Abax Global Equity Prescient Feeder Fund Commentary

Q4 2023

Prescient

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Returns (%, annualised)(Inception Date 06-04-2016)

	YTD	1 yr	3 yrs	5 yrs	Incep.
ABAX Global Equity Prescient FF A1	25.3	25.3	9.0	15.0	11.0
MSCI ACWI (ZAR)	31.3	31.3	13.8	17.2	12.9
Peergroup(ZAR)	27.6	27.6	10.4	14.6	10.1

* All performance shown is net of fees

Best and worst periods (%)

Best 12-months	36.8
Worst 12-months	-15.1

Source: Morningstar, January 2024

After the disappointing 2022 market performance, 2023 brought a strong recovery, especially in the last two months. The Abax Global Equity Fund gained 18% for the year, a pleasing performance in a volatile year. 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, reversing the 18% decline of 2022. The contributors to this strong growth were heavily skewed though; Developed Markets trumped Emerging Markets (for 5th year of 6) with the S&P500 delivering 26%, the Nasdaq 43% and the Eurostoxx600 20.5%. At the other end, the Shanghai Composite declined 4%. The beginning of the year view of a sluggish US and rebounding China was not to be (more on this later). Within the S&P500, 7 stocks delivered 15.8% of the 26% total return (Microsoft, Apple, Nvidia, Amazon, Google, Tesla and Meta) – put differently, 7 stocks were responsible for 60% of the performance of the world's largest and most liquid market. The top 5 stocks alone contributed most to the market performance in history. Only 27% of the S&P500 stocks beat the S&P500 (the median stock only rose 9.7%) – the lowest in the last 20 years. As a result, only 28% of the funds managed to beat their benchmark (most managers would not risk having so much invested in a handful of technology companies only). Good growth from benchmarks then, but on account of very skewed drivers and tough to beat.

The Abax Global Equi DR likewDRe did noD beat the MSCI All World benchmark. In spite of owning large positions in 3 of the "magnificent 7" stocks, the fund actively took some profit during the year as these stocks rose. Top contributors to the fund's performance were Amazon (up 81%), Microsoft (58%), Google (58%), Trex (95% - recovering from poor performance in 2022), Samsung (37%), L'Oreal (43%), Eagle Materials (54%), Siemens (40%) and JP Morgan (27%). This list is proof positive of the fund's investment process of bottom-up stock picking as they represent a well-diversified group of businesses across the world. L'Oreal, Siemens and Eagle Materials were new additions to the fund last year. The outsized % gains for most of these stocks were largely because of the recovery of their declines in 2022 (Trex -68%, Amazon -50%, Alphabet -40% and Samsung -33%).

The most material detractors from the fund's performance were Li Ning (-69%), British American Tobacco (-32%), JD.Com (-48%), Kering (-26%), BYD (-16%), Thermo Fisher Scientific (-3.6%), Alibaba (-11%) and Tencent (-8%)

Frustratingly, the allocation to China detracted most from the fund's performance. The much-anticipated post-Covid recovery failed to materialize in any significant way. Their cautious consumer (who did not ramp up spending, despite record savings levels), limited government stimulus, the struggling housing market (digesting earlier excesses) and continued impact of shifts in global supply chains with the US focus on onshoring/ friendshoring production all contributed to lackluster operational performance. In addition, the US/China standoff lead to withdrawals (or no further investment, at best) from the Chinese and Hong Kong stock markets.

The fund's luxury holdings disappointed in 2023. Richemont, whilst still gaining 9%, could not match the fund's overall return. Kering and Prada declined 26% and 18% respectively. Operationally, the businesses continued to deliver superior results, but could not overcome a general market selloff in luxury goods companies as investors became increasingly concerned about a slowdown in US luxury shopping (they have been a strong driving force for luxury companies since Covid) and the somewhat lackluster recovery in Chinese luxury consumption. The luxury spending of travelling well-off Chinese has been a strong driver for luxury companies in recent years. However, Covid stopped this and even after opening the economy, the travel sector has had a slow recovery (closed airspace over Russia and Middle Eastern tensions have made European travel more complicated, time consuming and expensive from China).

Today Li Ning is a $4bn revenue business (growing 13% at last results), with 23% growth in operating cashflow, gross margin of 49% (Nike at 44%), whilst maintaining working capital at 7.5% of revenue only (they learned an expensive lesson in 2012 when they pushed too much inventory to wholesalers). Net cash on the balance sheet is 40% of the market cap (admittedly after the material decline in market cap this year). Footwear is ~53% of revenue, apparel 41% and equipment and accessories make up the balance at 6%. Sales are through wholesale (48%), eCommerce (27%) and own retail stores (25%). The good gross margin performance is on account of low inventory in the channel; 87% of sales are new product – other sports brands often struggle with the sales of older stock that needs to happen at a material discount, directly impacting margin and cashflow.

Commentary (cont..)

The investment thesis is straightforward.

- Li Ning is a recognized national champion for sportswear, both professional and for leisure. Their products are close enough to the likes of Nike and adidas in terms of functionality and quality, enabling them to price accordingly (as can be seen in their gross margins). The Chinese Guochao custom (supporting local, somewhat nationalistic brands) supports their demand.

- Sportswear is a fast-growing category globally, but in China there is the additional stimulus from government incentives and programs to develop sport participation. Winter sport is relatively new, and already Li Ning has a specialist snowboarding line.

- Li Ning's financials are solid; strong growth, strong cashflow, 43% of market capitalization in cash on the balance sheet. Being a relatively new and smaller company, they have made some mistakes in the past – from inventory levels to marketing glitches; they seem to have learned their lessons along the way and are now well run.

- The Chinese consumer has much savings (they have not spent their Covid savings yet) and Li Ning ticks one of the desirable boxes for 18–25-year-olds (and others).

The share price decline is harder to pinpoint, but the following factors played a part.

- China's consumer economy did not recover at the pace envisaged and seen elsewhere in the world.

- Li Ning gained much local support after the Xinjiang cotton controversy, but that advantage faded in consumer minds last year.

- They recently announced the purchase of a building in Hong Kong as a new regional head office. Although affordable (given their significant cash pile and strong cashflow generation), the market did not seem to like this allocation of capital. They announced a simultaneous share buy-back soon after which somehow appeased the market, but not enough.

- China is certainly out of favor with investors and there is not much marginal investment entering the market. Sabre rattling around Taiwan is also not helping the investment mood.

In conclusion, Li Ning's fundamental investment case is not much different from when we first invested (even if one pairs the revenue growth for a softer consumer market). The financials look as strong as before (cash percentage more so given the decline in market capitalization). However, the Chinese equity risk premium is certainly elevated, and the investment mood is rather somber. We continue to see value in Li Ning and believe some patience will be rewarded. It is probably unlikely that the share will reach prior highs, but from current levels, the share could easily double on above mentioned positive drivers.

In the last quarterly comment, we mentioned the regulatory/administrative quagmire the fund finds itself in with the holding in Pomegranate – a Swedish private company with investments in mostly consumer facing companies in Iran. Whereas neither Pomegranate, nor its investee companies in Iran, are sanctioned, the US based bank which holds the share certificate, as the designated custodian, is refusing to implement any transaction instructions relating to it on account of US sanctions against Iran. Despite significant effort expended on our and the company's side, we could not find any common ground with the existing custodian or any other solution. It was therefore decided to write down this investment to zero, a negative 0.6% impact on the NAV of the fund. The fund still holds the share certificate, and should sanctions be reversed in the future, the fund would be able to recoup some value. Given the geopolitical shifts worldwide, but more specifically in the Middle East, we unfortunately think a positive resolution in the foreseeable future is unlikely.

After the 2023 performance, the US market appears expensive (much of the performance came from multiple rerating, rather than earnings growth). At the same time, there are fewer companies delivering solid growth than before. The JPM Economic Surprise Indices for US/China/Europe/Global are all down and in negative territory. One therefore needs to be circumspect about further investments, and/or, the continued levels of investments as we've had in the last couple of years. A series of interest rate cuts seems to be the consensus view (same as in 2023, when it did not happen). Real rates in the US are much higher than elsewhere, supporting these cuts. As before, the tiniest detail in the Fed's wording when they finally do start the cutting cycle would be overanalyzed and will most probably cause much market volatility. At the same time, the world's growth market, India, appears even more expensive – one is tempted to invest, but we are doing much due diligence first. We remain convinced that China's economy will regain some growth in the foreseeable future and that the consumer-oriented companies we're invested in will recover.

However, the elevated geopolitical tensions, nationalistic rhetoric, disrupted supply chains, global warming and decarbonizing the energy complex all remain challenges for equity markets. This will make global stock picking more complex and will require more diversification across sectors and regions. Adversity and geopolitics do not curb investment opportunities, it just shifts them. The fund remains relatively conservatively invested and will continue to do detailed, fundamental research before investing. We remain confident that over the medium term the earnings growth of our shares should translate to attractive returns for investors.

Steve Minnaar

Important Information

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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.

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

This document was issued on 19 January 2024.