Investment Quarterly
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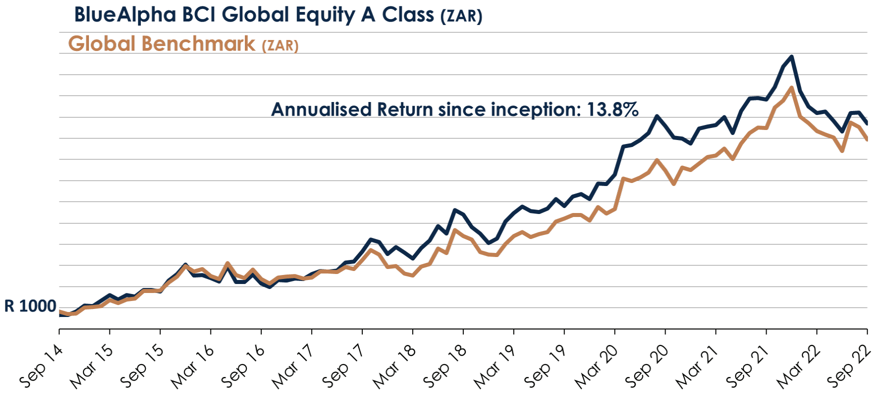
BLUEALPHA
INVESTMENT MANAGEMENT

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*	-7.4%	11.2%	11.7%	13.8%
Fund Benchmark	-3.9%	10.8%	11.6%	12.8%
Out-Performance	-3.5%	0.4%	0.1%	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

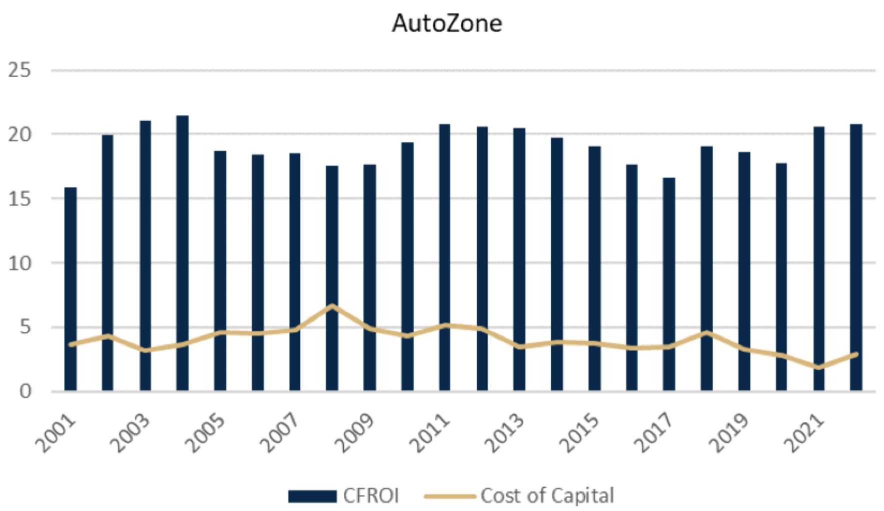
Take a look

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

Looking Back: AutoZone

We aren't in 'Arkansas' anymore...

FIGURE 1: AutoZone Cash Flow Return on Investment



Source: Credit Suisse Holt

Back in the 70s, while working in the retail division of his father's company, Malone & Hyde (an American Wholesaler). J.R. "Pitt" Hyde noticed a gap in the market, he saw a need for an automotive parts store with accessible products and excellent customer service. So, he, and some of Malone & Hyde's top leadership team started a company then known as Auto Shack, with one little store in Arkansas.

In 1986, Auto Shack was spun off as a freestanding company, of which Pitt Hyde served as Chairman and CEO and renamed it to AutoZone. The firm listed its shares publicly for the firm time in April 1991.

The company has never stopped evolving and has become the leading retailer of automotive replacement parts in the United States. Now ranked as a Fortune 500 company, AutoZone is one of the largest public companies in the world.

AutoZone – Best of Breed Auto Parts Retailer

AutoZone boasts strong business fundamentals and a solid long-term operating history. With a 20% cash flow return on investment, 10-year growth rate of 18% (CAGR) and topped with price appreciation of 38% in the last year alone, it's hard to find fault with the company. The amazing thing is its valuation is also attractive at a 5% FCF Yield.

Besides great fundamentals, Growth opportunities are there too:

- **Expansion into Latin America:** The chief driver of growth for AutoZone in Brazil and Mexico will be an increase in store count. The market in these two countries is far from saturated.

- **Moving into the DIFM space:** While AutoZone is known for being the go-to place for do-it-yourself (DIY) repairs, they have become a force to be reckoned with in the DIFM (Do it for me) space as well. For those wondering, the difference between DIY and DIFM is that DIY is individual consumers, while DIFM is geared towards repair shops. At the end of 2021, AutoZone reported that DIFM grew 29.4% on a YoY basis.

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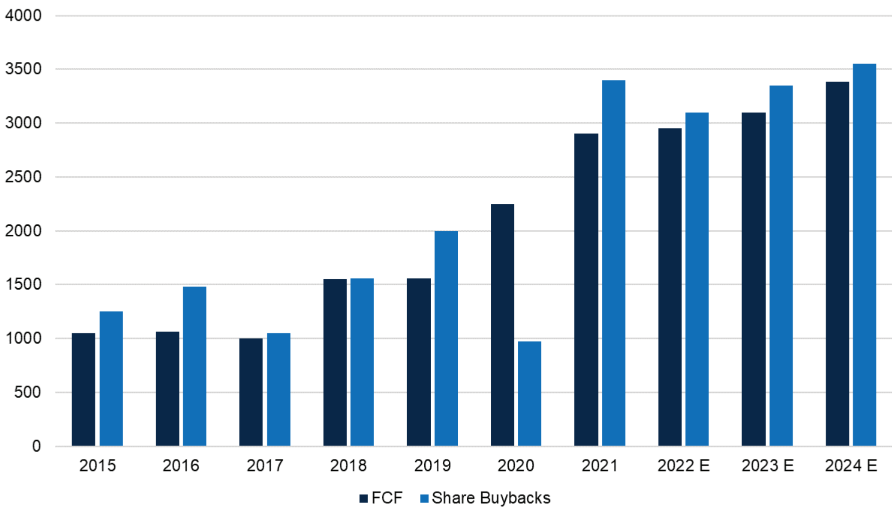
- **Mega hubs:** AutoZone separates their stores into three groups: satel-litestores, hubs, and mega hubs. Traditionally, AutoZone focused on satellite stores. They are now concentrating on hubs and mega hubs as they are more efficient and drive higher sales.

- **Share Buybacks:** AutoZone's share repurchase program has boosted shareholder value by directing the FCF at buybacks, while remaining at an attractive valuation. Unlike some companies who spend excess cash flow on dubious acquisitions, this company doesn't. In March 2022 AutoZone announced the repurchase of an additional $2.0 billion of the Company's common stock in connection with its ongoing share repurchase program. Since the inception of the repurchase program in 1998, and including the above amount, AutoZone's Board of Directors has authorized $31.2 billion in share repurchases.

Are Electric Vehicles a threat to AutoZone's success?

With the rise of Electric Vehicles should there be cause for concern about the future for AutoZone? Electric Vehicles have far fewer moving parts, no engine oil, many have no transmission fluid, etc. On top of that the U.S. government plans to end purchases of gas-powered vehicles by 2035 as they want to lower emissions and promote electric cars. This is great for companies such as Tesla and Ford, but a potential headwind for automotive retailers such as AutoZone. I mean, how long did it take for Blockbuster to go under after Netflix hit the scene? AutoZone will need to adapt their business to be able to supply parts for EVs. One thing to remember though, is electric vehicles may have different engines, but they still have windscreens, doors, wheels etc which still need to be maintained or replaced. Saying all of this, I think we are a long, long way off from electric vehicles replacing normal vehicles.

FIGURE 2: AutoZone FCF vs. Buybacks

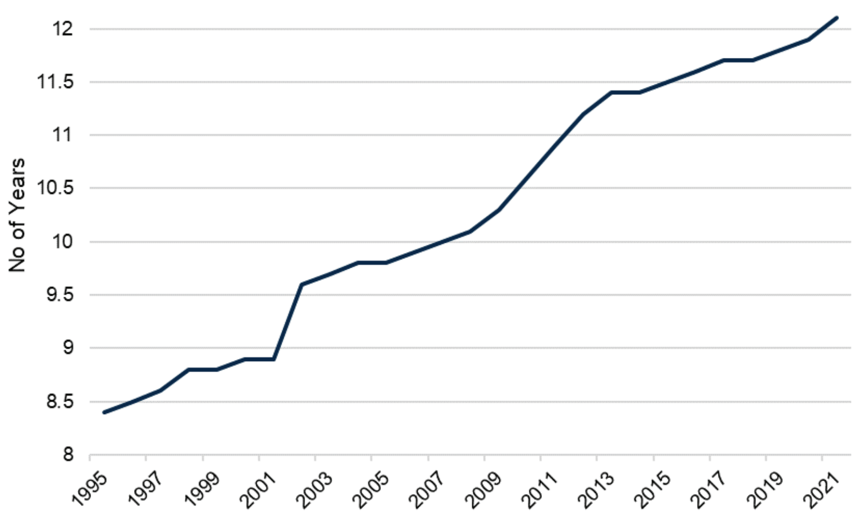


Source: Wilcox Research

AutoZone is setup for success in coming years

The Covid-19 pandemic with its supply constraints and a tough economic climate have supported the idea that automotive retailers are somewhat recession resistant. This is because stressed consumers are less likely to purchase new vehicles during economic hard times but will instead opt to repair and/or maintain their existing vehicles to save money. Considering the U.S. is currently teetering on the edge of a recession or may already be in one, this may be a driving force for AutoZone. The average age of the vehicle pool in the US continues to rise, hitting a new record with an average age 12.2 Years.

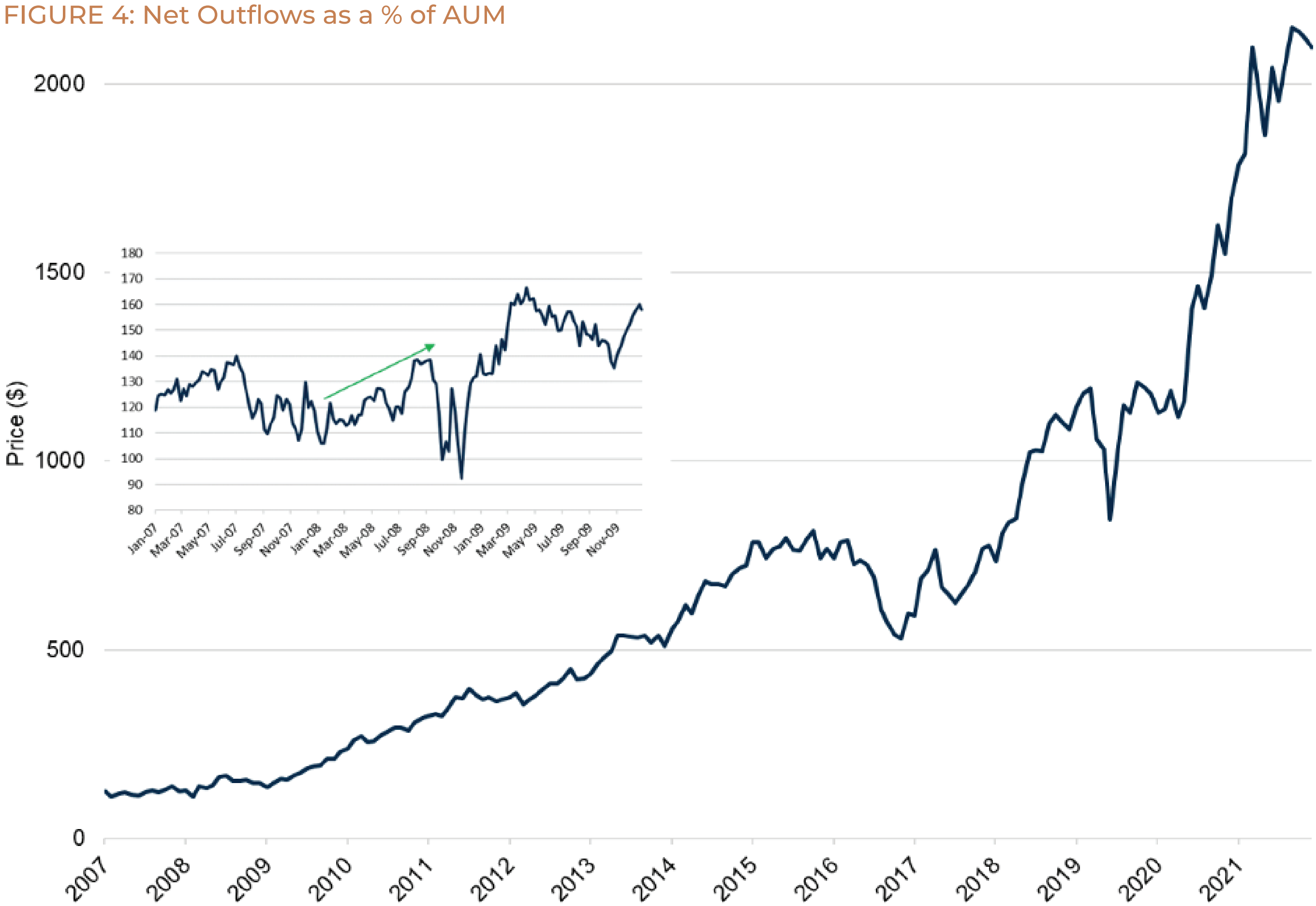
FIGURE 3: US Total Average Age of Light Vehicles



Source: Bloomberg

History confirms this as AutoZone performed well in prior recessions. For example, during The Great Recession of 2008, AutoZone grew sales and its stock gained 16% while the S&P 500 dropped 37%.

FIGURE 4: Net Outflows as a % of AUM



Source: Bloomberg

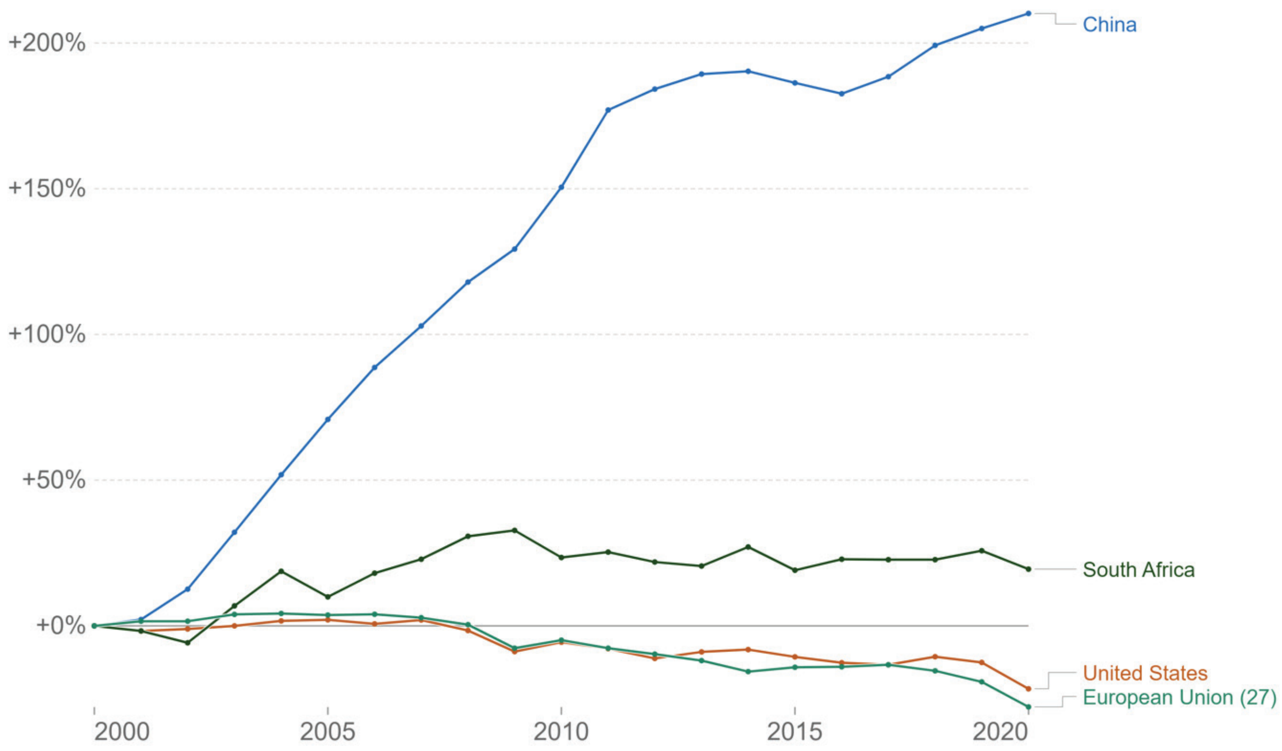
AutoZone has been a better way to play the Automotive industry in the US, rather than buying companies such as General Motors and Ford and it seems AutoZone will continue to thrive notwithstanding inflation pressures or recession risk.

With performance history as reliable as an old Toyota - AutoZone is an example of slow and steady wins the race.

Chart Focus:
Burning the Planet to Grow

Since 2000 when the world started to get serious about emissions, Europe and the USA have been able to achieve reduction. Chinas emissions have now more than doubled. Getting emissions to stop rising and reduce is now completely in the hands of China.

FIGURE 1: Change in Annual CO2 Emissions



Source: Our World in Data

	2020 emissions (tons)
China	10.7 billion
United States	4.7 billion
European Union	2.6 billion
South Africa	452 million

First the good news. The USA and Europe have shown that setting out goals and policies to reduce emissions do work. They even fell during Donald Trump's term. A lot of these policies are now set and have broad support of developing countries corporates and citizens. Europe has clearly achieved a lot with almost 1 trillion reductions in emissions (about 25%). Of course, Europe has grown slower than the USA and does not have a large oil and gas sector like the USA. So, for all the flaws with current policies, both in the USA and Europe, a reduction has been possible. The biggest flaw is that there is no serious repercussion for a flagrant corporate. They do not have to shut down, nobody goes to jail and certain offenders even use the current mania for green bonds to lower their interest burden.

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This luck of consequences while bad at a regional level, is catastrophic at a global level when all the good work of the complying nations is undone by China. China does have a policy document for a net-zero carbon emissions target but no visible results.

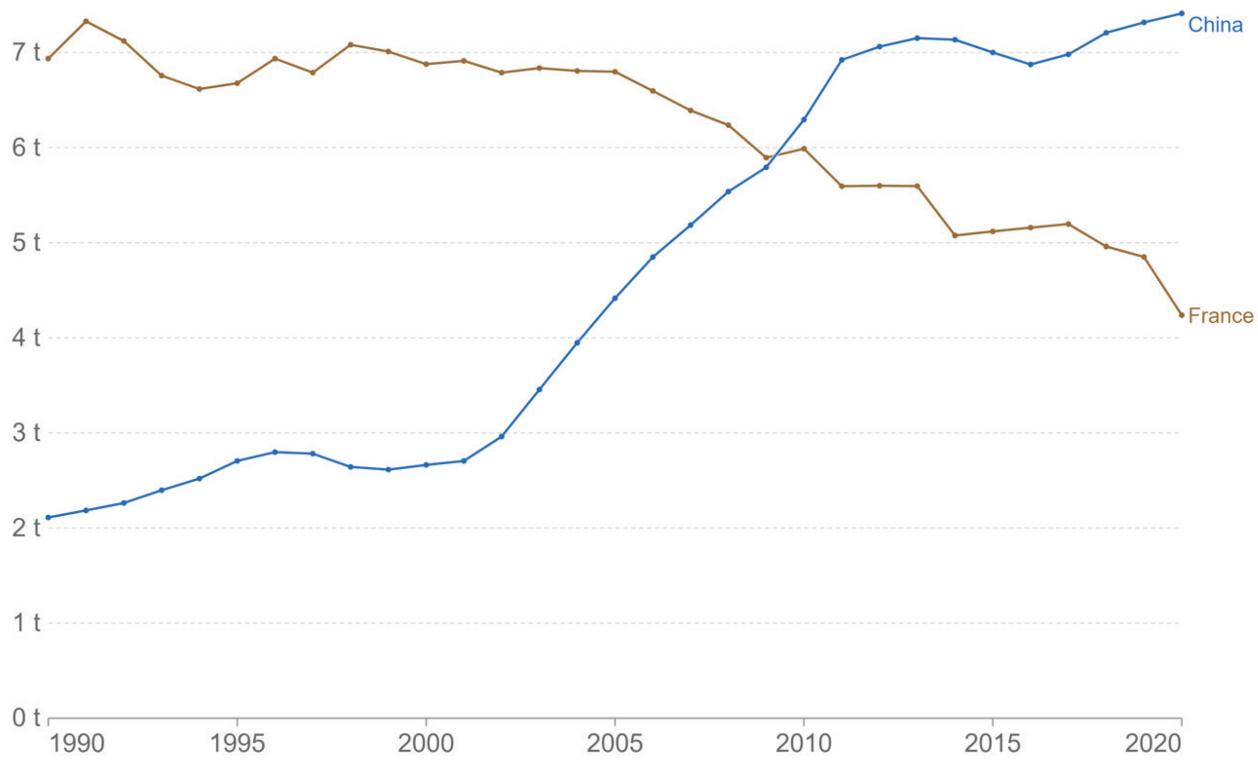
Of course, China has more people than the USA and has grown quicker than the USA up until 2019 but in per / Capita terms it's still bad. Below is the per capita graph comparing France to China. France's per Capita emissions have fallen by some 25 % over the last 20 years. China now has a higher Emissions per capita than France. So, Chinas economic GDP growth is getting more inefficient. I could also say its economic growth is getting dirtier. Normally you would expect wealthier countries to have higher emissions per capita, but not for China. France's GDP/capita is $38 000 vs Chinas $13 000. Therefore, each dollar of GDP created, China is emitting 5x more CO2 per person than France.

The Pandemic certainly made China stray even further from any emissions targets they might of set. Firstly, as they worried about the economy, they juiced up infrastructure spending, (always dirty) and then gave an extra push to the export sector. We can also expect this year and next year to be worse in terms of emissions because of the drought that is plaguing China. The Three Gorges hydroelectric scheme can generate over 22 gigawatts.

Two more generators upstream of the Dam on the Yangtze are among the world's biggest six. However, a drought has led to drying of the river so that hydro generation has fallen by 50%. To fill that gap China has turned to Coal. Not just a couple of tons, about half a billion tons more. That's the equivalent annual consumption of the USA.

The thinking of the Policy makers is extremely short term. So, the drought is clearly caused by CO2 emissions of which they produced 11 Billion of the 35 billion. And their solution is to produce more coal. For China energy security is more important than decarbonization.

FIGURE 2: Per Capita CO2 Emissions



Source: Our World in Data

Investment Focus: HOLT - ROE vs CFROI

When analysing a business' returns, investors will find no shortage of metrics to apply. For a measure to be appropriate it needs to measure some sort of fundamental value created by it's operations, regardless of accounting choices and capital structure. Similarly, we might want to compare firms to one another and to their own histories. Bearing this in mind we examine some common measures, try to improve them, and eventually show why we prefer CFROI.

Return on Equity

ROE is a widely cited measure in corporate literature. It is intuitive and simple to calculate. Defined as the after-tax earnings attributable to the equity owners of the business, it may seem to make sense if we were considering buying shares in the business. Unfortunately, this widely used metric is influenced by more than just the operations.

Debt, and its resulting gearing effect on earnings pre-sent a complication when comparing firms to one another. In exhibit one, we show two businesses with different capital structures, and otherwise identical characteristics. Both these businesses are going to be shown in two states, one in a \ stable environment, and one where they experience a bumper year.

During stable times, Co.A returns an ROE of 1.8% vs Co.B's -2%, using ROE as our guide we should prefer Co.A. But if we examine the same businesses, under an expansionary environment, Co.B's 5%% trumps Co.A's 4.5%. We see that ROE is easily impacted by leverage, making it not very helpful when comparing businesses with differing capital structures.

ROIC

So rather than make some adjustments to improve on this – instead of looking at a firm's equity, we can scale the return by the asset base. Here we are looking for what generates the return, namely net non-current assets. We also want to include the balance of current assets and liabilities; because in practice these are both part of working capital and are managed in tandem in the daily operations of the firm. So instead of keeping them on opposite sides of the ledger, we rather see the net figure.

ROE to ROIC					
	Stable Environment			***Expansionary Environment***	
	Co.A	***Co.B***		***Co.A***	***Co.B***
EBIT	*20*	*20*		*50*	*50*
Interest at 6%	*0*	*-29*		*0*	*-29*
Tax at 25%	*-6*	*3*		*-15*	*-6*
Net income	*14*	*-5.95*		*35*	*15.1*
Current Assets	*250*	*250*		*250*	*250*
Non-Current Assets	*750*	*750*		*750*	*750*
Total Assets	***1000***	***1000***		***1000***	***1000***
Current liabilities	*225*	*225*		*225*	*225*
LT Debt	*0*	*475*		*0*	*475*
Equity	*775*	*300*		*775*	*300*
Total Equity and Liabilities	***1000***	***1000***		***1000***	***1000***
ROE	*1.80%*	*-2.00%*		*4.50%*	*5.00%*
ROIC	*1.80%*	*1.80%*		*4.50%*	*4.50%*

ROE is volatile over different capital structures, while ROIC returns the same regardless of funding.

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Since we are now interested in the firm's return on the asset base, we need to adjust our net income figure too. The effect of debt is still present as the interest paid component of the income statement, so we can add back this amount (i.e. it's after tax equivalent) to arrive at the firm's NOPAT.

Readers of our previous newsletter (Q2 2022) would recognise what we have derived here is ROIC. And what we can observe is that we now see a return that is identical between A and B, despite their differing structures.

In both our previous articles and now, we have employed performance metrics to compare two firms, but only at a single point in time. What happens to our measures as the assets age?

CFROI

Here we will examine another Co.C, and look at these effects over time.

In most industrial companies the Invested Capital total is usually some form of plant, measured at its net value (Cost less accumulated depreciation). As we move through the years this diminishing asset value will incrementally flatter the ROIC figure, and even with no change in NOPAT of the business. we see the ROIC figure rise. This doesn't mean the economics of the business improve as the business matures, this means this metric isn't comparable over time.

So far, we have mostly 'fixed' the denominator, without changing too much about the numerator – relying mostly on stated accounting earnings. These published figures are the result of what is left after all costs associated with operating the business as deducted from revenue. However, what is classified as an accounting expense is often left to the CFO to decide.

A famous example is expenditure that is intended to generate future cash flow (like Research) which should be classified as investment, not an expense. And while reclassifying the expenses as a form of investment may help us adjust for such (not too uncommon) anomaly, a firm's measure of profitability and ultimately its quality should be something objective and not one open to interpretation. Therefore, we want to rather look at cashflow as the return.

Starting from our Net Income Cash flow is obtained through the reversal of the noncash charges (depreciation, revaluations) and the deduction of the capex paid, as well as accounting for the working capital changes.

Using this cash flow figure and scaling it by the investment figure we calculated a 13.2% return, which remains constant over the lifetime of the project, as it should, given the economics of the business are the same over the period in our example. And to prove the validity of the figure, calculating the firm's IRR over this period will yield the same return..

CFROI provides the investor with an objective measure of corporate performance and forms the first step in BlueAlpha's research process. By incorporating CFROI the investor is greatly advantaged to identify firms that truly create value. (1)

ROIC to CFROI						
	Today	Y1	Y2	Y3	Y4	Y5
Net Income		100	100	100	100	100
Gross Non-Current Assets	500	500	500	500	500	500
Depreciation		100	100	100	100	100
Accumulated Depreciation		100	200	300	400	500
Net Non-Current Assets	500	400	300	200	100	0
Working Capital	200	200	200	200	200	
Total Gross Assets	700	700	700	700	700	
ROIC		14.30%	16.70%	20.00%	25.00%	33.30%
CFROI		13.20%	13.20%	13.20%	13.20%	13.20%
Net CF	-700	200	200	200	200	200
IRR	13.20%					

**Footnote: There are further adjustments in the complete definition of CFROI that adjust both numerator and denominator into the same units of purchasing power. These have been omitted for the sake of space but will be covered in forthcoming articles.*

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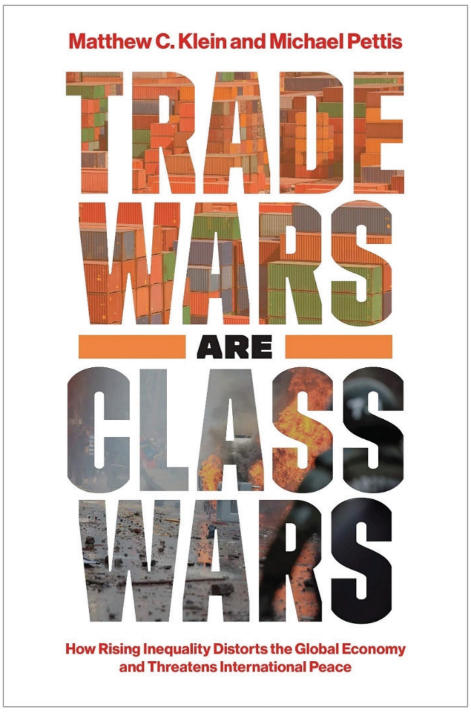
Recommended Read:

Trade Wars Are Class Wars *by Matthew C Klein & Michael Pettis*

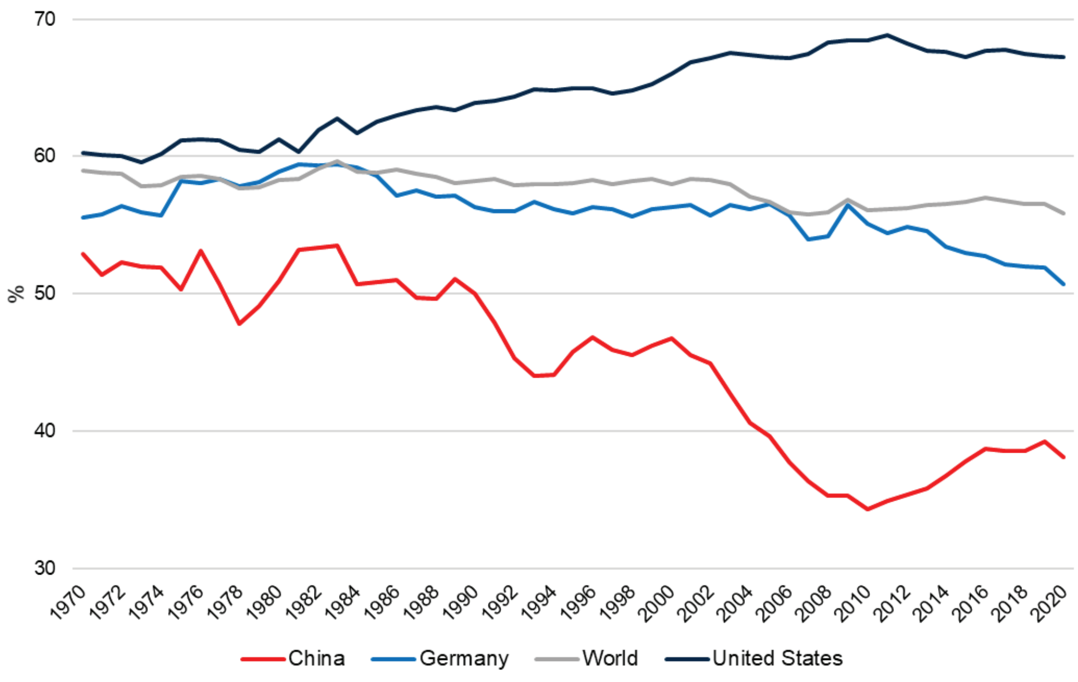
Which is better a trade surplus or a trade deficit? The short answer is neither. The conventional view is that trade surpluses are good and a desired outcome.

This book argues that you should rather view persistent deficits or surpluses as a function of a countries trade policies and not because a country has a more productive workforce. They go on to link trade policies enacted by countries wishing to chase export growth with the cost of those policies hurting the domestic worker. Hence the title for the book. An easy example would be a country giving tax incentives to a certain export sector. It might boost those exports but to pay for those tax incentives the county raises taxes on the household sector. Most countries have seen falling tax rates for corporates and rising taxes for individuals. However China's tax rate is still at 25% while Germany's tax rate is much lower at 15%.



China for example, produces many consumer goods at a cheaper cost than other countries can and so its share of global exports have risen. But this export competitiveness comes about from low wages, scant regard for environmental pollution and state subsidies. Europe and the US have manged to reduce CO2 emissions, but China's have skyrocketed from 3.44 billion t in 2000 to 10.67 billion t in 2020.

FIGURE 1: Chinese household consumption's share of GDP is one of the lowest in the world



Source: World bank

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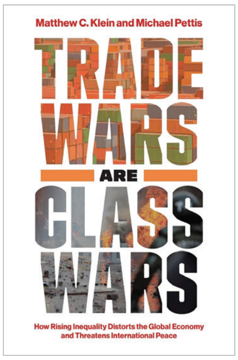
If a country is really successful, imports and exports should be rising but because China chases export growth at the expense of the household sector its import demand is quite muted. The story of the last 2 years has been how poor the Chinese consumer demand has been. Chinese trade policies have effectively reduced the purchasing power of their citizens. One way to plot this is to look at HCE as a % of GDP. This is why for all of China's economic GDP success, GDP/ capita is just above Bulgaria. *



Too few countries ask the question how can we boost domestic demand? The answer to that question is countries need to increase disposable income, wealth per capita, provide protection of property rights and lastly provide policies that are stable, consistent and transparent. Of course China is doing none of that, because like most politicians, cutting the ribbon on the opening of a new bridge looks good on TV.

Look at the mess in SA regarding poultry import duty and scrap steel. Import duties on clothes in South Africa are 40%. That cost is paid by all households in South Africa. Every new year means many poor South African households have to pay out this extra cost.

So the world is now one where household demand is very anaemic with the exception of the USA. So most countries seeing this feel they must enact policies to chase this diminishing demand but collectively end up shrinking global demand. Notwithstanding the current supply issues post recovery from Covid in general there is too much global capacity for supply and too little household demand.

Of course countries policies are sometimes so entren-ched that they just remain features of that economy regardless of circumstances. So China continues to provide more debt to the corporate sector and other supply measures when the demand side of the economy needs to be fixed. South Africa continues to reject foreign investment (based on ideology from the 1960's) to stimulate the economy and rather tinkers with poultry imports.

South Korea encourages more big manufacturing plants, and lastly Australia sees high house prices as vindication of policy rather than address the detrimental impact on household disposable income. So unfortunately it takes a lot, (normally a crisis) for a country to switch paths.

So the next time SA goes into a trade deficit don't get fearful, it could be that the SA consumer has recovered their confidence and are spending their well earned income.

GDP per Capita ($) 2021: China 12556.3, Bulgaria 11635.0

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	**-3.6%**	**5.8%**	**5.2%**	**7.1%**
SA Equity – General Sector Average	1.8%	8.5%	5.3%	5.0%
Benchmark**	-1.3%	7.3%	5.6%	5.9%
Out-Performance to Benchmark	-2.3%	-1.5%	-0.4%	1.2%

** 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.

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