Abax Equity
Prescient Fund Commentary

Prescient

Q4 2023 Commentary

Market Commentary

After the disappointing 2022 market performance, 2023 brought a strong recovery to international markets, especially in the last two months. This performance stands in contrast to heightened geopolitical tensions, trade wars, real wars, higher-for-longer interest rates and continued uncertainty over how global economies will normalize post the Covid disruptions.

The MSCI All World Index appreciated 22% in 2023 (33% in SA Rand), reversing the 18% decline of 2022. The contributors to this strong growth were heavily skewed though; Developed Markets trumped Emerging Markets (for the 5th year in 6) with the S&P500 delivering 26% and the Eurostoxx600 20.5%. At the other end of the scale, the Shanghai Composite declined -4%.

In SA, the JSE Capped Shareholder Weighted Index appreciated a modest 7.9% in Rand. The Rand depreciated 7.8% against the US Dollar, the fourth year in a row of 5-8% declines. The SA performance is disappointing, considering that about 67% of the profits of SA listed equities come from outside SA and should have benefited from the weakening Rand (almost all the mining houses, Naspers, Richemont, British American Tobacco and Anheuser Busch are practically 100% offshore earners, with a range of other companies also generating profits significantly outside our borders – all material holdings in the fund).

Top performing sectors for the year were Life Insurance (+38.6%), Consumer Services (+29.2%) and General Industrials (+23.2%). The laggards were Chemicals (-21%), Tobacco (-12.1%), Basic Materials (-11.9%) and Telecoms (-9.6%).

The early 2023 view of a sluggish US and rebounding China was not to be. Within the S&P 500, seven stocks (what have come to be known as the 'Magnificent Seven') delivered 15.8% of the 26% total return (Microsoft, Apple, Nvidia, Amazon, Google, Tesla and Meta).

Returns (%, annualised)(Inception Date 01-10-2004)

	YTD	1 yr	3 yrs	5 yrs	10 Yrs	Incep.
ABAX Equity Prescient B2	5.9	5.9	12.2	7.4	6.2	13.2
Equity benchmark	7.9	7.9	12.7	9.0	7.2	12.9
Peergroup	7.3	7.3	11.9	9.1	6.2	11.5

Best and worst periods (%)

Best 12-months	61.3
Worst 12-months	-30.8

Portfolio Commentary

The top contributors to the fund's absolute performance in Q4 were FirstRand (+18.6%), Standard Bank (+13.3%), Shoprite (+14.7%), and Richemont (+10.1%). It was pleasing to see the solid performance from FirstRand; we continue to believe that the SA banks are well managed and regulated, whilst they have solid and conservative balance sheets with good provisioning, whilst trading at single digit PE ratios and high dividend yields. The broader concerns over the SA economy and political stewardship weighs heavily on SA stocks and the banks specifically. Likewise, Shoprite remains a quality retailer that has transformed the business over the years into a market share winning powerhouse.

Top detractors were Sasol (-29.1%), Anglo American (-9.9%), Bidvest (-7.5%) and British American Tobacco (-6.5%). Anglo American's decline came following their annual Capital Markets Day where they reduced production volume guidance from several of their mines for the next 2 years – although increased it from year 3. The market's reaction was frustrating as we believe the company has shifted their commodity complex in favour of less harmful commodities (they exited coal, for example) and more towards those commodities that have strong long-term demand fundamentals (i.e. copper and more recently a new project in a sophisticated kind of fertilizer, for both of which the demand prospects are positive). Bidvest declined over the quarter following a weaker than expected operational update. It remains a well-managed, diverse, and quality company and we are satisfied with its full year performance (+21.8%). British American Tobacco (BATS) remains a big disappointment; in spite of their science driven approach to developing reduced harm and alternative smoking products, and their strong cash generation, the market seems to take a very pessimistic view of BAT as a harmful tobacco company with no future and a value trap. We however still think that there will be a future for their reduced/no harm products post the eventual demise of combustible tobacco and on a 6X PE and almost 10% dividend yield, expect our now very long-term confidence to eventually be rewarded.

The last cruel blow to end a very difficult quarter came on Christmas eve as the Chinese gaming regulator made a public announcement of several new possible regulations designed to curb predatory billing practises (as an example) but which was poorly handled and resulted in an immediate rout of all stocks in the sector, including Tencent, which naturally dragged down Naspers and Prosus. Although the authorities were very quick to provide qualifying commentary to calm the market and even took the unprecedented step of dismissing the individual who made the announcement, it hit a market that has become increasingly nervous and sensitive to regulatory interventions in China and consequently the damage has proved to be impossible to repair in the short-term - reflected in the share prices which have not recovered fully to their already weak bases prior to the event.

Performance relative to the fund's benchmark was hard hit in Q4 by our low weighting in gold shares, with Gold Fields and Harmony performing especially strongly as the gold price rallied again to above $2,000 per ounce. This is not a sector to which we are comfortable to expose client portfolios to a material extent considering the speculative and highly unpredictable factors that drive the performance of the companies.

While our conviction has been heavily tested and we are very aware of the short-term hit we have experienced to relative performance in Q4, we have increased our position sizes in some of the under-performers and note that by mid-January we have already clawed back a significant portion of the deficit.

Current Positioning and outlook

2023 was relentlessly challenging for SA given unprecedented levels of load shedding, Transnet's freight volume and operational deterioration, foreign policy missteps (Lady R debacle, Russia-Ukraine non-alignment versus Palestinian open support), SA's grey listing by FATF, the continuation of the Phala Phala scandal, and ongoing reports of widespread corruption (most recently within NSFAS) - all of this sapped the prospects for an economic recovery. Investor sentiment towards SA has remained weak given the issues above, and exacerbated by fears of a grid collapse as well as concerns that SA could be sanctioned by the US following the US Ambassador to SA's arms sale accusations. While there has been some progress in key areas (eg government-business relations) in the latter half of 2023, this uplift has been offset by worrying retreats in areas such as crime, local government administration, and the ineffective pursuit for state capture accountability.

The overhanging concerns have manifested themselves in a sub-par growth outlook and a deteriorating fiscal position evidenced by the Medium-Term Budget Policy Statement. However, there is some cause for tempered optimism given the realisation by government that private participation in key enterprises is a necessity. While the gradual liberalisation of key SOEs like Transnet and Eskom may remain ideologically distasteful to the ANC, it has become the only solution to ensure an effective functioning state.

In this context it is understandable that the SA market faced another year of strong headwinds of selling pressure as foreign investors remained net sellers of SA stocks (for the 6th year in a row) and institutional (as a result of increased regulatory investment limits on foreign assets) and retail investors continued to reduce their SA equity exposure and to diversify away from domestic assets. We expect this selling pressure to continue into 2024, although at a slower pace and to diminish post the election.

Despite the incredibly difficult operating environment, SA Corporates manage to drive earnings growth well ahead of GDP and there is a significant amount of caution already priced into SA equity prices with the MSCI SA forward PE at <10X, a 25% discount to its 10yr average and at a 17% discount to Emerging Markets.

The portfolio continues to retain a preference for banks over discretionary consumer businesses. The endowment effect and net interest income sensitivity to higher rates is positive for bank earnings provided this benefit isn't eroded by a deterioration in asset quality (higher bad debts). To date, this relationship has held for our core bank holding – FirstRand. The recent share price weakness in Absa has provided an attractive opportunity to add to our position – we believe that the performance track record and returns delivered from their CIB division are underappreciated by the market, the business is best placed when interest rates fall (given their structural hedge), and its valuation remains extremely compelling at a 6x Fwd PE as well as offering a 9% dividend yield.

The pace and magnitude of rate hikes in SA has left the consumer in a precarious position with little time to adjust household balance sheets, hence our caution to this segment of the market. We do expect relief for consumers in the latter half of 2024 given the expected retreat in both inflation and interest rates, but current indicators point to a distressed situation in the short-term. South African consumer confidence recorded its lowest fourth-quarter reading (-17) in more than two decades according to the FNB/BER Consumer Confidence Index - this doesn't bode well for the key festive season trading period. Our core holdings remain Shoprite and Pepkor, both offering defensive growth characteristics.

We believe that commodities should perform better in 2024 on a possible rebound in the Chinese economy, a weaker US dollar, and depressed inventories. In addition, the monetary squeeze around the world is ending. All these developments suggest a stronger commodity market in 2024. Of course, different commodities have different profiles with us retaining a preference for the diversified miners such as Anglo American and BHP.

Looking to 2024, we anticipate that SA will face a tough first half given election uncertainty with still high interest rates curtailing consumption and challenges at Transnet negatively impacting SA exports. The trajectory for domestic businesses should improve in the second half of the year as the impact of rate cuts and lower inflation feed through, together with less load shedding given more private sector investment in renewables and which is already making a material contribution to lightening Eskom's proportional contribution to electricity generation. In addition, a recovery in China will aid emerging markets, including South Africa. The steady improvement in SA's growth constraints should also facilitate scope for a rerating of our stock market.

Responsible Investment

In line with trends in recent years, 2023 has seen the breaking of multiple climate-related records. The first 10 months of 2023 were 1.4°C warmer than pre-industrial levels and the GST synthesis report shows that we aren't on track to meet the Paris Agreement goals. There is, however, a consensus among most global leaders (noted at the recent COP28 conference) that climate action has been insufficient to date, and that more coordinated efforts are required to halve emissions by 2030 and keep global warming to 1.5°C above pre-industrial levels.

The cost of inaction is high, with some regions significantly more vulnerable to climate events than others. As a result, company (and country) resilience will remain an area of ongoing focus given the increased damage from extreme weather events. According to Munich Re, the world's largest reinsurer, natural disasters caused an estimated US$95bn in insurance losses in 2023 which is well above the 10-yr average.

Given the trend of rising global emissions, there has been increased investor scrutiny of companies' decarbonisation targets and whether these are achievable given the viability, required capital and technological advancements needed. In addition to the ongoing focus on Climate Change, ESG's Social pillar has become a growing area of emphasis for investors.

At Abax, we focus on doing the right thing for our clients, community and the environment and we expect the same from the companies in which we invest. We actively engage with companies and other stakeholders to address ESG issues. Notable ESG engagements during the fourth quarter of 2023 include:

- Reunert: Engagement with Board members around the proposed changes to the Conditional Share Plan.
- Shoprite: Engagement with the Chairman of the Board and Chairman of the Remuneration Committee on governance matters, with a specific focus on executive remuneration.
- Absa: Engagement with the Chairman of the Board regarding the resignation of the Financial Director as well as Absa's approach to succession within the organisation.
- Oceana: Engagement with management, specifically focusing on island exclusions and the plight of the African Penguin.

Conclusion

The last few years have been extraordinarily complex. The pandemic lockdowns pushed the world into a historic bust, then re-openings plus unprecedented macro stimulus (principally in the US) resulted in a sharp rebound across the board. Monetary policy then switched from super easy to the fastest tightening in history, and what went up came back down during 2022.

In South Africa, national elections (expected in May) will remain a source of debate and uncertainty with polls pointing towards ANC support falling below 50% for the first time since 1994.

We believe inflation has peaked globally, allowing central banks to reduce interest rates. Markets are forecasting that the Fed will begin to cut rates from their current 22-year high as early as March 2024, with the central bank's primary interest rate at 4% by the end of 2024. Rarely has the Fed cut that rapidly outside of recessions, with rates cuts of this magnitude more consistent with a 'hard landing'. This indicates an inconsistency with the market's assumption of an economic 'soft landing', together with rate cuts >100bps. We anticipate rates will move lower, so too the US dollar as the U.S. economy heads for a weaker patch (probable recession).

Given the above-mentioned considerations our investment outlook remains cautious, with your portfolio represented by diverse businesses across the globe that are resilient and that trade on valuations offering a margin of safety.

We remain mindful that the returns delivered by the fund are disappointing, aware that some of the SA picks dragged us down in the last quarter with an especially weak patch driven by a few specific events (discussed above) but which we believe to be temporary in nature. Abax is a team of experienced investment professionals who share an unwavering commitment to our clients and community. We have been dedicated to serving investors for more than two decades by building portfolios of what we believe are high-quality companies as well as fostering a culture of results. We remain as committed to these ideals as we did when the firm was established in 2003.

Thank you for your ongoing trust in us and best wishes for 2024.

Important Information

Collective Investment Schemes in Securities (CIS) should be considered as medium to long-term investments. The value may go up as well as down and past performance is not necessarily a guide to future performance. CIS's are traded at the ruling price and can engage in scrip lending and borrowing. A schedule of fees, charges and maximum commissions is available on request from the Manager. A CIS may be closed to new investors in order for it to be managed more efficiently in accordance with its mandate. There is no guarantee in respect of capital or returns in a portfolio. Performance has been calculated using net NAV to NAV numbers with income reinvested. The performance for each period shown reflects the return for investors who have been fully invested for that period. Individual investor performance may differ as a result of initial fees, the actual investment date, the date of reinvestments and dividend withholding tax. Full performance calculations are available from the manager on request.

Annualised performance shows longer term performance rescaled to a 1-year period. Annualised performance is the average return per year over the period. Actual annual figures are available to the investor on request. Highest and lowest is returns for any 1 year over the period since inception have been shown. NAV is the net asset value represents the assets of a Fund less its liabilities.

Prescient Management Company (RF) (Pty) Ltd is registered and approved under the Collective Investment Schemes Control Act (No.45 of 2002). For any additional information such as fund prices, fees, brochures, minimum disclosure documents and application forms please go to www.abax.co.za.

*The forecasts are based on reasonable assumptions, are not guaranteed to occur and are provided for illustrative purposes only.

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