AYLETT BALANCED PRESCIENT FUND
Q4 2023 COMMENTARY

FUND MANAGER COMMENTARY

MARKET REVIEW

The United States entered 2023 with an inverted yield curve – traditionally a predictor of a recession - this being the result of a large and rapid kick-up in rates in the prior year and precipitated a mini-banking crisis. There was much concern about what other unintended consequences might emerge.

However, inflation came down faster than expected and that elusive soft landing began to look more likely than it did a year before, with the economy proving to be stronger than expected.

Expectations of more rate hikes shifted to no more hikes and then even cuts as Powell turned more dovish, resulting in bonds rallying hard at year's end.

Just as it seemed that big tech was coming back to earth; AI dominated the headlines giving their stock prices a substantial boost.

Moving onto South Africa, in January loadshedding went from bad to worse, fuelling the anti-SA sentiment, further depressing SA Inc share prices. The concerns we had about other infrastructure such as water, ports and rail unfortunately began to prove valid.

Index	Total Return %
Nasdaq TR* Index	68
S&P TR* Index	26
ALBI TR* Index	10
JSE All Share TR*	9
USD/ZAR	8
World Bond Index	5

**Total Return assumes dividends and distributions are reinvested.*
***Source:** Bloomberg, 31 December 2023*

Globally, equities were the best-performing asset class last year – more specifically, global technology stocks. In South Africa bonds were the best-performing asset class, narrowly outperforming the JSE All Share Index and Cash (Stefi). With the benefits of hindsight, the perfect portfolio would have had maximum exposure to global equities with as little rand exposure as the mandate allowed (Rand depreciated 8% vs USD).

FUND PERFORMANCE

The fund returned a respectable 11% for the year, outperforming South African equity and bond markets. However, it lagged its benchmark slightly due to not participating in the strong global tech rally. Investing in "long duration" assets (where most of the value lies in expectations of huge returns a decade out) can be perilous and is not our style. We simply do not find sufficient margin of safety in these assets should lofty expectations prove too optimistic.

From an equity perspective, strong performances from Reinet and Jumbo contributed positively for the year, helped by some smaller SA Inc positions such as **Curro**, **AECI**, **Spur** and **Transpaco**. Against this, the fund was hurt by its exposure to **Transaction Capital**, **Impala platinum** and **British American Tobacco**.

The funds’ holding in South African government bonds contributed significantly to its total return and it is pleasing too to see that the chosen bonds outperformed the All Bond index.

CONTRIBUTORS

Reinet is the fund's largest holding and appears as the top contributor for a second year in a row (here's hoping for a hat-trick!). Reinet is a holding company trading at a substantial discount to net asset value. Its biggest asset is its investment in Pension Insurance Corporation, which we mentioned last year had a long runway for growth as a result of the increase in the number of defined benefit funds in a position to be bought out. In 2023, that proved to be the case, with Pension Corp executing on the opportunity and the market starting to reward them for it. Reinets' strong performance was achieved despite its investment in British American Tobacco. Notwithstanding British American Tobacco's robust and growing free cash flow generation, the share derated during the year. Challenges in the U.S. combustible market and execution missteps on the next-generation nicotine portfolio hurt investor sentiment and sent the shares to new lows. BAT is being valued like a business that will cease to exist over the next decade - an outcome we deem very unlikely. In addition to the exposure we get through our holding in Reinet, we also own BAT directly in the funds and believe the share price is well below a very conservative estimate of fair value.

Jumbo, an Athens-based retailer of everything from bath toys to ballpoint pens, experienced an outstanding year. The company demonstrated significant revenue growth in its existing stores and expanded by opening new stores in new geographies. Jumbo's retail strategy resonates well with its customers, resulting in a year of impressive results and a swift increase in its share price.

DETRACTORS

Transaction Capital had a terrible year, with its share price declining 89% from peak to trough. The sell-off was driven mainly by poor performance from its taxi financing and refurbishment company, SA Taxi. A combination of bad luck, a weak economy, COVID-19, and management errors resulted in the business performing very poorly. Nutun and We Buy Cars, the other assets in the group, are performing much closer to our expectations.

While the decline in the value of SA Taxi means that we think the value of the group is unlikely to recover to the price at which it started the year, we think the market's reaction to the events over the past year is overdone. A conservative estimate of the value of the group, excluding SA Taxi, generates a fair value higher than the current share price.

While we may be optimistic about the business's prospects from this point forward, the decline in intrinsic value at SA Taxi means that we have marked down our assessment of the group's fair value materially from what we thought it was this time last year. This is a painful admission to make as we work hard to avoid permanent capital loss. We have spent time analysing the investment process relating to Transaction Capital, learning a number of lessons from the experience.

2023 was a tough year for **Impala** and the PGM miners generally. The platinum group metals basket price declined from a high of over R36 000 per PGM ounce to R22 000 per PGM ounce at one point, weighing on earnings and share prices. The PGM basket price is now well into the cost curve, a situation that can't last forever. Either the metal prices recover, or supply is cut, or both. South African PGM miners were slow to cut supply in the last down cycle, and it remains to be seen how fast that happens this time. Amplats, Impala, and Northam (three of the four biggest producers) all have strong balance sheets after the last upcycle. This gives them the ability to suffer, so it may be a while before they are forced to cut supply - the industry may be in for a prolonged period of pain. We note that recent electric vehicle demand has surprised analysts and car manufacturers on the downside, which means internal combustion engine demand may well surprise on the upside, driving PGM demand.

NOTABLE CHANGES TO THE FUND

Total bond exposure was reduced through the year in favour of offshore equities. The bond portfolio was relatively stable except during the "Lady R" crisis, which we used as an opportunity to extend duration slightly.

On the equity front weakness in the **Transaction Capital**, **British American Tobacco**, and **Ninety One** share prices gave us an opportunity to deploy more capital into those ideas. Fairly low banking exposure was held through the year but, in Q4, **Firstrand** was added to during a period when the market was unimpressed with their bid for a foreign asset. So far this has worked out well.

Positions in both **Sonic Automotive** and **Woolworths** were exited. The rapid price appreciation of **Reinet** meant that it had to be trimmed more than once, to avoid being too large and out of mandate.

Overall equity exposure increased from 64% to 71%.

OUTLOOK

We enter 2024 with an expectation that less load shedding is imminent as repaired Mudupi and Kusile units are brought back by Eskom and private power production grows. It is an election year, one in which governments understand the importance of pulling out all the stops. Positive noises are being made around privatising infrastructure (port power and rail). However, talk is cheap, and we watch closely to see what progress is actually made.

Globally, the US, the UK, and the Eurozone all are running large deficits. In order to fund these deficits a large number of bonds will need to be issued this year. Something we are keeping a close eye on. Inflation has receded faster than market expectations, but we remain cautious – it is still far from the 2% Fed target, and the US economy has yet to falter. Rate cuts may not start as early as the bond market is pricing in.

At >70% equity exposure, the fund is fairly fully invested, a reflection of the number of attractive investments we have been able to find. Officially, the fund is 34% offshore but, on a see-through basis, that number is closer to 54%. Exposure to South African sovereign bonds remains greater than 20%, with the bulk of that exposure in the 8-year space.

There's a great deal in South Africa to be concerned about. This pessimism may well be justified but it has served to provide us with very cheap share prices. Our job is to take advantage of Mr Market. It is our experience that when exuberance abounds, things are never really as good as perceived. On the other hand when extreme pessimism takes over, it is normally not as bad either. Maintaining a clear, rational perspective and investing when the odds are in your favour is the only way we know. This is what we shall do.

Dagon Sachs

31 December 2023