mindset. Trying to forecast short-term macro-outcomes does not add value. Macro forecasts, even from the most skilled economists, are more frequently wrong than right. Our company valuations, which are based on conservative through the cycle assumptions, fluctuate significantly less than company share prices. This means that periods of share price volatility often provide opportunities to buy quality companies at attractive prices. Periods of market weakness affect sentiment and emotions. In this regard, we are not immune. But we rely on our investment process and systems to highlight emerging opportunities for the portfolio. Experience has taught us to use volatility to tilt the portfolio towards companies that provide better risk adjusted returns for the benefit of long-term portfolio performance. We understand that to outperform, we need to hold positions that are different to the broader market. Doing this seldom feels comfortable. It also shouldn't feel comfortable as bargain assets are seldom the popular assets.

As has been the case in the past, South Africa is once again failing to fully capitalise on the full potential of its rich resource endowment, particularly coal, manganese and iron ore because infrastructure constraints have created bottlenecks.

Transnet rail's operational issues are proving to be the achilles heel in terms of realising our full potential when it comes to commodity export volumes. Many of our key commodity export rail lines are currently operating well below nameplate capacity. On this note, we are cautiously optimistic that some positive changes are afoot as part of the presidency's operation Vulindlela, which is aimed at eliminating bottlenecks across the economy to boost growth. The government's recently published new rail policy is advocating the wholesale opening up of the South African rail network to third party private players. Despite elements of our rail network being neglected, South Africa's rail network is equivalent in size to that of Germany's and with a bit of effort can be revitalised to unlock enormous potential. This is a critical step in creating a more reliable rail network and boosting export volumes for the benefit of the fiscus and economic growth. Additionally, it will also provide a significant opportunity for private sector credit extension as a substantial investment will be required by private players looking to play a role in future rail services and energy generation. There will no doubt be teething problems as to how the 'rubber meets the road' and Transnet's role will need to be carefully managed to ensure fair access across the network. Government now needs to prioritise executing and implementing these new Vulindlela policies.

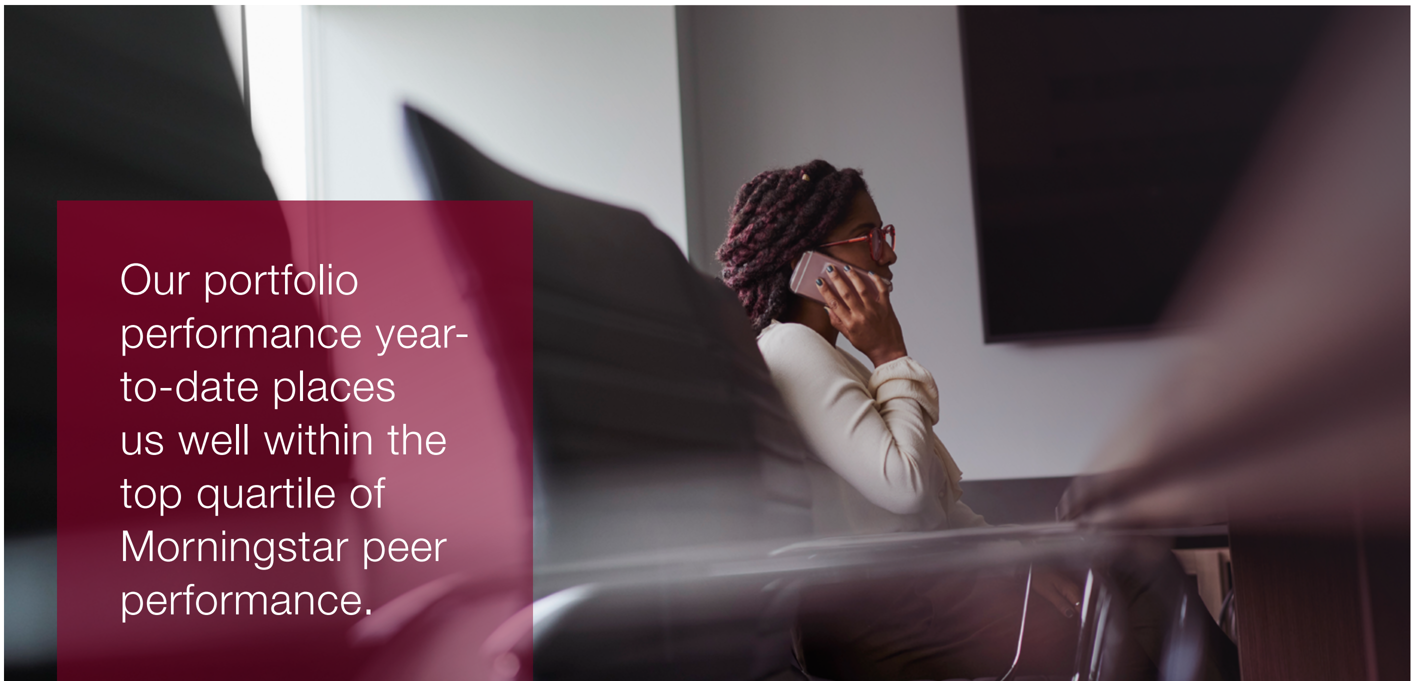


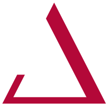
PORTFOLIO PERFORMANCE

The second quarter of the year was tough from an absolute market performance point of view with the JSE All-Share Index declining by -11.7%, while the JSE Capped Swix declined by -10.7% over this same three-month period. The Ashburton Equity Fund performed relatively well in this context of the broader market decline, only falling by -7.6% over the three months. This implies the portfolio generated +4.1% of positive alpha for the quarter, mitigating some of the downside from weak market performance. While this outperformance is pleasing from a relative point of view, we are mindful of our primary objective of growing our clients' assets in real terms to meet retirement and savings objectives. We are much happier delivering positive alpha during periods of positive absolute market growth, in the knowledge that our clients' assets are growing in real terms.

Looking at the year-to-date or six-month performance, the JSE All-Share Index has fallen by -8.3% and the JSE Capped Swix by -4.6%. This highlights just how tough the second quarter of the year was from a market performance point of view. Pleasingly, the Ashburton Equity Fund's performance has been flat over the six-month period delivering 0%. This implies +8.3% of positive alpha for the year thus far versus the JSE All-Share Index.

Our portfolio performance year-to-date places us well within the top quartile of Morningstar peer performance. As was the case in the prior quarter, we remain pleased with the fact that the drivers of portfolio performance over the last six months have come from ideas where we saw value and backed our conviction. A number of these non-consensus ideas have performed well ahead of the market and have been the source of the positive alpha that the portfolio has produced over the past quarter and year-to-date.





OUTLOOK AND STRATEGY

At the end of the first quarter, we were concerned that the outlook for the resource and financial sector had diminished somewhat post a period of sustained strong performance.

It now appears that this concern was warranted, and we saw a pullback in share prices across both the resource and financial sectors. Post this pullback, valuations are now more attractive on a forward looking basis. The Platinum Group Metals (PGM) sector has seen a significant pullback as auto demand was particularly weak due to the chip shortage and Chinese hard lockdown policies impacting global auto production. Global auto inventories are now at extremely low levels. With the chip shortage largely behind us, the potential for a pickup in auto production seems reasonable as global inventories are replenished off record lows, despite global growth being somewhat shaky. This should result in a gradual improvement in PGM demand for the second half of the year and through into 2023. The better demand outlook and a weaker rand bode well for the PGM basket price from current levels, but companies will have to work hard to keep costs under control in this inflationary environment. Sector margins are unlikely to go back to recent highs. Unfortunately, the corporate action within the South African PGM sector is muddying the waters and creating significant uncertainty for investors. This will more than likely continue until the Public Investment Corporation (PIC) has selected its horse as to who out of Impala Platinum and Northam Platinum will ultimately control Royal Bafokeng Platinum.

Outside of PGMs and banks, we continue to find opportunities in the South African mid cap space. We remain hopeful that this source of recent outperformance versus the market can continue to deliver for the fund. In this regard, we have added some new positions to the portfolio over the last quarter.

We would also like to remind you that FSCA has approved our application to change the portfolio's benchmark to the FTSE JSE Capped Swix (from the FTSE JSE All-Share Index). This change will be officially implemented on the fund's minimum disclosure document post the mandatory three-month communication and notification period has lapsed. We are targeting 1 September 2022 as the official change over date.

As always, the team's focus remains on the consistent application and implementation of our investment process. Detailed company analysis remains the cornerstone of our process and the area where we invest the bulk of our energy and effort.

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