Bateleur Flexible Prescient Fund

Third quarter 2022 commentary

bateleur capital

Bateleur Flexible Prescient Fund – 2022 third quarter report back to unitholders

"We have to get inflation behind us. I wish there was a painless way to do that…there isn't."

Jerome Powell – September 2022 FOMC press conference.

"Ricky, remember: The field mouse is fast, but the owl sees at night."

Chip – Talladega Nights – The Ballad of Ricky Bobby – Sony Pictures – August 2006.

In the investment world, the third quarter of 2022 will be remembered for the US Federal Reserve ("Fed") moving unequivocally in its fight against stubbornly high inflation by again raising interest rates aggressively and expressing that there will be more rate hikes to come as they attempt to bring inflation back to the 2% target.

The Fed appears to be moving like a field mouse in raising rates, with the Fed Funds rate expected to end the year at 4.6% versus 0.25% at the start of the year, the fastest hiking cycle in over 40 years.

However, they are certainly no owl; initially failing to see the inflationary impact their over-accommodative monetary policy had; and now failing to see the negative economic repercussions from the rapid rate hikes currently being implemented.

Capital markets, on the other hand, are forward looking and have been quick to adjust for a potential global recession, evidenced by the sharp sell-off in risk assets. For the nine-month period ending September, the S&P 500 and MSCI World Index have declined 23.9% and 25.4% respectively when measured in US Dollars (chart 1). Bonds have fared equally poorly, with the World Government Bond index (WGBI) declining 21.3% YTD (chart 2), the worst performance since inception of the index in 1985.

Chart 1: Global equity indices YTD returns (USD)

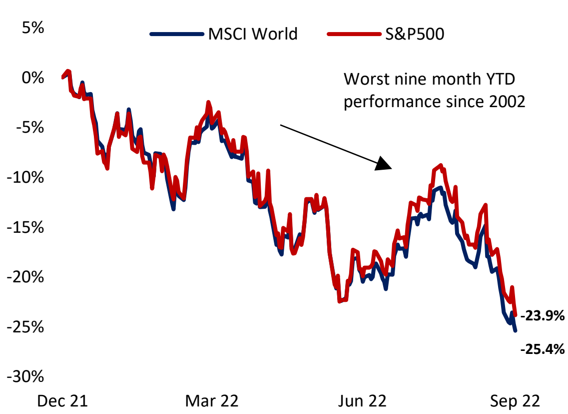
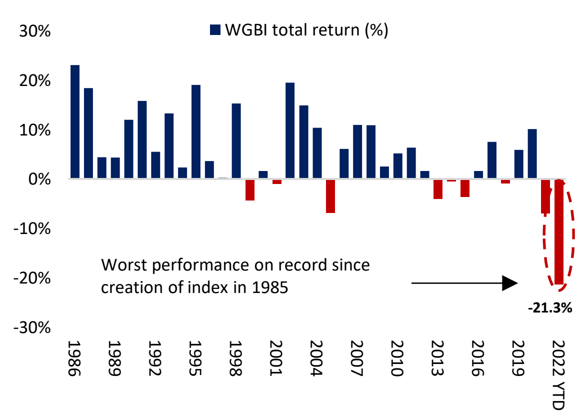


Chart 2: Global bond index annual returns (USD)



Source: Bateleur; Bloomberg

Under the circumstances, SA capital markets held up reasonably well, with the JSE All Share Index declining 10.1% in Rands over the review period, while a basket of SA government bonds (ALBI) declined 1.3%. SA equities benefitted on a relative basis from the large resource sector weighting, low earnings base, and already cheap valuations. Similarly, SA bonds offered respectable real yields at the start of the year unlike their global peers.

Against this backdrop, the fund held its own – declining 4.6% YTD when measured in Rands. In terms of attribution, the fund's JSE listed holdings made a marginal positive contribution to returns (+0.3%), while the foreign holdings detracted 3.8% as the widespread sell-off in global equities overpowered bottom-up stock picking. A summary of fund attribution and contributors/detractors are shown below.

Attribution by strategy	YTD 2022	Top contributors	Top detractors
JSE listed equities	0.3%	African Rainbow Minerals	Sony
Foreign listed equities	-3.8%	British American Tobacco	Comcast
Bonds (capital & interest)	0.1%	RMI Holdings	Amazon
Other (net of costs)	-1.2%	Merck	Mpact
	-4.6%	Dollar General	Alphabet

Source: Bateleur

Current fund positioning

In the existing risk-off environment, capital preservation remains a top priority. Resultantly, the fund is conservatively positioned both in absolute terms and relative to history. 16.1% of fund value is invested in cash and money market instruments – earning an average annual income yield of 6.4%.

SA government bond exposure of 8.9% predominantly resides in the January 2030 maturity. The average yield on the domestic bond portfolio is currently 10.9%.

Taken together, 25.0% of the fund's value is held in highly liquid instruments – a portion of which is available to be deployed into equities when appropriate.

Within equities, the fund's foreign exposure is currently 25.3%, well below the maximum allowed level of 45.0%. Although US equity valuations have de-rated to long-term averages, forward earnings projections are too high and therefore the forward P/E multiple is understated.

Consensus forecasts are for the S&P 500 to grow earnings by 8.2% and 8.5% in 2023 and 2024 respectively. These growth rates are unrealistic given: 1) slowing demand (and therefore revenue) as interest rate increases take effect; 2) an expected decline in operating profit margins from rising input costs (especially wages, packaging and distribution); and 3) an increase in finance costs due to higher interest rates on new debt issuances.

S&P 500 earnings have historically declined on average by 17% during a recession (chart 3 overleaf). If the US does enter a recession in 2023 and the average earnings decline holds, then earnings estimates could be overstated by up to 25%.

Under this scenario, the 2023 forward P/E multiple of the S&P 500 is no longer the projected 15.6 times, but rather 19.6 times – well above the long-term average (chart 4 overleaf).

Chart 3: S&P EPS decline during recessions

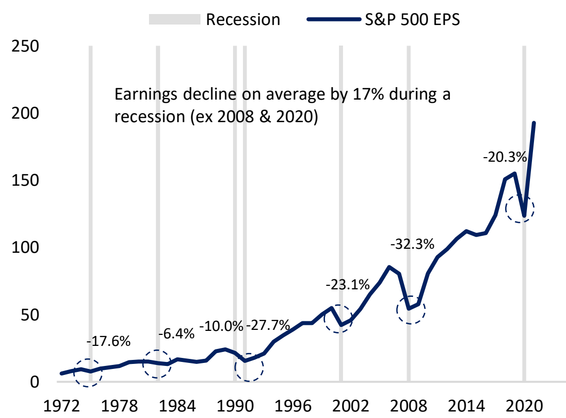
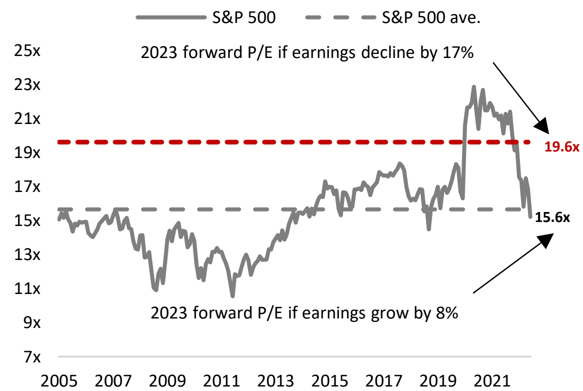


Chart 4: S&P 2023 P/E on differing EPS profiles



Source: Bateleur; Bloomberg

Foreign fund holdings are stock specific and include quality defensives (Dollar General, Philip Morris, J&J, Merck and Comcast), quality growth (Amazon, Alphabet, Accenture, Visa and Sony), and the energy sector (Total Energies and Woodside).

Total Energies ("Total") is a good example of the wide opportunity set available in offshore equity markets. Domestically, the only direct energy share available to investors is Sasol. Our analysis on the two companies concludes that Total has significantly lower operating costs, higher refining margins and lower emissions than Sasol (chart 5). Unlike Sasol, it has an ungeared balance sheet and offers a healthy dividend yield of 6%. Despite these superior metrics, Total trades at a valuation discount to Sasol (chart 6). The fund has zero exposure to Sasol and a meaningful weighting in Total.

Chart 5: Comparative metrics Total vs. Sasol

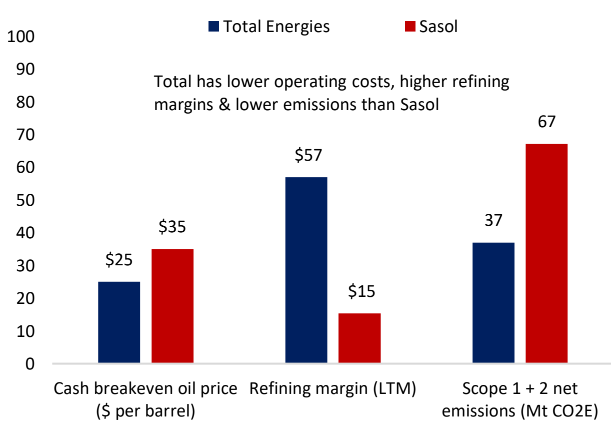
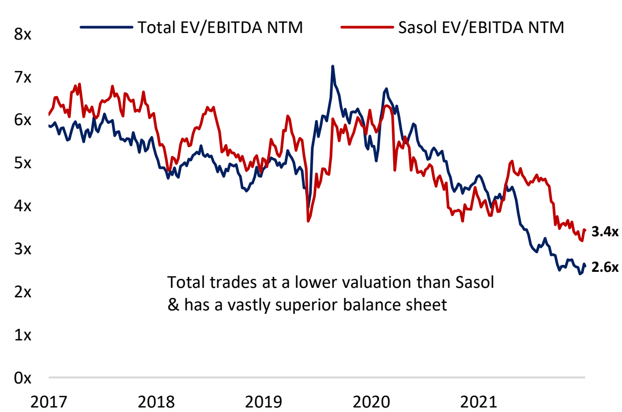


Chart 6: Total trades at a discount to Sasol



Source: Bateleur; Bloomberg, Company financials

Exposure to JSE listed equities was marginally below the prior quarter at 49.7% of fund value. We continue to see good value in domestic equities notwithstanding the low growth environment and plethora of well documented parastatal challenges (power, ports, rail and more recently water).

Unlike the US and other developed markets, the JSE earnings and operating margin base is low and has not been inflated from monetary policy stimulus programs (chart 7). Domestic balance sheets are in good health and leverage is limited. Recent interaction with executives of SA listed corporates indicate positive near-term prospects and generally sound execution. Fund holdings Bidvest and FirstRand are two such examples (chart 8).

Chart 7: JSE and S&P 500 operating margins

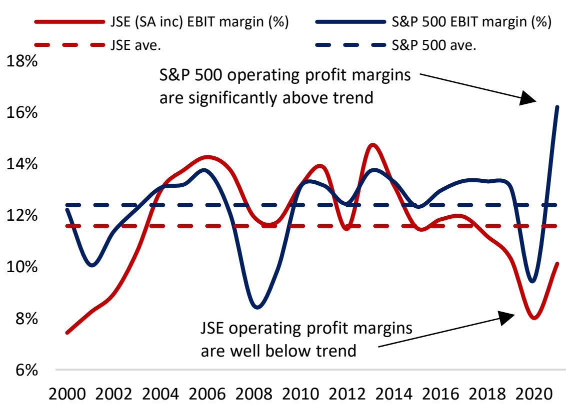


Chart 8: Company June 2022 outlook statements

Bidvest

"South Africa's mining & agricultural sectors **remain robust**.."

"Ongoing private sector investment & renewable energy project's are **contributing positively to demand**."

"Local manufacturing & production capacity has normalised, **showing increased activity**"

FirstRand

"the group expects the current credit cycle to **continue to gather momentum**.."

"these trends will support **accelerated advances growth** across the domestic retail, commercial and corporate portfolios"

"**Execution on reforms** could lift potential GDP growth further"

Source: Bateleur; Bloomberg; Company results commentary

The JSE All Share Index currently trades on an estimated forward P/E of 8.2 times, a significant discount to its long-term average and the most attractive level since the financial crisis of 2008 (chart 9). Fund exposure is held via five key investment themes – 1) diversified resources with high free cash flow, capital discipline and low levels of debt; 2) mainstream banks that benefit from a rising interest rate environment; 3) differentiated stock specific mid-caps; 4) quality industrials expected to gain market share and compound earnings; and 5) value unlock opportunities (chart 10).

Chart 9: SA equity valuations are attractive

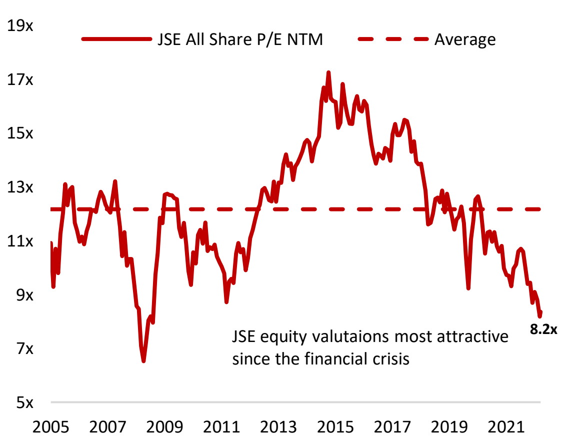


Chart 10: Fund domestic exposure by category

Resources	**High FCF, low levels of debt & capital discipline**	AGL, ARI, GLN & S32
Financials	**Low valuation multiple's, geared to rising interest rate cycle & expected to deliver solid earnings growth**	FSR & SBK
Mid-cap	**Differentiated stock specific opportunities and M&A optionality**	AFE, AIP, HDC, ITE & MPT
Quality Industrials	**Quality compounders, expected to gain market share and deliver continued earnings growth**	AVI, BVT, SHP, SPP & BID
Value unlock	**Large discounts with value unlock opportunities**	NPN & REM

Source: Bateleur; Bloomberg

During the quarter, the fund initiated two new investments in Bidcorp and Growthpoint.

Bidcorp is a cash generative, global foodservice business with a strong balance sheet - that is well managed under the astute leadership of Bernard Berson. The company gained market share during the Covid pandemic when many of its smaller competitors folded due to restrictive policies limiting out-of-home consumption.

Bidcorp has recovered well from the lockdown period, producing record profits in its most recent results. The outlook is positive as the group should benefit from the normalisation of out-of-home activities, further market share gains and the ability to successfully pass on food inflation. The share is trading at its lowest valuation since listing in 2016.

Until recently, the fund held no local listed property exposure. Fundamentally, there has been an oversupply of space in certain property categories (office and to a lesser extent retail), high vacancies, negative rent reversions, and high administered prices (rates and taxes, energy) that could not be fully recovered from tenants.

In addition, the dividend yields offered by listed property were at a discount to SA long-term government bond yields - at a time when property earnings and therefore future dividend distributions were declining.

While the environment remains challenging, especially in the office space, the property market is showing some signs of improvement. Rental reversions are narrowing, and vacancies are declining. Importantly, dividend yields for some of the listed property companies now approach or exceed long-term government bond yields, and property distributions are expected to grow from the current base.

Our initial investment into the SA listed property sector was via Growthpoint – the diversified and conservatively managed REIT whose assets include 50% of the V&A Waterfront amongst others. Growthpoint currently trades on a historic dividend yield of 10.8% on an 82.5% pay-out ratio. We expect the dividend distribution to increase from current levels and the pay-out ratio to revert to 90% over the medium-term.

We also see a value unlock opportunity as Growthpoint owns stakes in three listed overseas property groups (GOZ Australia, Globalworth, and Capital & Regional). Our preference would be for these assets to be unbundled and accessed directly by investors – partly unlocking the sizable 44% discount to NAV that Growthpoint currently trades on.

A summary of the current fund positioning by strategy is shown below. The forward P/E multiple of the combined equity (JSE and foreign) portfolio is an attractive 8.7 times. Our assessment of the fair value of the fund's equity holdings is significantly above current levels.

Current fund positioning by strategy	**%**
JSE listed equities	49.7%
Domestic facing holdings	27.9%
Dual listed/Rand hedge	21.8%
Foreign listed equities	25.3%
Total equity exposure	**75.0%**
SA government bonds	8.9%
Cash & money market	16.1%
Total	**100.0%**

Sincerely,

Kevin Williams

20 October 2022

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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. There is no guarantee in respect of capital or returns in a portfolio. A CIS may be closed to new investors in order for it to be managed more efficiently in accordance with its mandate. CIS prices are calculated on a net asset basis, which is the total value of all the assets in the portfolio including any income accruals and less any permissible deductions (brokerage, STT, VAT, auditor's fees, bank charges, trustee and custodian fees and the annual management fee) from the portfolio divided by the number of participatory interests (units) in issue. All documents, notifications of deposit, investment, redemption and switch applications must be received by the Manager by or before 13:00 (SA), to be transacted at the net asset value price for that day. Where all required documentation is not received before the stated cut off time the Manager shall not be obliged to transact at the net asset value price as agreed to. Fluctuations and movements in exchange rates may also cause the value of underlying international investments to go up or down. Forward pricing is used. The Fund's Total Expense Ratio (TER) reflects the percentage of the average Net Asset Value (NAV) of the portfolio that was incurred as charges, levies and fees related to the management of the portfolio. A higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER cannot be regarded as an indication of future TER's. During the phase in period TER's do not include information gathered over a full year. A Money Market portfolio is not a bank deposit account and the price is targeted at a constant value. The total return is made up of interest received and any gain or loss made on any particular instrument; and in most cases the return will have the effect of increasing or decreasing the daily yield, but in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio. The yield is calculated as a weighted average yield of each underlying instrument in the portfolio. Excessive withdrawals from the portfolio may place the portfolio under liquidity pressures and a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed A Fund of Funds is a portfolio that invests in portfolios of collective investment schemes, which levy their own charges, which could result in a higher fee structure for these portfolios. A Feeder Fund is a portfolio that invests in a single portfolio of a collective investment scheme which levies its own charges and which could result in a higher fee structure for the feeder fund. The Manager retains full legal responsibility for any third-party-named portfolio. Where foreign securities are included in a portfolio there may be potential constraints on liquidity and the repatriation of funds, macroeconomic risks, political risks, foreign exchange risks, tax risks, settlement risks; and potential limitations on the availability of market information. The investor acknowledges the inherent risk associated with the selected investments and that there are no guarantees. Prescient is a member of the Association for Savings and Investments SA. Bateleur Capital Pty Ltd, an AFSP; is the investment manager of the Funds.
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