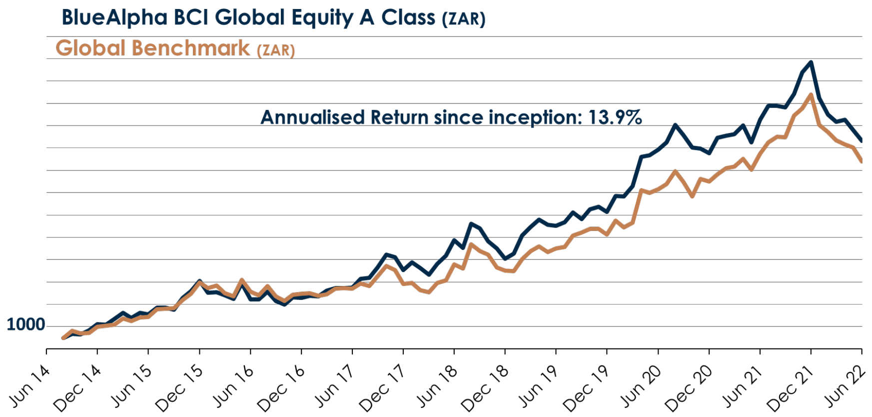
Investment Quarterly
June 2022 | Vol. 34

BLUEALPHA
INVESTMENT MANAGEMENT

BlueAlpha BCI Global Equity

Our Global Equity Performance



*Benchmark: 20% USD Libor, 80% MSCI World Index ZAR until 30/09/2020 and MSCI World TR index (in ZAR) from 01/10/2020
Inception: September 2014

Source: Fund Focus (Iress), Bloomberg

Investment Objective

The primary objective of the BlueAlpha BCI Global Equity Fund is to offer investors a high long term total return by investing across global equity markets.

Our Global Equity Track Record

Performance reported in ZAR	1 Year	3 Years (annualised)	5 Years (annualised)	Since Incept. (Sept 2014 - annualised)
BlueAlpha Return*	-6.5%	11.3%	13.8%	13.9%
Fund Benchmark	-2.7%	12.8%	12.4%	12.9%
Out-Performance	-3.8%	-1.5%	1.4%	1.0%

**BlueAlpha BCI Global Equity A Class net of fees*
Benchmark: 20% USD Libor, 80% MSCI World Index ZAR until 30/09/2020 and MSCI World TR index (in ZAR) from 01/10/2020

Source: Fund Focus (Iress), Bloomberg

Fund fact sheets (MDD's) available on www.bluealphafunds.com

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In this issue

Looking back
We take a look at the history of a **featured company** to get a feel for where they started and how they got to where they are now. In this feature, we're diving into the story of **Coronation.**

Chart Focus
This quarter we are looking at ESG investing, what works and what doesn't, more specifically we will look at **Chinese property – a slow moving train wreck.**

Investment Focus
In this series, we tackle a new investment concept every quarter - from which valuation metrics to use for different types of businesses, to how companies can create value for shareholders. In this edition we look at **HOLT – an introduction to BlueAlpha's black box.**

Recommended Read
Each quarter, we give you access to our reading list. We recommend each book for a different reason, but the common thread is how the book's concepts can be applied to your investment well-being. The latest addition to our bookshelf is **Freezing Order** *by Bill Browder.*

RAGING BULL AWARDS WINNER

Take a look

Find out more about BlueAlpha
– who we are and how we invest
– visit our home on the web:
www.bluealphafunds.com

Looking Back: Coronation Fund Managers

In 1993, 15 investment professionals orchestrated a mass walkout of Syfrets Managed Assets. With zero clients and zero assets this small group started Coronation Fund Management. Listing in 2003 with AUM of R53bn. Coronation has grown exponentially over the years, as of March 2022 Coronation now manages R625 billion in client Assets.

It's easy to think that investing in an asset manager is a proxy for the equity market as a whole, after all their revenue is largely a function of assets under management (AUM). We examine why this isn't the case by taking a look at SA's third largest asset manager, Coronation.

As you can see in Figure 1 graph, Coronation has outperformed the market handsomely, but after its peak in 2014, assets stopped growing. We are going to take a deeper look at the headwind's asset management companies face.

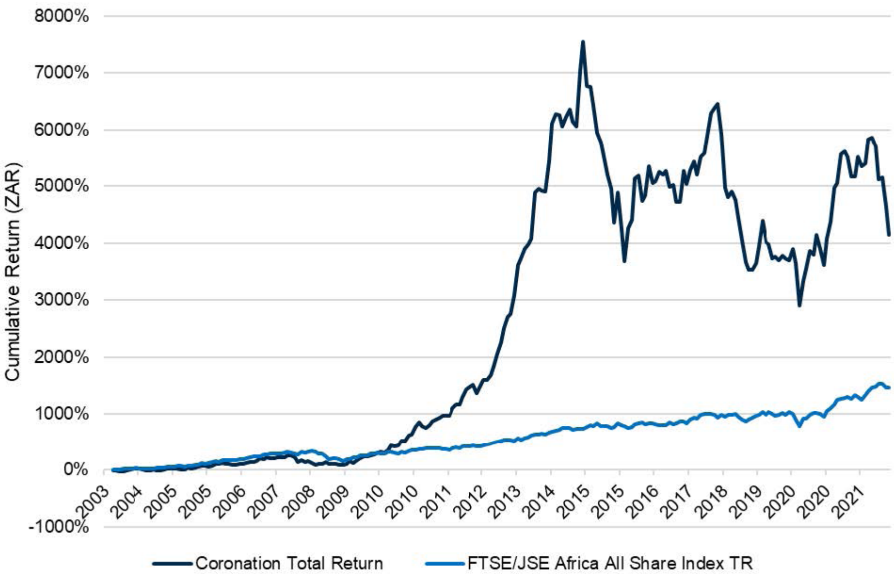
Investing in the Investors

Market capitalisation relative to assets under management (AUM) is a widely used ratio to assess the value of asset management firms. The below graph shows Coronations market cap/AUM through time.

Put simply, a market cap/AUM of 3% translates to a Price/sales of 3 (assuming gross fee of 1%). This would imply that the market is pricing in no growth and a margin of 50 bps (asset managers typically have a cost to income ratio of 50%).

This would also be our view of Coronation and other vanilla asset managers. Rarely should they be seen of as premium rated businesses. Yes the cash flow is good but your assets (being staff and funds under

FIGURE 1: Coronations versus the market



Source: Bloomberg

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management) are not stable. At one stage RMB asset management was one of the biggest independent managers and it now no longer exists. And of course, that 1% gross fee has still got room to fall.

The Figure 2 graph shows the company re-rating from 1.5% of AUM in the market low of 2008 to a high of 5.8% in 2014. Through this period, the company was attracting significant asset inflows, expanding its global reach, and rising fee generation. The market thought that Coronation was destined to keep growing. However, after the peak in 2014, the rating nosedived and has moved in a horizontal fashion since.

So where are the headwinds coming from?

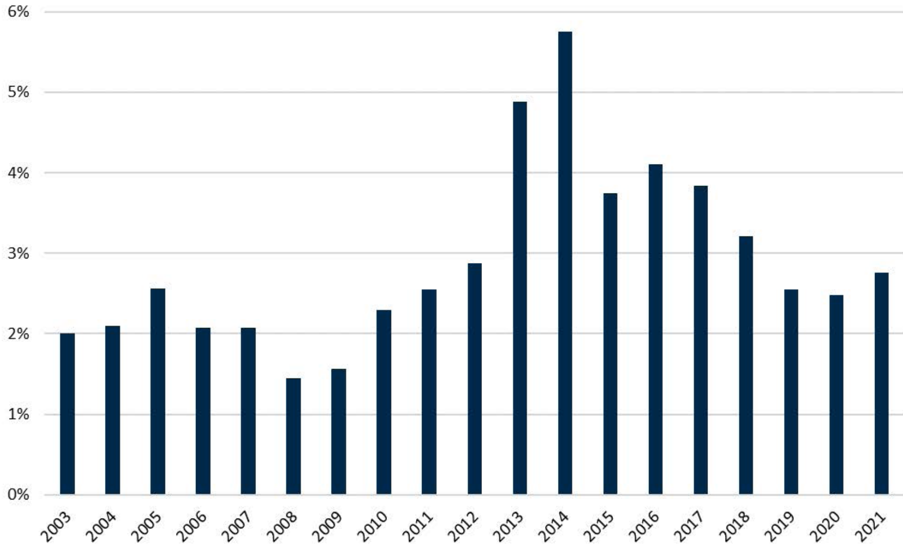
Share price performance for companies like Coronation is a function of AUM, fees, ratings, fund performance and employee costs. The first two have the biggest effect on Coronation's profits as employee costs tend to be variable with margins.

1. Asset Growth Stopped

Like many things in life, size matters, and this couldn't be truer for the asset management industry. Larger AUM means a larger fee base which means more revenues. However, the bigger you are, the harder incremental growth is to come by. Coronations' asset growth stopped in 2014 as illustrated below. Without additional client inflows, AUM growth is limited to the performance of your AUM less fees.

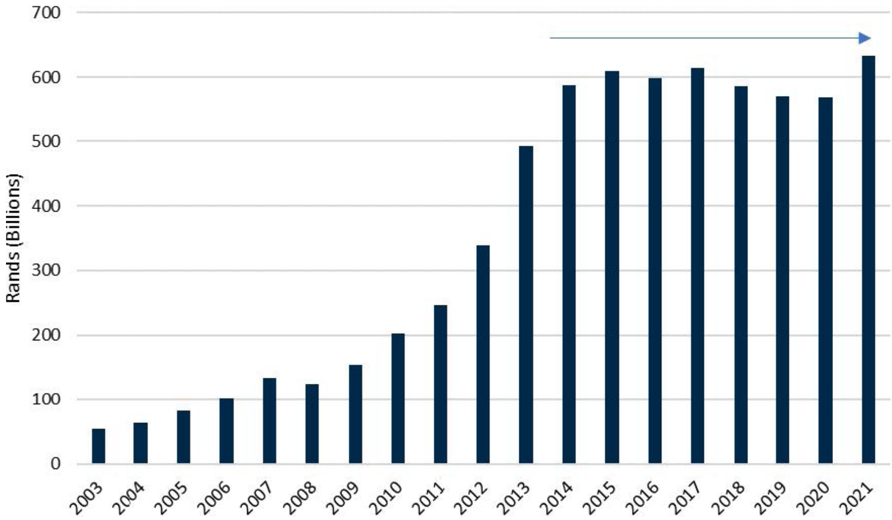
The current savings culture in SA also adds pressure to AUM growth. Historically there was a huge savings pool in South Africa which was a driver behind the start of many asset manager firms, today we see very little savings growth in the country.

FIGURE 2: Coronations Market Cap to AUM



Source: Bloomberg

FIGURE 3: Coronations Asset Growth



Source: Bloomberg

CORONATION

2. Net Outflows exacerbate AUM stagnation

AUM can grow in three ways: organically, because of rising markets boosting the value of the assets managed, successful active management resulting in outperformance (alpha), or from investor inflows. More inflows are often the result of good performance. Whether a function of performance, competition or emigration of investors, Coronation have reported net outflows for the last 4 consecutive years.

3. The big squeeze: Pressure of fees

Adding further pressure to revenues is the increased pressure on fees. Human capital businesses, by their

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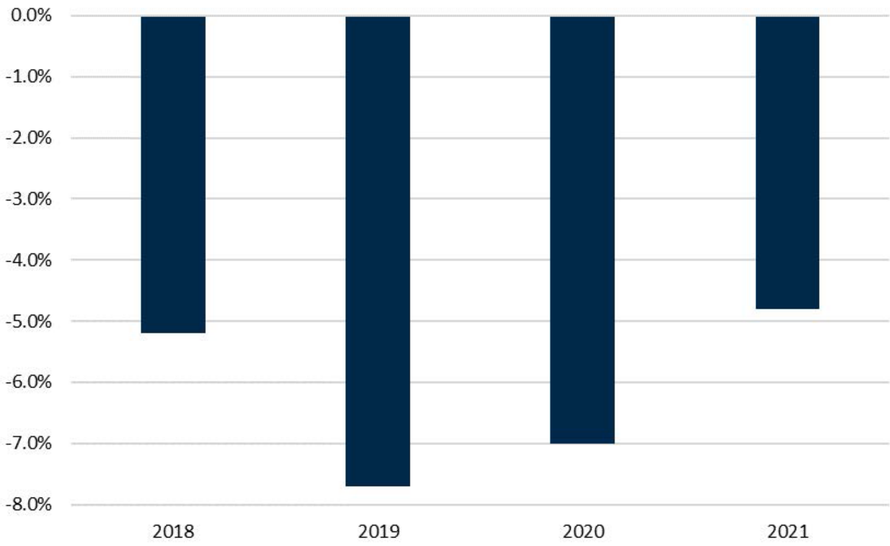
nature, have relatively low barriers to entry, resulting in a very fragmented industry. With stunted savings growth in SA and increased competition, the only way to attract assets is by lowering fees. There are too many trains and too little gravy! Coronation, like other active managers, is also largely doing away with performance fees, especially on retail funds.

Is the Dividend Yield a Better Way to Value Coronation?

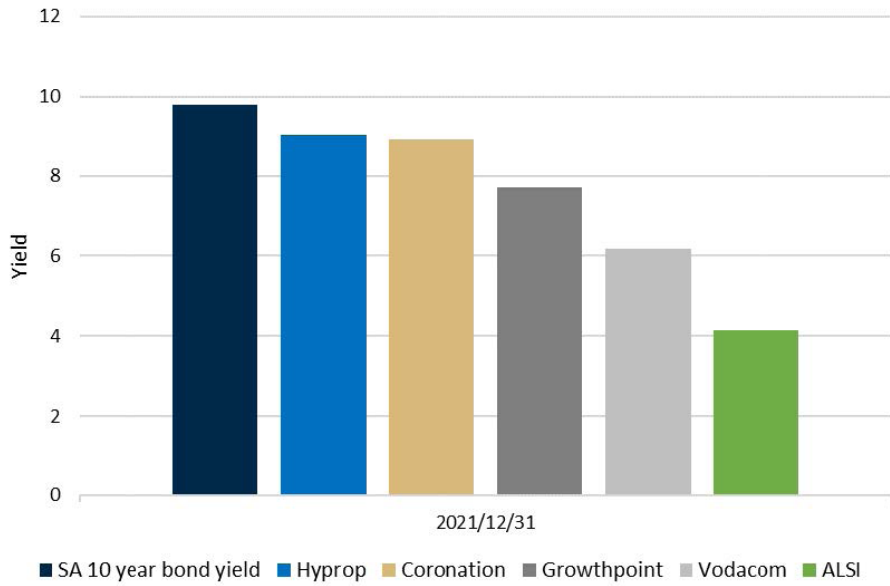
Because asset managers are human capital companies and don't need to invest in fixed assets, they are cash-generative and able to pay out the majority of profits as dividends. For this reason, the dividend yield is also relevant when valuing an asset management firm. Investors argue that Coronation's dividend yield is attractive and by this metric the company looks cheap. At a yield of 8.9% in December 2021, it certainly looks appealing relative to the equity market indices. However, as soon as investors suspect a company is ex growth its dividend yield starts gravitating towards the 10-year bond yield, because of the tax advantage, the dividend yield tends to be lower. Some examples of companies where growth has stopped and have high dividend yields are Vodacom and SA property companies.

FIGURE 4: Net Outflows as a % of AUM



Source: Coronation

FIGURE 5: Yield Comparison



Source: Bloomberg (December 2021)

Another point to make is that diversified financial companies have different streams of growth that they can rely on, where pure asset managers only have one. So if they fail, they fall out the sky without the parachute of say a banking or insurance division. Investing in pure play asset managers makes sense if asset inflows are strong but as soon growth dries up it's very hard for asset managers themselves to outgrow the equity index.

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Chart Focus:
Chinese Property – a slow moving train wreck

Developed Countries 3 main avenues of growth are population growth, resource extraction and productivity. A 4th avenue for developing economies is through infrastructure spending. So here are 4 questions:

1. Who has the larger birth rate Italy or China?
2. Is China's GDP / capita closer to Botswana or the USA?
3. Are residential starts in China higher than 10 years ago?
4. What is steel consumption growth in the USA over the last 20 years?

The answers are China, Botswana, No and -2%.

When people discuss China, growth is always the main discussion. Is it 6%, maybe 4%? Rarely do we ask could it be 0%? We know that the labour market in China peaked some two years ago, so it can't be population growth and China depleted its own resources (including agriculture) many years ago.

FIGURE 1: USA vs China yield per hectare – June 2022

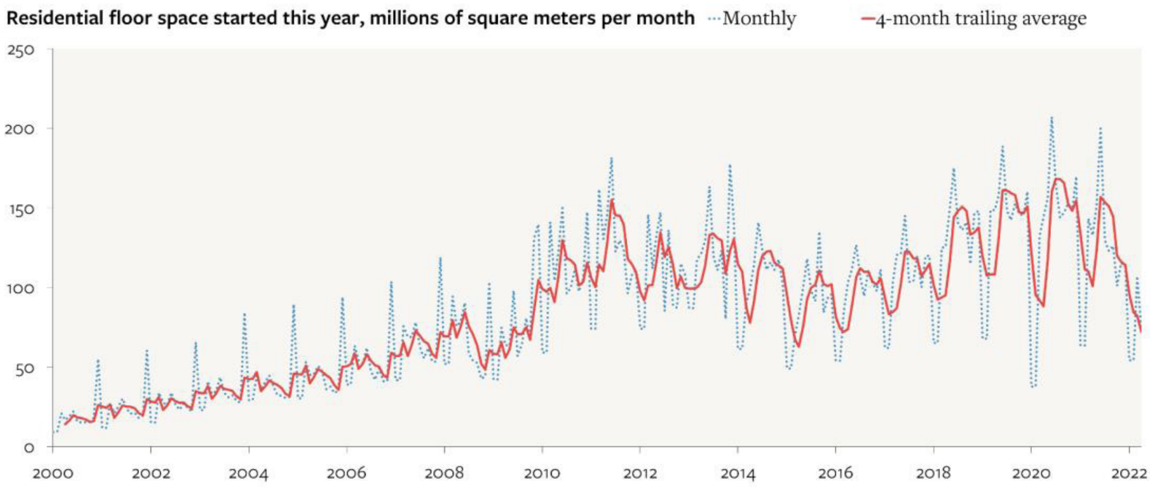
	United States	China
Population	329 million	1.4 billion
Worlds Arable Land	17%	11%
Coarse Grain Yield (metric ton per hectare)	10.4	6.1

Source: US Census Bureau, Agweb, united states department of agriculture

In terms of productivity many Chinese private firms have been productive, but this is negated by the growing share of the state. So we are currently in a situation where the Chinese Government is engineering growth through Infrastructure (good, bad or wasteful), growing the size of the state (can be good or bad) and financing it with debt. A large part of infrastructure spend was aimed at housing and urbanisation. So most people now believe that infrastructure spend at current rates, and housing supply is wasteful.

So it is no wonder that residential starts have been slowing. The residential value line would look different. Given SA resource bias it's no wonder that SA investors are worrying about the slowing infrastructure demand. Nobody believes the current iron price long term. Hence the low multiples. Analysts correctly regress volumes and margins lower when looking at the next 10 years for commodity companies. Remember US steel consumption has declined over the last 20 years.

FIGURE 2: Residential starts slowing



Source: China National Bureau of Statistics, Matthew Klein calculations

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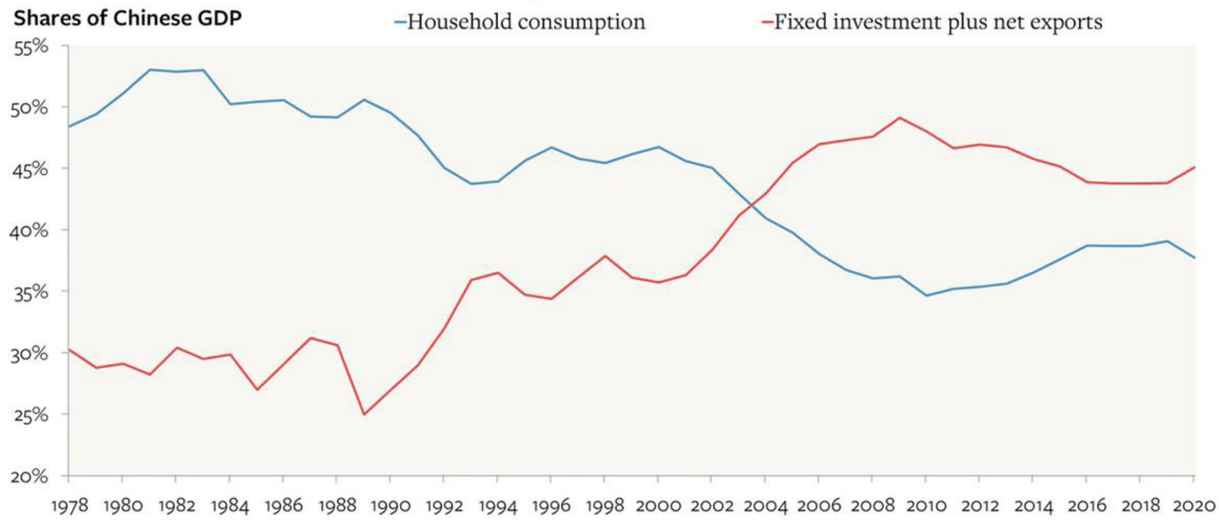
More importantly, going forward, what is the effect of residential asset prices either stagnating or falling?

From an investors perspective household consumption is key (as it is difficult to invest in the state). Below is a graph showing HCE (Household Consumption & Expenditure) as a % of GDP for China. As you can see it is declining and it is way below the levels in the USA of 60%.

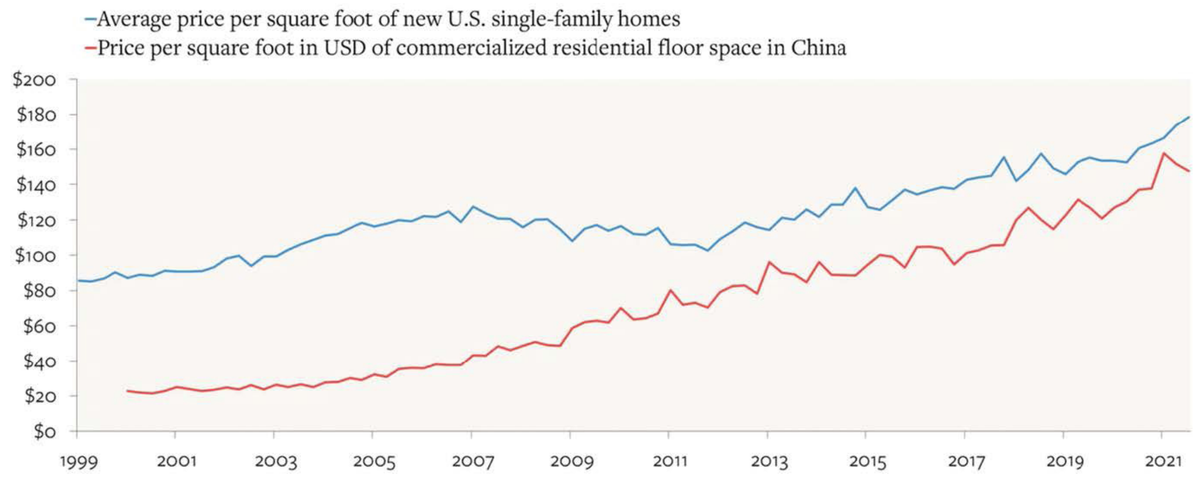
FIGURE 3: HCE as a % of GDP



Source: China National Bureau of Statistics, Matthew Klein calculations

In addition, the cost of housing eats up a huge amount of personnel income in China. Let's start by looking at the cost of residential housing through time compared to USA.

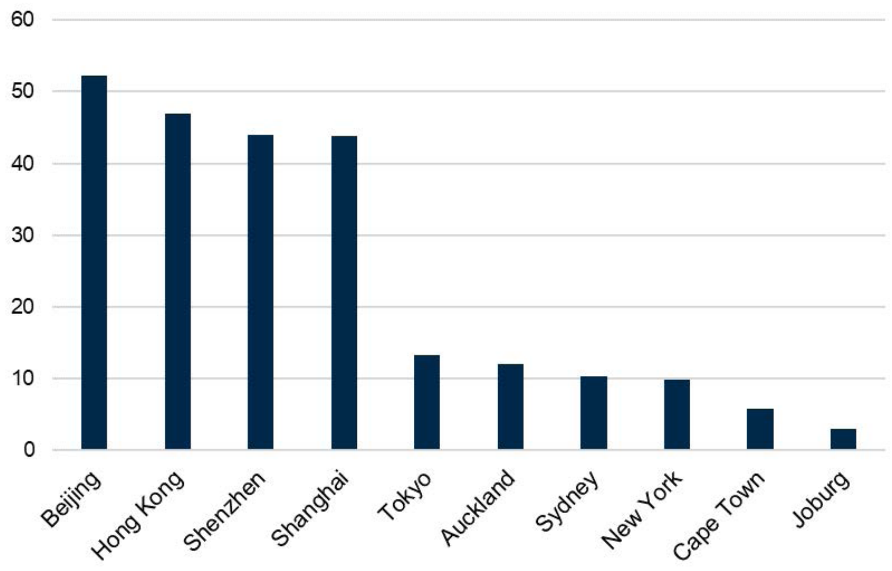
FIGURE 4: Housing prices per square foot



Source: China National Bureau of Statistics, Matthew Klein calculations

China's number is quite close to the USA which is ludicrous given that the USA GDP/capita is 6 times that of China. (Please don't use PPP). This affordability index by Numbeo shows Chinese cities dominating the ladders. Sydney is at 11 while Beijing is at 52.

FIGURE 5: Affordability Index using price to income ratio



***Price to income ratio shows how much net income is required to purchase a property*
Source: Numbeo

Looking at the above numbers, a huge amount of property in China is bought for investment or speculative purposes. Residential property in China is a speculative bubble on a large scale.

The wealth effect on the way up is great and it is necessary. You want your population to be getting wealthier. But falling house prices has a massive effect not just on household finances but consumer confidence and spending.

A bigger problem is trying to deal with an asset bubble that is deflating.

In order to delve further we need to look at the word "bezzle". The three statements below explain it perfectly:

Economist John Kenneth Galbraith wrote "Weeks, months or years may elapse between the commission of the crime and its discovery. (This is a period, incidentally, when the embezzler has his gain and the man who has been embezzled, oddly enough, feels no loss. There is a net increase in psychic wealth.) At any given time there exists an inventory of undiscovered embezzlement in—or more precisely not in—the country's business and banks"

British economist John Kay explains "The joy of the bezzle is that two people—each ignorant of the other's existence and role—can enjoy the same wealth."

Vice chairman of Berkshire Hathaway, Charles Munger states "If a foundation, or other investor, wastes 3% of assets per year in unnecessary, non-productive investment costs in managing a strongly rising stock portfolio, it still feels richer, despite the waste, while the people getting the wasted 3% think they are virtuously earning income. The situation is functioning like undisclosed embezzlement without being self-limited. Indeed, the process can expand for a long while by feeding on itself. And all the while what looks like spending from earned income of the receivers of the wasted 3% is, in substance, spending from a disguised "wealth effect" from rising stock prices."

I'm sure the Chinese authorities are aware of the problem hence some bizarre solutions: Firstly the local governments rely on land sales to support 30% of local govt spending.

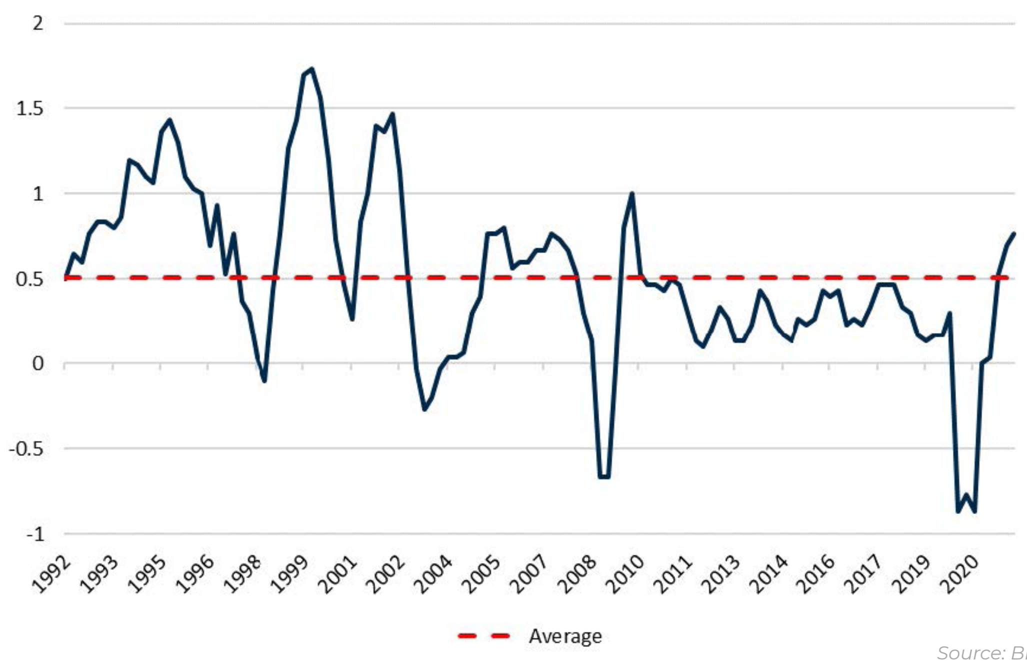
To fill in the gap vacated by broken property companies they have created subsidiaries owned by the local government to buy the land (financed by debt in the subsidiary).

To keep up the illusion of wealth many cities now have a floor on the price that apartments can be sold for. Not to protect the property companies but to protect the citizens who borrowed money to buy apartments at a higher price.

And of course we also have price ceilings to maintain the charade of common prosperity. I'm sure Zuma wished he had coined that phrase.

This is not a problem that can be solved by goal seek on Excel. So what does the future hold for Chinese property going forward? We do have 3 good examples of property bubbles deflating. The USA in 2008 is not a good example as prices were allowed to clear. Also there was no government involvement on infrastructure and housing. South Korea (1997) and Japan (1980's) were very close replicas. Both were characterised by over 20 years of 0% HCE.

FIGURE 6: South Korea Real Consumption Expenditure



Source: Bloomberg

It is very unlikely that the Chinese government will just allow prices to clear (Lehman style 2008) so the path forward is probably the path followed by Japan and South Korea. Both countries also had very subdued demand post the deflating of their property bubble. They also both made the mistake of having policies which supported the supply side (infrastructure & export sector) at the expense of the demand side (household consumption). In the last 2 years China has shown a similar trend supporting the supply side and not the demand side. Lastly, post the peak of the property bubble, the demographic situation (at the time) in South Korea and Japan acted as a tailwind where in China the demographic situation is already a strong headwind.

Investment Focus:
An introduction to BlueAlpha's black box

"BlueAlpha is a Quality investor with a Growth tilt - investing in high quality businesses with the ability to grow", this soundbite is easy to agree with and most investors would say they target businesses with similar attributes, but what actually is the thinking around our process? In this first of a three-part series, we take a closer look inside BlueAlpha's black box.

The concepts of quality, growth, value, and risk are inseparable from one another, so the order in which we choose to focus on them is going to have an influence on the conclusions we reach. In general, we will ask three questions in our process:

- **Quality** – Can the business earn a return ahead of its cost of capital?
- **Growth** – Can the business grow ahead of its cost of capital?
- **Valuation** – what is a fair price to pay?

Quality

Below we show some select data from two hypothetical companies. A quick glance will show that these businesses are almost identical. The two firms earn the same nominal amount of 100 – and here we will use NOPAT* as a measure of earnings - Company A achieves this return off an asset base of 500, while Company B employs 1000 worth of assets to generate the same return.

As mentioned, our first step is to measure operational quality, and here we will use ROIC*. Company A earns a higher ROIC than B, demonstrating a higher level of operational efficiency. This return can't only be looked at in isolation though, it has to cover cost of capital for the business (WACC*) and both of the businesses have a cost of capital of 12.5%. Company A earns a return more than this hurdle rate, while Company B does not. This difference to the respective hurdle rates, when multiplied by the asset base translates into the value that the firm has created over the last year, also called Economic Profit.

At this point we can observe how these firms are valued by the market. One way we can look at it is the ratio of a firm's total value (Enterprise value) vs the value of its assets. Company A's value is at a premium to its asset base, while Company B is at a discount. With this information in mind, let's walk forward one year and see how the two businesses have fared.

Year 1	Company A	Company B
Earnings (NOPAT)	100	100
Operating Assets	500	1,000
ROIC	20.0%	10.0%
WACC	12.5%	12.5%
Economic Profit	38	- 25
EV to IC	1.6	0.8

Year 1	Company A	Company B
Growth	10.0%	10.0%
Earnings (NOPAT)	110	110
Operating Assets	550	1,100
ROIC	20.0%	10.0%
Economic Profit	41	- 28
EV to IC	4.0	-
Justifiable PE	20	?

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Growth

Both companies have grown their assets and earnings by 10%, and both are achieving the same ROIC levels they were last year. Again, we are looking at the operational quality, as well as the value created and see that Company A's Economic profit has improved from last year, while Company B was already destroying value, has destroyed even more value this financial year.

This brings us to an important point that our process leans on. Not all growth is the same. Company A was creating value, and by growing was able to further improve that level, but Company B, by not beating its cost of capital, its growth only further worsened its financial condition.

Valuation

Now the last step, valuation. With only the information we have on hand we can get to a justified PE ratio for Company A of 20, for company B however this isn't possible. B's is continuing to add capital to value destructive operations. Even keeping the mechanics of our example aside, how could we holistically derive a price for an operation that burns through capital?

It is only because of assessing the business' quality first, are we lead to choose Company A over B. If we started by first examining which of the two are relatively cheaper, we might have made the case for Company B - was it is trading at discount to assets and growing at the same rate as Company A after all.

This difference between the two approaches' conclusions should be a word of caution for investors – where you start will determine how you end.

***NOPAT: Net Operating Profit After Tax**
***ROIC: Return on Invested Capital (NOPAT / Asset Base)**
***WACC: Weighted average cost of capital**

Recommended Read:
Freezing Order *by Bill Browder*

This book is more gripping than any John Grisham or James Patterson crime novel, with the slight difference, everything in this book is true, and it's happening right now.

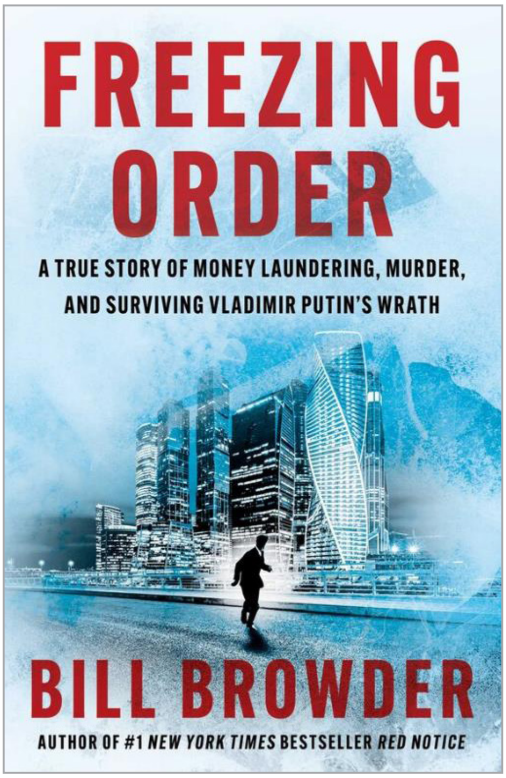
Bill Browder the CEO of the London based Hedge Fund, Hermitage Capital was once the largest foreign investor in Russia. When Browder began to expose Russia's corporate corruption, he was declared a threat to national security and wasn't allowed back into the country.

Following his banishment, 50 officers from the Interior Ministry of Russia raided Browder's Moscow office. The officers seized control of three Hermitage holding companies and used them to steal $230 million of taxes. Browder's lawyer, Sergei Magnitsky, was investigating the matter when he was arrested, detained, and tortured for 358 days and later died.

After Magnitsky's devastating death, Browder has dedicated most of his life to lobbying for the adoption of the Global Magnitsky Act around the world. The law initially barred 18 Russian officials thought to be involved in Magnitsky's mistreatment and death from entering the US or using its banking system. It also banned any assets these individuals had in the US. From 2016, Congress voted to expand it into the Global Magnitsky Act, which allowed for sanctions against human rights abusers in other parts of the world too.

Freezing Order, the second book after Red Notice, takes us through Browder's fight for the Magnitsky Act to be implemented across the world, all whilst playing a real life game of cat and mouse with Putin. A combination of dogged investigation, leaked documents, partnerships with journalists and co-operation with law enforcement agencies has led to some notable victories for Browder and certainly makes for a very gripping (and utterly shocking) read.

The tragedy of Russia's invasion of Ukraine on the 24th of February 2022 has bought to light many ESG investing issues. Predominately how many asset managers claim lip service to sustainable and ethical investing but that's where it ends. Many ESG complying asset managers got their fingers burnt recently with Russian investments. It makes little sense to focus on a company's ESG policy and ignore the policies of the government. If a countries



government principles are poor, it doesn't really matter what governance is like at a company level.

Bill Browder continues to highlight the autocratic criminal regime which is Putin's Russia and how Putin and his cronies will unabashedly ignore any international law. Those who stand in their way mysteriously fall off roofs, get poisoned or go missing. Also highlighted, and equally concerning in this book is how many powerful politicians and global firms in the West are enthusiastic enablers of Putin.

Bill Browder is tenacious and incredibly brave in his fight for the Magnitsky Act to be implemented across the world and we will continue to watch his unrelenting endeavors and hope that he succeeds. It should be mandatory that everyone, especially those in investment management read this book.

BlueAlpha Investment Offering

Our long term track record demonstrates our ability to create wealth for our investors.

Our Domestic Equity Performance – BlueAlpha BCI Equity

	1 Year	3 Years (annualised)	5 Years (annualised)	Since Incept. (July 2014 annualised)
BlueAlpha Return	**1.9%**	**5.1%**	**6.8%**	**7.4%**
SA Equity – General Sector Average	6.6%	7.7%	6.9%	5.3%
Benchmark**	1.1%	6.2%	7.3%	6.3%
Out-Performance to Benchmark	0.8%	-1.1%	-0.5%	1.1%

** A Class, Net of Fees*
*** Fund Benchmark: Local section of the fund BM changed to 75% CAPPED SWIX (from SWIX) in March 2022.*

Source: Fund Focus (Iress), Bloomberg

With an experienced investment team which is recognised for outstanding investment performance in various fund classifications, we are able to offer both institutional and retail investors diverse products to meet their investment objectives.

For our **institutional investors** we currently manage South African focused equity and balanced mandates as well as a global equity product.

Our **retail** and **IFA investors** have the same access to the BlueAlpha investment process via our BlueAlpha managed unit trusts:

BlueAlpha BCI Equity Fund: is our general equity fund, managed with exposure locally and globally. Its benchmark is 75% JSE Capped Swix, 25% MSCI All Country World Index. The fund aims to provide long-run market out-performance. It has a high risk profile.

BlueAlpha BCI All Seasons Fund: our longest running unit trust, started in 2005 and managed with a high equity exposure in the SA Flexible Sector, aims to provide investors with consistent long term capital growth.

BlueAlpha BCI Global Equity Fund: our global equity fund provides investors with offshore equity exposure. The fund invests in developed markets with a focus on quality growth companies with a large market cap. For further details, see page 1.

BlueAlpha BCI Balanced Fund: this fund aims to achieve high capital growth through maximizing exposure to both local and global equity, as well as through sizable exposure to property. It is managed to comply with Regulation 28 and is therefore appropriate for retirement products. The fund has a medium risk profile.