Bateleur Flexible Prescient Fund

2023 final report back

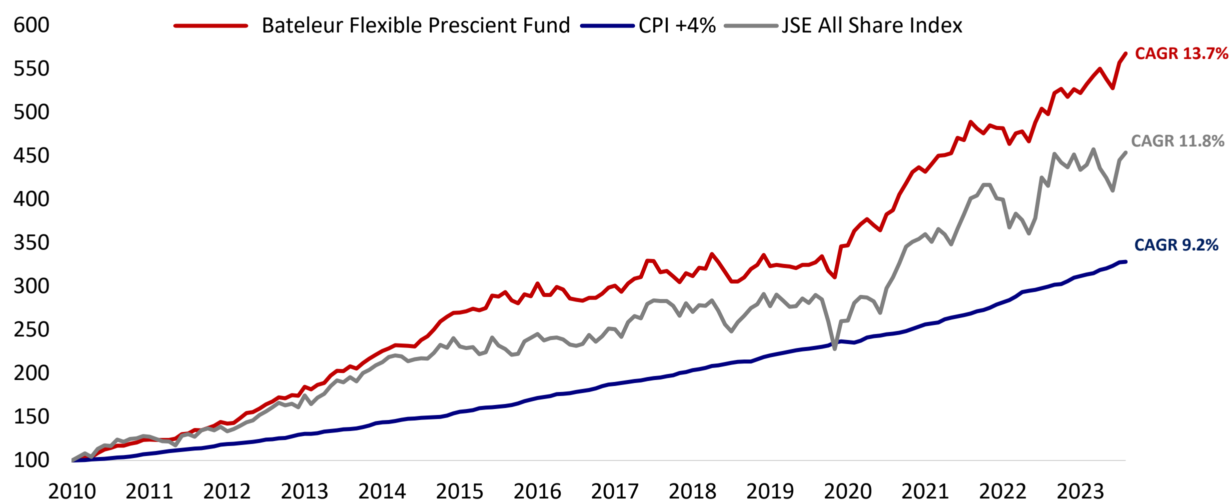
bateleur capital

Bateleur Flexible Prescient Fund – 2023 final report back to unitholders

The fund appreciated 14.0% net of fees for 2023. As comparatives, the JSE All Share Index returned 9.3% including dividends reinvested but before fees, a basket of SA government bonds (ALBI) gained 9.7%, while cash (STeFI) returned 7.8%.

In the thirteen-and-a-half years since inception, the fund has compounded at 13.7% p.a. net of fees compared to the JSE All Share Index's 11.8% p.a. gross of fees (Chart 1). The fund's hurdle rate (CPI inflation + 4%) compounded at 9.2% p.a. over the same period. Returns were generated at significantly lower volatility than the overall market (average volatility of 8.8% since inception versus 16.0% for the JSE All Share Index) highlighting the capital preservation attributes of the fund.

Chart 1: Bateleur Flexible Prescient Fund (A1) illustrative performance since inception – 1 July 2010 (indexed)



Source: Bateleur, as at 31 December 2023

Highest rolling 1 year return | 39.0%

Lowest rolling 1 year return | -7.2 %

The investment performance is for illustrative purposes only. The investment performance is calculated by taking the actual initial fees and all ongoing fees into account for the amount shown and income is reinvested on the reinvestment date.

The fund's attribution by strategy for 2023 is shown in Table 1. JSE listed equities averaged 46% of fund NAV during the year and contributed 7.1% to overall returns. Foreign listed equities averaged 30% of fund NAV and contributed 6.2%, while government bonds averaged 11% of fund NAV and contributed 1.4% to returns.

Table 1: Fund attribution by strategy for 2023

Strategy	Return (%)	Ave. exposure (%)
JSE listed equities	7.1%	46%
Foreign listed equities	6.2%	30%
Government bonds	1.4%	11%
Cash & money market	0.8%	13%
Costs (and other)	-1.5%	
Total	14.0%	

Source: Bateleur, as at 31 December 2023

Over time, the foreign holding component of the fund is expected to increase toward the upper allowed limit of 45% of fund NAV. At year-end, the foreign weighting (foreign equity + foreign bonds + foreign cash) was 36%, a meaningful increase over the 31 December 2022 level of 28%.

A further increase in foreign holdings will only be implemented when suitably priced investment opportunities arise, and after considering prevailing foreign exchange rates.

The top individual contributors and detractors to 2023 returns are shown in Table 2. Broadly, stock picking was sound, and the fund largely avoided JSE sectors and companies that experienced notable headwinds. These include the platinum group metals ('PGM's), telecoms (MTN and Vodacom), and domestic oil and gas (Sasol) sectors, where the fund had zero direct exposure throughout the year.

Table 2: Top individual contributors and detractors for 2023

Top contributors	%	Top detractors	%
Amazon	1.5%	Alibaba	-0.9%
Bidcorp	1.2%	British American Tobacco (BTI)	-0.4%
Microsoft	0.9%	African Rainbow Minerals (ARI)	-0.4%
FirstRand	0.9%	Dollar General	-0.3%
Alphabet (Google)	0.9%	Italtile	-0.3%

Source: Bateleur, as at 31 December 2023

The top individual contributors were, in order: Amazon, Bidcorp, Microsoft, FirstRand and Alphabet (Google) – collectively contributing nearly 40% to overall fund returns. All five companies remain core holdings at the date of this report.

The technology trio (Amazon, Microsoft and Alphabet) were all beneficiaries of the generative AI tailwinds that commenced shortly after the initial public launch of ChatGPT and continued throughout the year. AI hype aside, these technology behemoths delivered stellar financial results in 2023, with strong revenue growth, sound execution in their core franchises and excellent free cash generation. All three are investing aggressively in both cloud and AI, where a long and profitable growth runway awaits the eventual winners. This is still undecided in the AI space.

Individual fund detractors were limited to Alibaba, British American Tobacco ('BTI'), African Rainbow Minerals ('ARI'), Dollar General and Italtile.

The fund exited Alibaba in its entirety in the last quarter of 2023 after the company reneged on its previously announced restructuring and continued to lose e-commerce market share to the more aggressive upstart Pinduoduo ('PDD'). The Chinese regulatory environment remains volatile and uncertain, resulting in global investors withdrawing funds from the Chinese and Hong Kong equity markets in favour of jurisdictions with more coherent government policies and friendlier investor rights.

The fund sold out of Dollar General in mid-2023 after three quarters of disappointing financial results. Dollar General had been a long-standing investment in the fund since 2018 contributing consistently to returns over this period.

In hindsight, Dollar General expanded too aggressively in terms of new store rollouts, new distribution centres, and in its range of product and service offerings. This loss of focus ultimately led to substantial stock write-downs, a large increase in the expense base and uncomfortably high debt levels.

Although underperforming in 2023, the investment cases for ARI, BTI and Italtile are largely unchanged. All three remain core fund holdings.

Current fund positioning:

Global capital markets rallied strongly over the last two months of 2023 with investors calling the end of the US rate hiking cycle after a string of relatively benign inflation readings. The S&P 500 rallied 14.1% in November and December to end the year up 26.3%, while the MSCI World Equity Index rose 23.8% over the calendar year. These returns are staggering, especially as they occurred into a rising interest rate environment with quantitative tightening (normally considered a poor cocktail for equity market prices).

Global bonds also staged a late surge with the FTSE World Government Bond Index ('WGBI') rallying 9.3% in November and December to end the year up 5.2%, while the US Treasury Index rose 4.1% over the calendar year.

These moves suggest that capital markets are already partially discounting a normalisation of interest rates in 2024.

The US bond market is currently forecasting six interest rate cuts (of 0.25% each) from the Fed during 2024, with the first expected in March (Chart 2); while equity market valuations are once again above trend, even after the 'magnificent seven'[1] technology shares are down weighted[2] (Chart 3).

Chart 2: Six Fed rate cuts expected in 2024

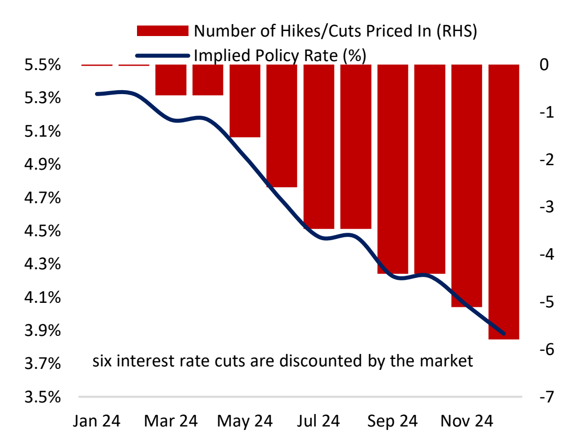
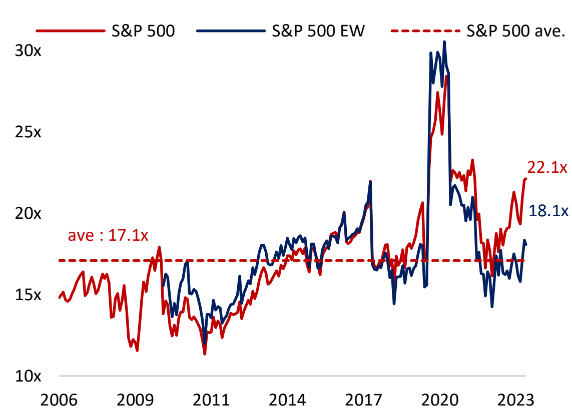


Chart 3: S&P 500 P/E multiple over time



Source: Bateleur, as at 31 December 2023

[1] Comprising Apple, Microsoft, Alphabet ('Google'), Amazon, Nvidia, Meta ('Facebook') and Tesla.
[2] S&P 500 forward P/E multiple estimated at 22.1x vs average of 17.1x. Equal weighted S&P 500 forward P/E multiple estimated at 18.1x.

If inflation and economic growth surprise to the upside in the first half of 2024, further delaying Fed rate cuts, then both equities and bonds are likely to endure a challenging period. Against this backdrop, the fund is currently conservatively positioned with a capital preservation 'mindset'.

Cash and money market funds comprise 16% of fund value (up from 10% in September 2023) after select equities were lightened into the year-end rally. The fund's cash holdings currently yield 7.8%.

SA government bonds comprise 9% of fund NAV, while US 2 Yr. T-Bills comprise 4%. The domestic government bonds currently yield 9.8%, while the US 2 Yr. T-bills were purchased at an average US dollar yield of 4.8%.

Equity exposure is currently 71% of fund value, 41% in JSE listed equities and 30% in foreign listed equities.

JSE listed equities are split between dual listed/rand hedge (22%) and domestic facing (19%). Domestic equity exposure is well below average, despite appearing attractively valued both in absolute terms and relative to history.

The low weighting is a direct consequence of 1) the increased offshore limit available since mid-2022 (wider opportunity set and diversification benefits), and 2) generally poor earnings growth prospects for domestic listed corporates (negligible SA GDP growth, unfriendly investor policies and deficient state-controlled infrastructure).

Turning to foreign listed equities, aside from the technology sector, the fund's global shares are not thematic, but rather selected on bottom-up fundamentals.

Within technology – Amazon, Microsoft and Alphabet have been core fund holdings for several years. More recently, following extensive research, investments in the global semi-conductor industry via ASML and Taiwan Semiconductor Manufacturing ('TSMC') were initiated.

2023 is likely to have marked the trough in the global semi-conductor cycle, with a rebound expected in 2024. The improved outlook is not overly reliant on a surge in demand for AI chips.

Both ASML and TSMC are formidable leaders in their fields with clear competitive advantages. ASML is a front-runner in the manufacture of advanced lithography machines that are vital to the chip manufacturing process. These highly engineered devices sell for up to 350 million Euro's each.

TSMC is the largest listed semi-conductor company in the world by revenue and dominates the manufacturing of advanced chips. One of TSMC's core strengths is that it consistently re-invests in R&D and new chip foundries, with an annual capex bill approaching USD 30bn. These investments have enabled the company to stay ahead of the competition through innovation, by constantly producing faster chips with more energy efficient architecture.

Both semi-conductor company valuations are reasonable relative to future growth expectations. ASML trades on an estimated twelve-month forward P/E multiple of 32.1 times with consensus[3] earnings growth of 18% p.a. over the next three years.

[3] Source: Bloomberg

TSMC trades on an estimated twelve-month forward P/E multiple of 18.6 times with consensus[4] earnings growth of 21% p.a. over the next three years. TSMC's major stakeholder risk is that it is headquartered in Taiwan, where most of its foundries are also located, placing a ceiling on the share's valuation multiple.

Outside of technology, the fund's offshore holdings have a defensive tilt and include the likes of Heineken, Comcast, Amgen, Philip Morris, Johnson & Johnson, Vinci and Universal Music. The rationale for these investments was addressed in prior report backs.

A summary of the fund's positioning at year-end is shown in Table 3. The weighted average 12-month forward P/E multiple of the fund's equity portfolio is estimated at 11.6 times – with the SA domestic segment at 8.3 times and the foreign segment at 15.3 times.

Table 3: Fund positioning on 31 December 2023

Strategy	%
JSE listed equities	41%
Domestic facing holdings	19%
Dual listed/rand hedge	22%
Foreign listed equities	30%
SA government bonds	9%
US 2yr T-Bills	4%
Cash & money market	16%
Total	**100%**

Source: Bateleur

We remain confident in delivering on the fund's investment objectives.

Sincerely,

Kevin Williams
24 January 2024

[4] Source: FactSet

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