SEPTEMBER 2022

QUARTERLY INVESTMENT COMMENTARY

ASHBURTON EQUITY FUND

OVERVIEW

The third quarter of the year was no different to what we have become accustomed to during the preceding two quarters.

The withdrawal of liquidity from the market coincided with central banks aggressively raising rates to try and catch up with and get ahead of runaway inflation. Combined with the Russian/Ukrainian geopolitical tension, these actions continued to be a powerful dampener on all global asset prices

The traditional 60:40 equity/bond asset allocation portfolio (which has traditionally provided diversification benefits during times of market stress), continued to decline in unison during the third quarter. In the United States, bonds and equities have both declined for the last three consecutive quarters. This is unprecedented, but perhaps a fitting testament to the scale of the previous monetary and fiscal interventions that have led us to this point in financial markets. Said differently, the severity of the hangover is directly proportional to the level of consumption that comes before and reminds us that eventually, one needs to 'pay the piper' for past indulgences. At times like these and as active participants in financial markets, we will do well to remember a quote from the author, Morgan Housel, relating to financial markets: "Things that have never happened before happen all the time".

While it is positive that Covid-19 related supply chain issues are starting to abate, the geopolitical conflict in Europe and the resultant impact on global energy markets remains front and centre. Western Europe is unfortunately in the firing line. Europe's lack of energy independence made it become overly reliant on Russian gas. Now they are scrambling to source alternative energy supplies and have even resorted to reinstating mothballed coal-fired power plants to replace lost Russian energy supplies.

There is little doubt that it is going to be a tough winter in western Europe with no obvious easy solutions.

There have been both positive and negative spillovers from the energy market imbalances into the South African listed company environment. Companies, where energy makes up a significant portion of their cost base, have had to contend with rapidly rising energy inflation which has been impossible to fully recover from their customers, giving rise to margins being squeezed. Other companies, who were previously pariahs and even purged from their ESG conscious parents (due to their unwanted coal exposure), have quickly become this year's market darlings as their share prices have soared to record highs. Some of these extreme energy price moves are without a doubt cyclical in nature and should abate over time. However, the timing of this energy price normalisation continues to remain uncertain.

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While the market volatility does little to instill client confidence, it is a friend of investors who have done their valuation work and are willing to execute on new opportunities during times of stress. On this note, we are pleased to report that we are finding attractive investment opportunities in the current market and have added some new positions to the portfolio. Pleasingly, some of our portfolio positions continued to add positively to performance during the third quarter and we have been able to use the proceeds of past outperformance to recycle into new portfolio ideas

PORTFOLIO PERFOMANCE

The third quarter of 2022 was another tough three months from an absolute market performance point of view with the JSE All-Share Index declining -1.9%, while the JSE Capped Swix Index declined by -2.4% over the three-month period. As of 1 September 2022, the Ashburton Equity Fund's benchmark officially changed to the JSE Capped Swix Index.

The Ashburton Equity Fund performed relatively well in this context of negative market returns, remaining flat with a -0.2% return over the quarter. This implies the portfolio approximately generated +2.24% of positive alpha for the quarter versus the JSE Capped Swix Index, shielding investors from the full downside from weaker market performance.

Looking at the year-to-date or nine-month performance, the JSE All-Share Index fell -10.1%, and the JSE Capped Swix Index also fell -7% over the past nine months. Pleasingly, the Ashburton Equity Fund's performance was only marginally down over the period with a -0.5% nine-month return. This implies approximately +6.5% of positive alpha for the year thus far versus the new JSE Capped Swix Index benchmark.

Importantly, the end of September 2022 marked the first full 12-month period that the new Ashburton Investments equity team has been managing the equity portfolio using an investment process and philosophy that has previously delivered positive long-term outperformance. For our first full year managing the fund, it has delivered a +7.4% positive 12-month return versus the JSE Capped Swix's +1.1% return, implying +6.3% of positive alpha for the year.

Our portfolio performance over the quarter and year-to-date places us well within the top quartile of Morningstar peer performance, while over the first full 12-month period, we fell in the top decile (10%) of peer performance. This is a very pleasing start to our tenure of managing the portfolio.

OUTLOOK AND STRATEGY

As the global macro concerns continued to weigh on non-energy (non-coal) related resource sector share prices during the third quarter, valuations are slowly becoming more palatable despite the uncertain macro outlook. Capital discipline across the sector over the past decade means that the recovery should be quicker than a typical commodity cycle, where over-capacity/new supply brought on at the peak of the cycle needs to be worked out of the system before the market can clear and rebuild. On average commodity markets are tighter than what their share prices imply, and balance sheets, free cash flow and shareholder returns remain robust.

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While some of the low-hanging fruit in the financial sector has been harvested, we continue to own some businesses that are well positioned to prioritise and improve cash returns to shareholders while still being able to fund new growth opportunities.

We continue to find exciting opportunities in the South African mid-cap space. These ideas remain a source of positive outperformance versus the market and an area where larger peers will struggle to compete due to liquidity constraints. We added some exciting new mid-cap positions to the portfolio over the last quarter which we are hopeful will be a source of future 'non-consensus' outperformance.

Looking at the current aggregate valuation of the South African market on a price-to-earnings, price-to-net asset value or price-to-free cash flow basis, the market is currently trading at a discounted level versus history. While past market performance is no indication of future market returns, investors who have had the stomach to remain invested in equities at similar aggregate valuation levels in the past have enjoyed strong subsequent three-year compounded annual returns.

The team's focus remains on the consistent implementation of the investment process, where detailed company valuation remains our passion and day-to-day focus.

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