FIRST AVENUE
INVESTMENT MANAGEMENT

Portfolio Management Report: Q2 2019

FUND MANAGEMENT REPORT: Q2 2019

Investing in the Highest Order of Value

First Avenue is an intrinsic value equity manager investing exclusively in high quality companies. The objective of our investment style is to grow our clients' wealth through the consistent application of our investment philosophy and process over long periods of time. We list below the simultaneous conditions necessary for this outcome to materialise.

1. We forgo opportunity to outperform the market during periods of over-valuation (momentum) due to either trend exuberance or risk acquisition:

These are periods when: (i) the valuation of most securities on the market do not reflect sufficient margins of safety, and (ii) the psychological and emotional make-up of investors who dominate market activity is one of valuing one's gains more than one's losses. We refer to our results during these later stages in the business and market cycle as our pain trade.

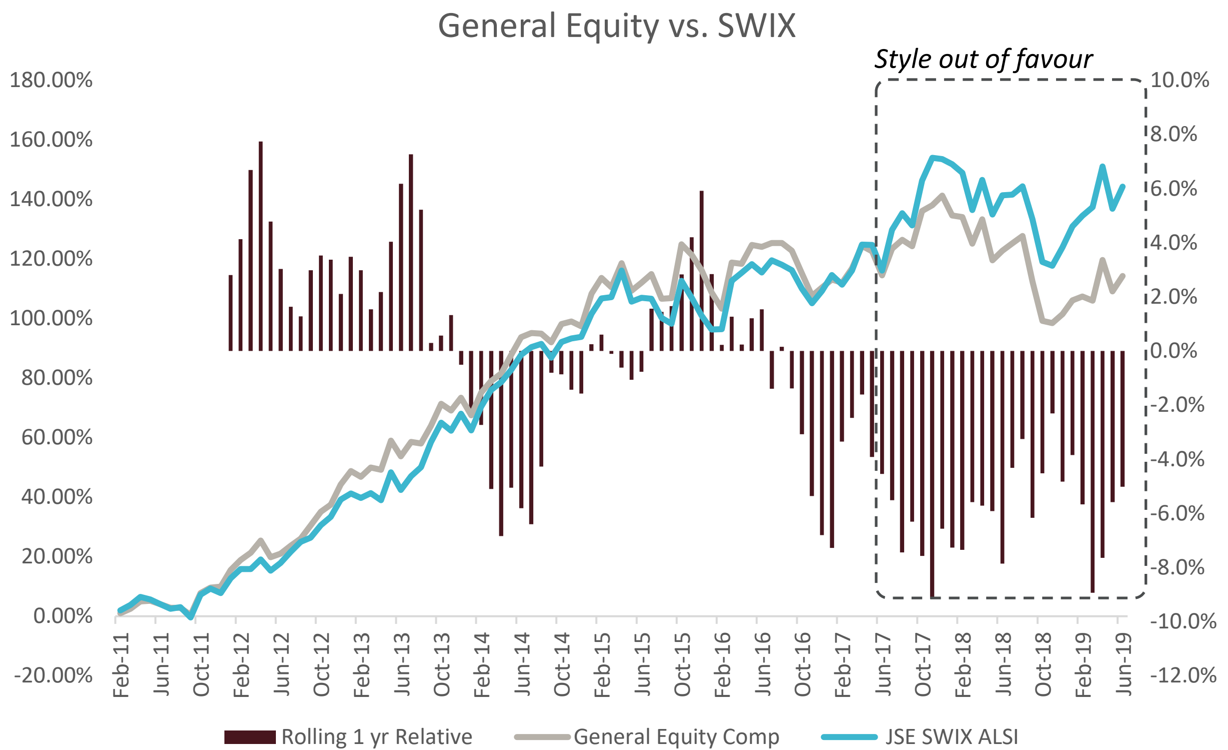
2. Our clients stay with us for extended periods of time:

By foregoing momentum related returns, investors in our funds appreciate our ability to: (i) avoid significant capital losses when the stock market corrects from over-valuation (momentum), and (ii) continue to grow from a higher base than a market-corrected level. Through this phenomenon, which is referred to as compounding, we aim to double our clients' investments with us every 3.9 years at the high end and 5.5 years at the low end. This works out to an average compound annual return of between 12.25% and 19% depending on where in the cycle a client invests with us. To further explain, 12.25% is our view of the cost of equity in South Africa, which is the bare minimum an equity investor should earn and 19% is the average annual compound return on the All Share since 1960 (the furthest back we could go to find clean data).

Investment Outcomes:

For the first time in three years (since January, 2016), South Africa appears to be in repair mode, and so is our portfolio. At the same time, frailties in the global economy, particularly the US and China, appear to be affecting global cyclicals, which include South African resource equities. Our investment style is directly correlated to the fundamental performance of the best business franchises listed on the JSE. Though some of these franchises are global companies (e.g. British American Tobacco, Anheuser-Busch, Mondi), a sizable number of the companies we hold earn the majority of their profits domestically. Their fortunes have been inextricably linked to South Africa's economic (mis)fortunes which began in earnest in 2015 when former Finance Minister Nhlanhla Nene was abruptly fired by former President Jacob Zuma. No sector typifies this more than South African banks. Domestic banks have been hamstrung by the deterioration in the finances of the sovereign. Domestic retailers and industrials have been hamstrung by low consumer spend and corporate investment respectively. As the new administration of the governing party engages in solutions to repair the finances of the sovereign, investors returned to attractively priced domestic stocks led by the banking sector. During the quarter (Q2 2019), our portfolio performed extremely well outperforming its benchmarks by between 0.3% and 1.1%.

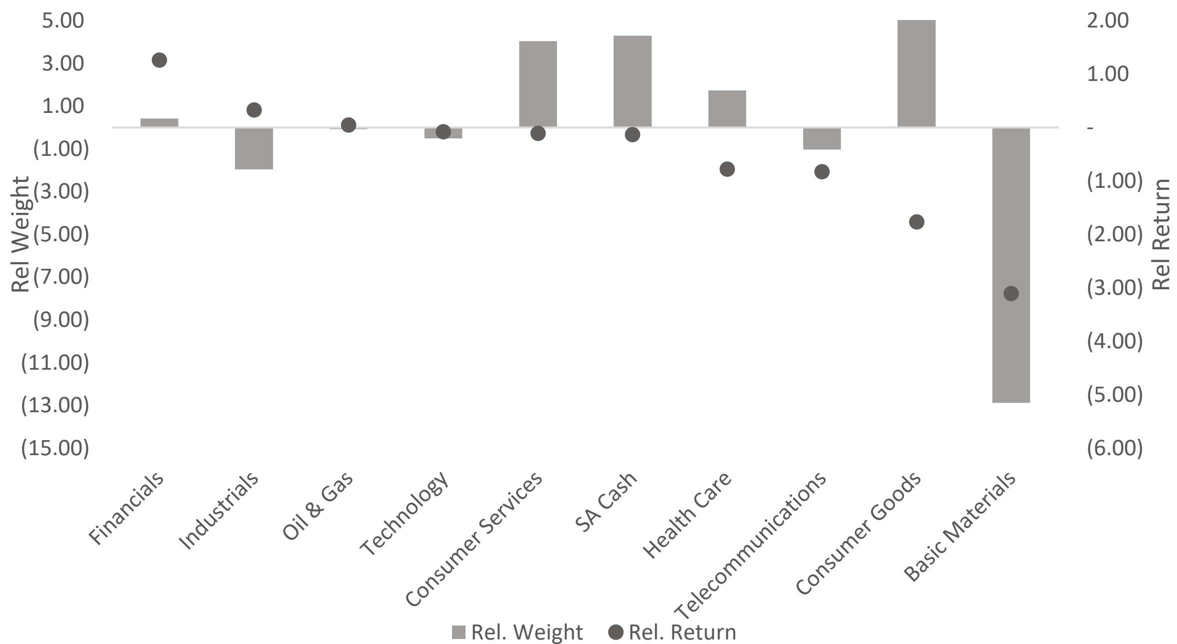
Figure 1: General Equity Composite Investment Performance vs. SWIX: Q2 2019 & Long Term



Style Attribution (Quality vs. Cyclicals)

That said, our portfolios are still materially under water on a cumulative basis over the longer term. It is hard to imagine, but, all the "damage" occurred between Jan 2016 and March 2019. We estimate that 75% of the relative underperformance was Style related (underperformance relative to Cyclicals, in particular, resource equities).

Figure 2: Sector Attribution 1 Year to June 30, 2019



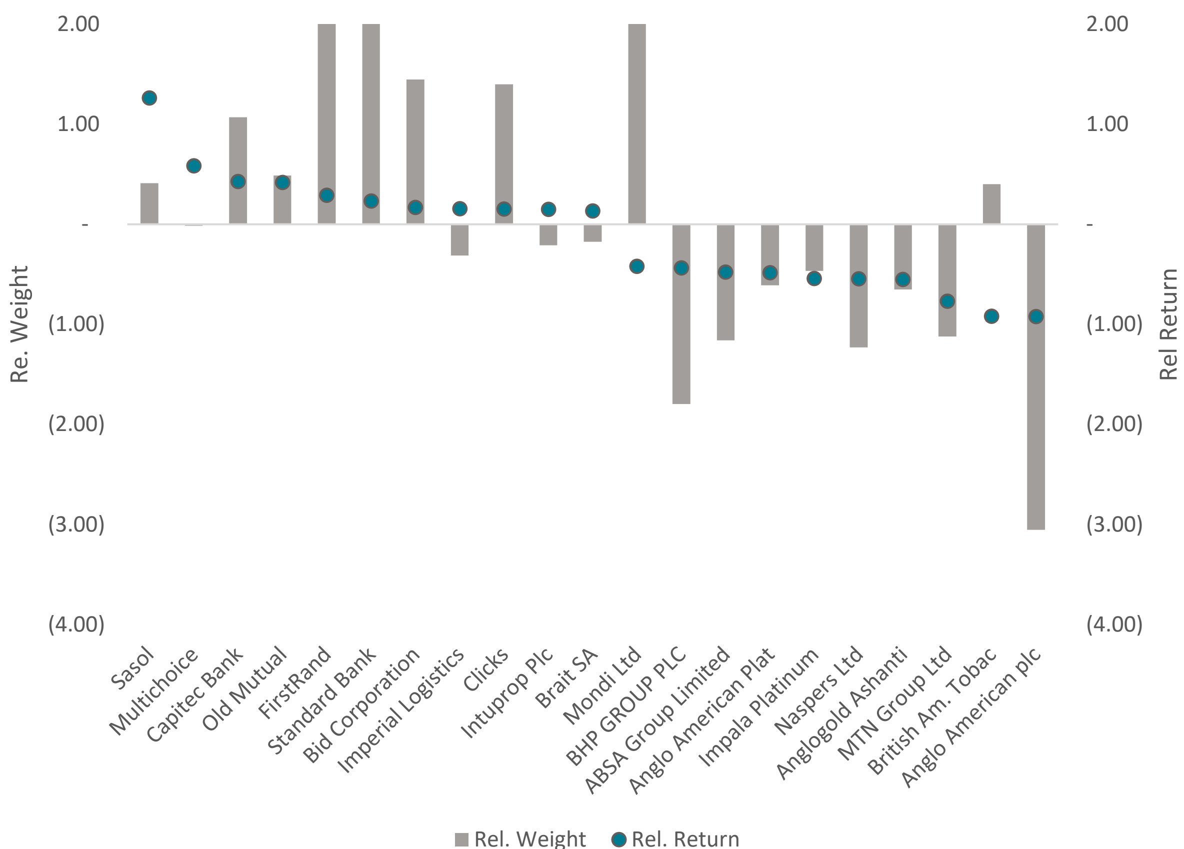
The outperformance of resource equities came at the expense of Industrials and Financials. We will recover from lagging the benchmark as the cycle reverts back strongly in favor of Quality, away from Cyclicals. Q2 2019's relative outperformance is indicative of a potential inflection point in favour of Quality. We say this not wishfully, but because Defensives (Quality) are outperforming Cyclicals in Developed Markets already. This trend has not fully embedded itself in the local market as yet. In fact, in Q1 2019, Cyclicals, particularly, basic materials equities, had their best quarter since 2016. Our view is that South Africa's divergence from global Style trends are unsustainable.

The performance of cyclicals in Q2 2019 shows just how much risk investors were taking in order to augment momentum related returns at the expense of sustainable returns. By contrast, we have been committed to the pursuit of sustainable returns from companies with sustainable competitive advantages. While these companies are often able to handle macroeconomic down cycles, they simply couldn't handle the extraordinary political environment that bred the macroeconomic malaise in South Africa. In trying to find a way out of the morass, these companies, in turn, made mistakes. Our portfolio felt these mistakes.

Stock Attribution

More than a quarter or 25% of our relative underperformance is related to stock specific matters where we made mistakes in our research (e.g. British American Tobacco, MTN Group).

Figure 3: Stock Attribution: Top and Bottom 10 Contributors 1yr to June 30, 2019



As we described to you last quarter, we have not wasted the crisis caused by stock specific errors. In late 2017 and early 2018, we developed a second stage to our fundamental research process by creating a risk management layer we refer to as Negative Selection (M&A, Corporate Criminality,

Forensic Accounting, ESG). This innovation has already yielded significant financial results. In the second half of 2018 and first half of 2019, we avoided many value destroying drawdowns in stocks where we applied the Negative Selection methodology. Out of the top 20 drawdown's over the past 3 years amongst stocks within the benchmark, we were exposed to only four companies. Within most of these companies, our Negative Selection methodology allowed us to exit the stock prior to the largest portion of its decline.

Figure 4: Impressive Results of Negative Selection

	3 Year Return	Key Risk	First Avenue Exposure
Steinhoff Intl	-98%	M&A, Forensic Acc.	N
Rebosis	-91%	M&A	N
Tongaat	-88%	M&A, Forensic Acc.	N
Brait	-87%	M&A	Y
Consolidated Infrastructure Holdings	-86%	M&A	N
EOH	-85%	M&A, Corp. Criminality	Y
Ascendis	-80%	M&A	N
Omnia	-74%	M&A	N
Blue Label Telecom	-73%	M&A	N
Mediclinic	-73%	M&A	Y
Intu Properties	-73%	M&A	N
Arcelor Mittal	-72%		N
Aspen	-71%	M&A	Y
Lonmin	-60%	M&A, ESG	N
Balwin Properties	-60%	ESG, Corp. Criminality	N
Net 1 UEPS	-59%	M&A	N
Fortress REIT	-57%	Corp. Criminality, Forensic Acc.	N
Pioneer Food Group	-56%	M&A	N
Tradehold	-53%	M&A	N
Delta Property Fund	-52%	M&A	N

Source: First Avenue

This improvement to our research process is critical to reducing the depth of the drawdowns our style has experienced relative to both the market and cyclicals. That is, in a perfect, style driven world, our drawdown against the market would be a quarter less than what it is currently. We are better off for building into our research process enhancements that help us avoid such problems in the future. Such problems may come across uncontrollable to our peers. Second, the evolution of our research process demonstrates that we are intellectually honest and not dogmatic about our mistakes. We are, in fact, signaling our intention to be the best Quality manager in the country by being sensitive to client assets.

Future Return Prospects

Our portfolio positioning reflects our deep conviction that Quality and Value very rarely converge on S.A. domestics, particularly, banks. We have an 8% overweight in banks and a 12% overall overweight in S.A. domestics. Banks led the resurgence of Quality in Q2 2019 and we believe their fortunes will continue to shine in the portfolio as: (i) sovereign risk dissipates and (ii) global Style trends of Quality over Cyclicals appear in South Africa.

Figure 5: Sector Positioning vs. Benchmark: June 30, 2019

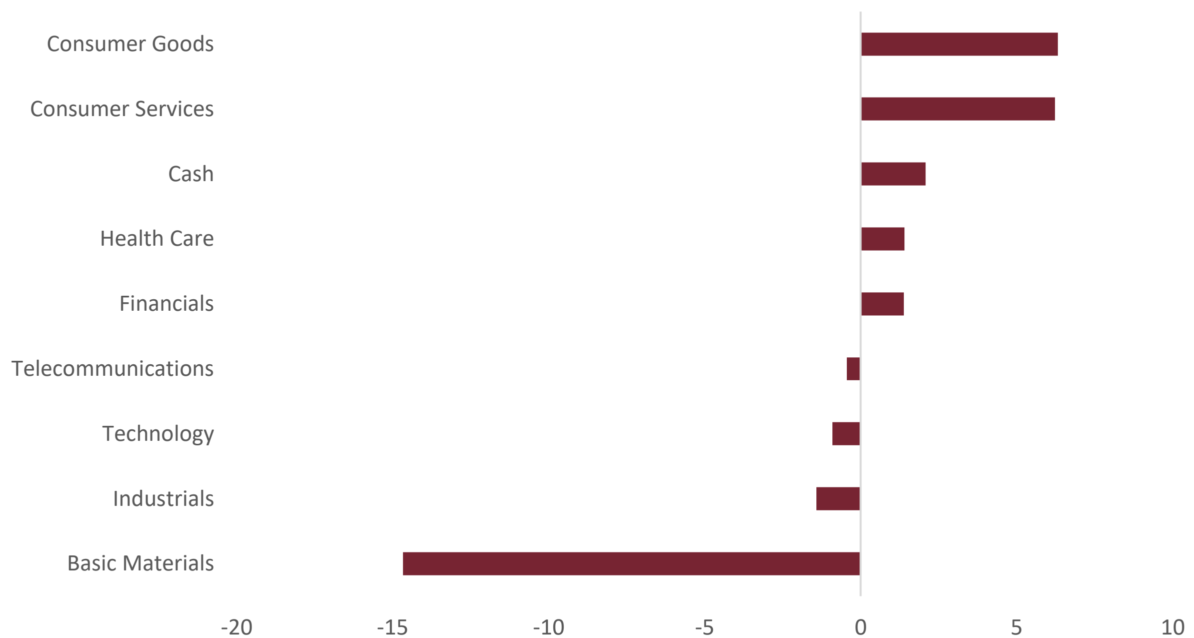
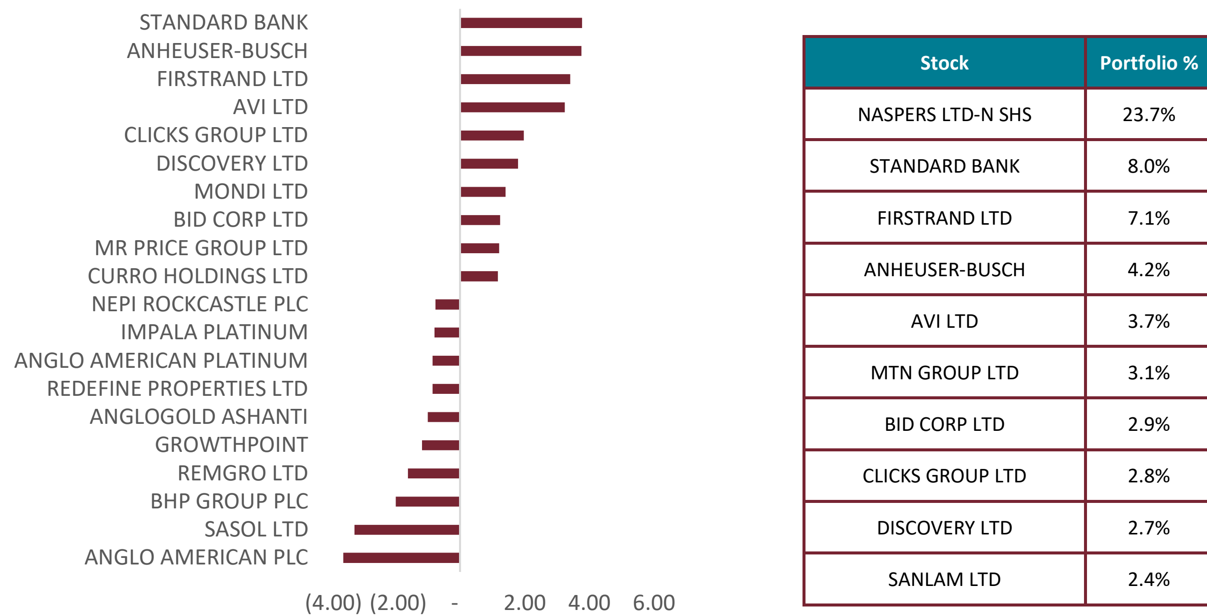


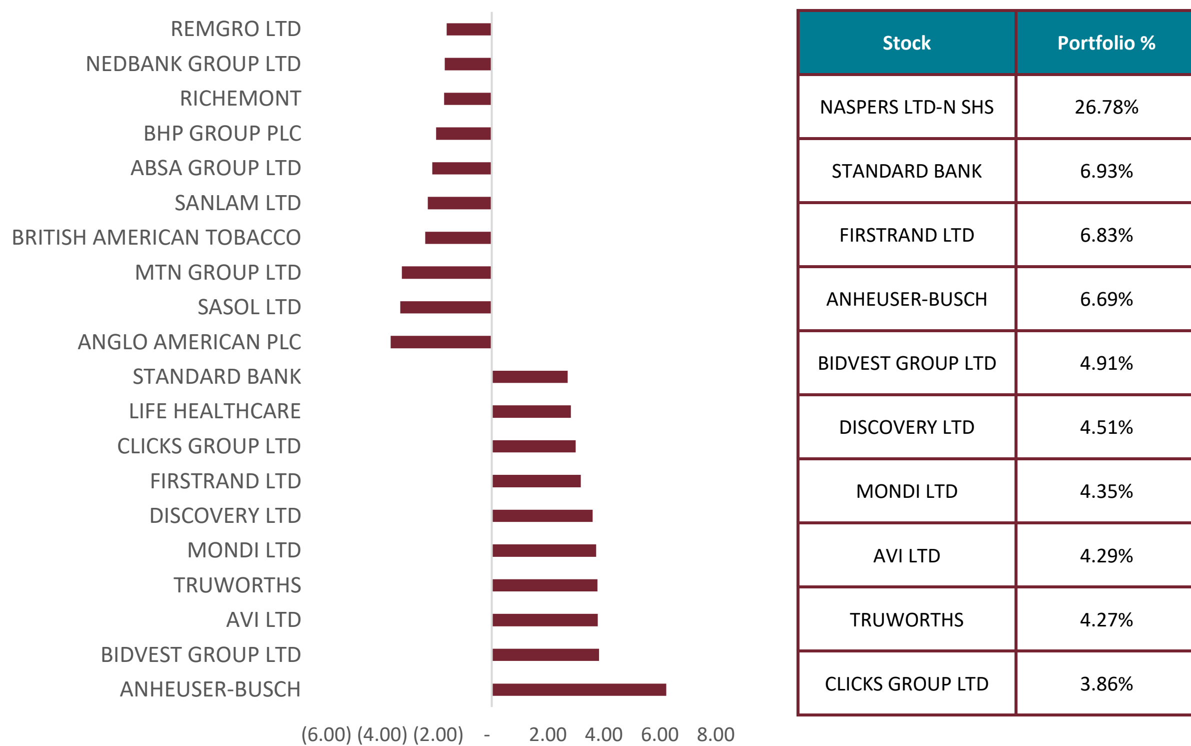
Figure 6: General Equity Strategy Top 10 Bets vs. Benchmark: As at June 30, 2019



Stock	Portfolio %
NASPERS LTD-N SHS	23.7%
STANDARD BANK	8.0%
FIRSTRAND LTD	7.1%
ANHEUSER-BUSCH	4.2%
AVI LTD	3.7%
MTN GROUP LTD	3.1%
BID CORP LTD	2.9%
CLICKS GROUP LTD	2.8%
DISCOVERY LTD	2.7%
SANLAM LTD	2.4%

Source: First Avenue, Bloomberg

Figure 7: Focused Quality Strategy Top 10 Bets vs SWIX: As at June 30, 2019



Stock	Portfolio %
NASPERS LTD-N SHS	26.78%
STANDARD BANK	6.93%
FIRSTRAND LTD	6.83%
ANHEUSER-BUSCH	6.69%
BIDVEST GROUP LTD	4.91%
DISCOVERY LTD	4.51%
MONDI LTD	4.35%
AVI LTD	4.29%
TRUWORTHS	4.27%
CLICKS GROUP LTD	3.86%

Conclusion: S.A. Equities

We are very confident that we have evolved our research capability to avoid "own goals" that showed up in the market this year (e.g. EOH, Tongaat). Consequently, we are a much better firm for the problems we experienced. The only thing outstanding now for our performance to fully repair is the return of Quality over Cyclicals. Globally, defensives have driven the market up this year. South Africa remains the last region where cyclicals are still outperforming defensives year to date. This, we believe, will change as (i) the Government takes steps to improve the sovereign, and (ii) cracks in global growth widen.

Global Equities: The Return of Quality

In the quarter, our global equity portfolios beat the MSCI World due to the resurgence of defensive Quality and a reversal of global cyclicals. This trend has continued beyond the quarter end

Figure 8: Top Ten Holdings: Global Equity Carve Out: June 30, 2019

Stock	Portfolio %
CLOROX COMPANY	8.86%
BERKSHIRE HATHAWAY	8.17%
KAO CORP	7.16%
AMAZON.COM INC	6.93%
LVMH	6.78%
SCHINDLER	6.68%
ROCH	6.60%
VISA INC-CLASS A SHARES	6.36%
M & T BANK CORP	6.28%
MASTERCARD INC - A	6.04%

Figure 9: Global Family Business Equity Fund vs. MSCI World: June 30, 2019

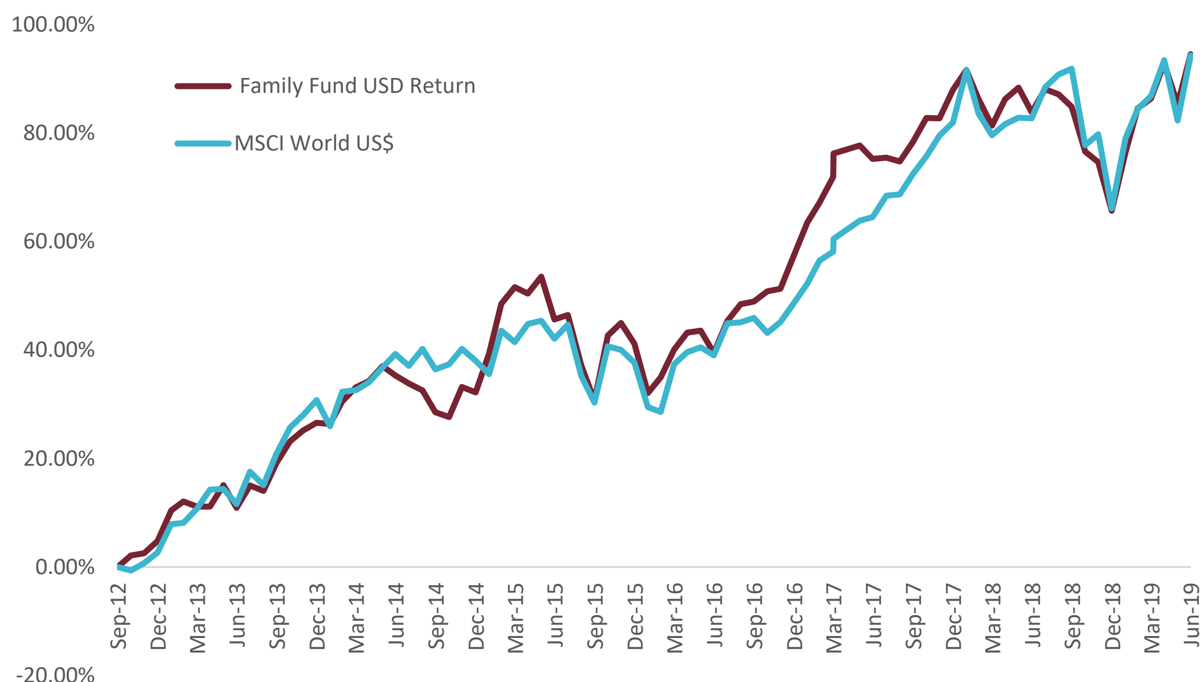


Figure 10: Top Ten Holdings: Global Family Business Equity Fund: June 30, 2019

Stock	Portfolio %
ROCHE HOLDING AG-GENUSSCHEIN	9.85%
BERKSHIRE HATHAWAY INC-CL B	9.75%
SCHINDLER HOLDING-PART CERT	6.03%
HEINEKEN HOLDING NV	5.98%
WALMART INC	5.62%
SAMSUNG ELECTR-GDR	5.27%
REMY COINTREAU	5.25%
CIE FINANCIERE RICHEMONT-REG	4.88%
ANHEUSER-BUSCH INBEV-SPN ADR	4.72%
ALPHABET INC-CL C	4.72%

Conclusion

We are excited about our global equity portfolio and its prospects. It is our considered judgement that Quality will outperform handsomely well into the coming 5 years as cyclical stocks require central banks to prop up conditions for their performance. So far, it seems as if all manager of stimulus has worked in favour of global cyclicals. Investors in those companies do not ask themselves what the damage will look like when, not if, central bankers fail. Our portfolios are well protected from the carnage that will likely ensue.

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