MARCH 2022

QUARTERLY INVESTMENT COMMENTARY

ASHBURTON EQUITY FUND

OVERVIEW

The first quarter of the year was another tumultuous one, with the Russian-Ukraine conflict overshadowing all the other significant macro developments that had been driving market sentiment and volatility.

Before analysing global macro developments through only a financial lens, we really need to pause to reflect on the human element and tragedy that plays out during any war. Unfortunately, mankind has a long and painful legacy of opting for the war over the mediation. Many wars have been fought over the past decades in smaller countries with no lesser element of human suffering. However, given that the current conflict involves global 'superpowers', it sharpens the mind in terms of potential dire consequences for all of us should one party resort to the nuclear options at their disposal.

When the dust settles, the consequences of the current Russian/Ukrainian conflict are likely to be with us for long after the politicians have withdrawn the troops and countries start rebuilding efforts. Pre 2022, the decades old globalisation trend had already been showing signs of slowing, with domestic and global geopolitical drivers having an increasing influence on domestic trade policy. This past quarter's conflict will fast track this de-globalisation trend. We are likely to see the further de-coupling of global supply chains, which have been built up slowly over the past decades. Supply chain security will be an increasingly important consideration, even if at the expense of lower costs of production in faraway regions. Countries will start focusing the factors of production more inward and reassess their energy and sovereign security.

Energy security had, in many cases, been outsourced to other countries, often in the name of environment, social and governance (ESG) friendlier green policies. Energy prices and policy are likely to remain a key pressure point and source of friction in the years ahead. The lack of new greenfield investment in new replacement baseload hydrocarbon capacity owing to diminishing investor appetite due to ESG concerns has led to a dramatic fall in supply. During Covid lockdowns, the supply and demand mismatch wasn't immediately apparent as demand was artificially weak. However, as we emerged from Covid lockdowns and energy demand started recovering, prices have skyrocketed. Given the long-dated capital cycles required to stimulate new replacement capacity, absent of large demand destruction due to a global recession, this supply imbalance looks set to be with us for some time.

This theme of lack of investment in new greenfield capacity extends beyond just energy markets and affects the broader commodity complex. After being punished by investors for their pro-cyclical capital allocation decisions in the previous commodity cycles, commodity companies' boards have now swung to the other extreme and have been prioritising shareholder cash flow returns over new greenfield capacity expansion. This capital restraint theme has resulted in several commodities prices trading well above what one would consider their long run equilibrium prices and has led to a significant commodity price inflation push.

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Globalisation over the past few decades had a global disinflationary impact as production shifted eastwards to take advantage of lower labour costs, loose capital allocation and state subsidies and support. As we now unwind this theme, the reverse should hold true. This onshoring of the factors of production will exacerbate the inflationary push beyond just the impact that we are seeing from commodities prices and energy.

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This leaves central banks in a precarious position as they are now forced to tighten monetary policy in response to rampant inflation despite being very aware of the risky state of their economies' recovery post Covid. The risk of stagflation looms large.

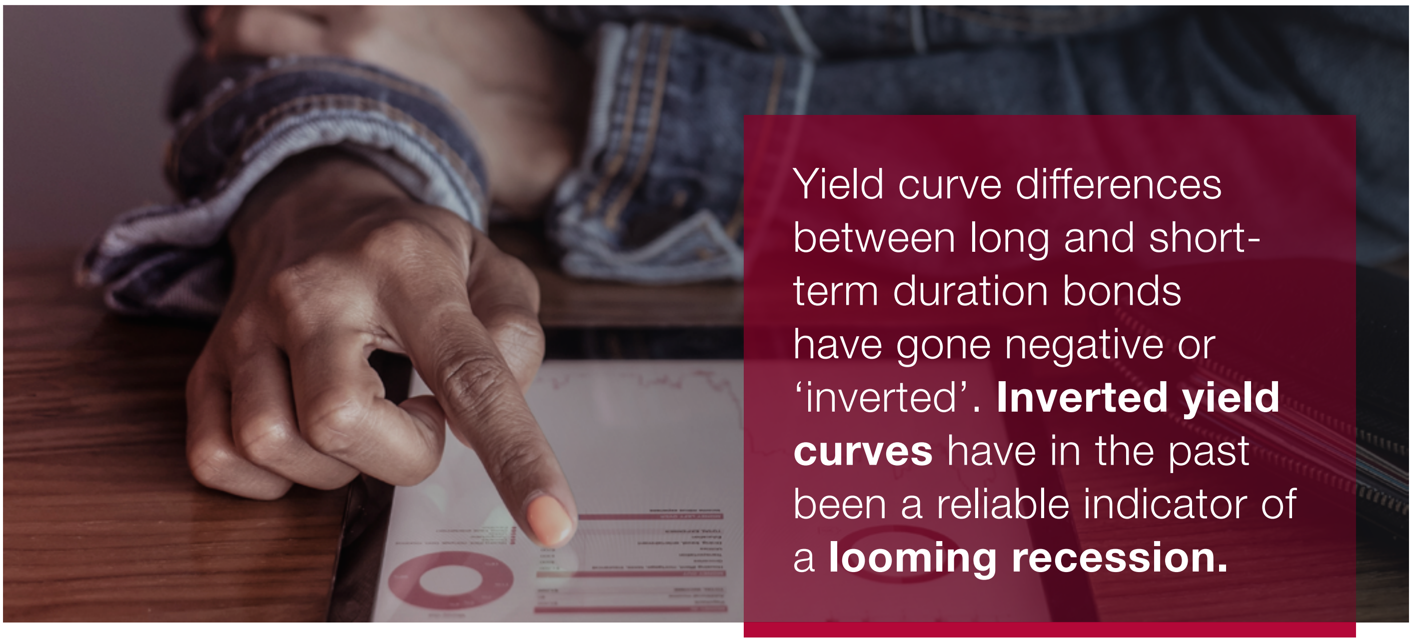
Yield curve differences between long and short-term duration bonds have gone negative or 'inverted'. Inverted yield curves have in the past been a reliable indicator of a looming recession. Recent yield curve inversions have nailed bond investors' 'colours to the mast' in terms of where they think economic growth is heading.

Finally, if the above is not enough, the withdrawal of quantitative easing (QE) during the quarter will only increase financial asset price volatility as this backstop of yester year is removed. The end of QE, together with rising global interest rates, will mean that financial conditions have and will continue to tighten considerably in the current year. Many past behaviours, such as growth without any regard for economic profit (which were previously being rewarded by financial markets awash with liquidity), will no longer attract the same level of investor interest as the opportunity cost of capital increases.

Investors may be forgiven for feeling somewhat 'punch drunk' given the numerous current uncertainties and macro risks. However, you may take comfort that while South Africa has many faults, many of which are our own doing, we currently find ourselves well positioned from a global and emerging market standpoint. We are blessed with a rich endowment of natural resources (commodities) that is allowing us to participate in the current commodity price cycle upswing. This natural resource 'dividend' is resulting in a strong terms of trade position and budget surplus, flowing through into rand strength versus the US dollar and other emerging markets.

On average, our listed companies have managed the Covid pandemic very well and have emerged with lean cost bases and balance sheets are not over extended and are now largely repaired. This leaves them well positioned to capitalise on the incremental improvement in economic conditions as the negative economic impact of Covid lockdowns wanes. Furthermore, our positioning at the foot of Africa also leaves us far from the current conflict zone, thereby increasing our relative attractiveness to foreign capital looking for a home in turbulent times.

With regards to tightening financial conditions, our investment process is valuation focused and therefore has a natural



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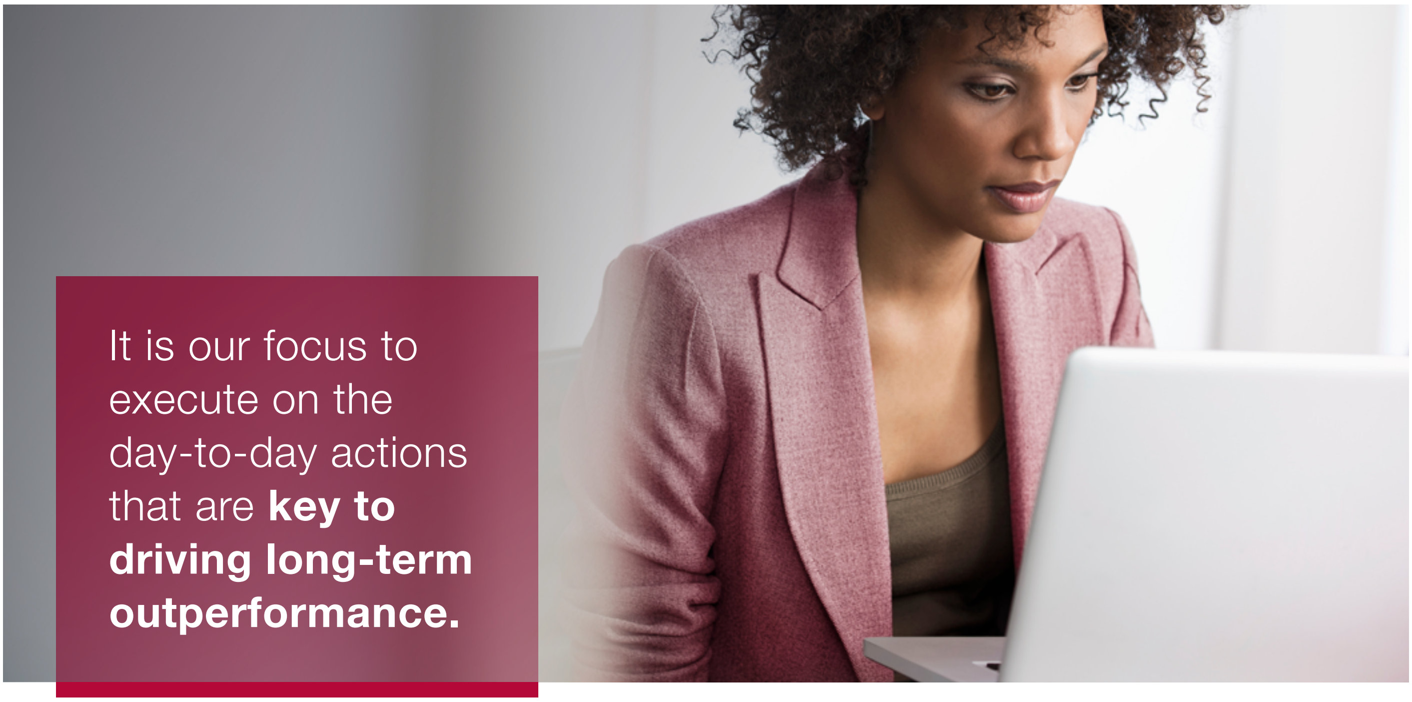

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value bias. We would expect our investment performance to do better in periods where markets are more rational and rewards behaviour which prioritises an appropriate level of return on capital for a given amount of risk assumed. This has not always been the case over the last decade as interest rates were falling and QE loosened financial conditions. Past conditions resulted in growth and momentum strategies delivering better performance over opportunities that focused on real cash flow value received for a given level of price paid.

From an internal perspective, the first quarter of 2022 was important to the Ashburton Investments equity team as we have now been managing the Ashburton Equity Fund for six months. We remain doggedly focused on the consistent application of our investment process and firmly believe that this will deliver long term results. Our team is functioning well. We acknowledge that there is no substitute for hard work. Detailed valuation work remains our passion and is the core of our day-to-day activities. Our new investment process/data analytics system is implemented and working well. The output of this proprietary in-house system becomes a powerful tool in constructing an equity portfolio that we feel delivers the best risk adjusted returns to clients over the long-term. We have a tried and tested recipe that has previously delivered top quartile long-term investment performance. It is our focus to execute on the day-to-day actions that are key to driving long-term outperformance.

While we acknowledge that six months is too short a period to measure portfolio performance (as we prioritise long term investment performance), we have had a strong start to our tenure of managing the Ashburton Equity Fund. Our portfolio performance placed us in the top quartile of Morningstar peer performances for the year-to-date. Most pleasing is the fact that the drivers of performance over the last six months have come from ideas where we saw value and were willing to back our conviction with decent portfolio positions.

PORTFOLIO PERFORMANCE

The Ashburton Equity Fund returned +8.1% for the three months to 31 March 2022. This placed the portfolio performance in the 1st quartile versus peers and was well ahead of the ASISA General Equity peer group average of +3.8%. The fund also outperformed the FTSE JSE Capped SWIX All Share Index which returned +6.7% for the three-month period. The FTSE JSE All Share Index delivered +3.8% for the same period.

Over the six months since the new team has been managing the fund, it has returned +16.8%, which is well above the ASISA peer group average of 14% and just outside the 1st quartile peer performance. It also outperformed the FTSE JSE Capped SWIX All Share Index which returned +15.9% for the six-month period. The more resource heavy FTSE JSE All Share Index returned +19.5% over the past six months.

OUTLOOK AND STRATEGY

The strong positive returns from the resources and financial sectors of the local market implies that the opportunities available in those sectors have diminished somewhat versus last year.

While near term multiples to earnings and free cash flow for the resource sector still look very compelling due to high current commodity prices, we need to remain congnisant of the risks of investing in counters whose current performance is being driven by commodity prices that are well above our internal assessment of their long-term normalised levels. We are congnisant that the lack of capital investment in the sector may mean that the current resource cyle upswing lasts longer than usual. However, we need to remain disciplined in our process and to start looking to re-allocate capital to areas and sectors that are showing value under normalised operating conditions.

As is often the case, new opportunities emerge within sectors that have sold off during the past year.

We have found some new stock specific opportunities and have chosen to recycle some of the resource and financial gains that we have made in the portfiolio over the last six months into other sectors at prices that we find attractive versus our assessment of instrinsic value. We remain invested in a number of opportunities within the mid cap sector of the local market where we still see good value.

As will always be the case, the team's focus remains on the consistent application and implementation of our investment process. Our process relies heavily on proprietary research and the power of patience in stock selection. We are comfortable investing in companies whose current performances are below trend, provided there is a reasonable path to better operational performance and where we are being adequately rewarded for investing before the general market sentiment agrees with our view.

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