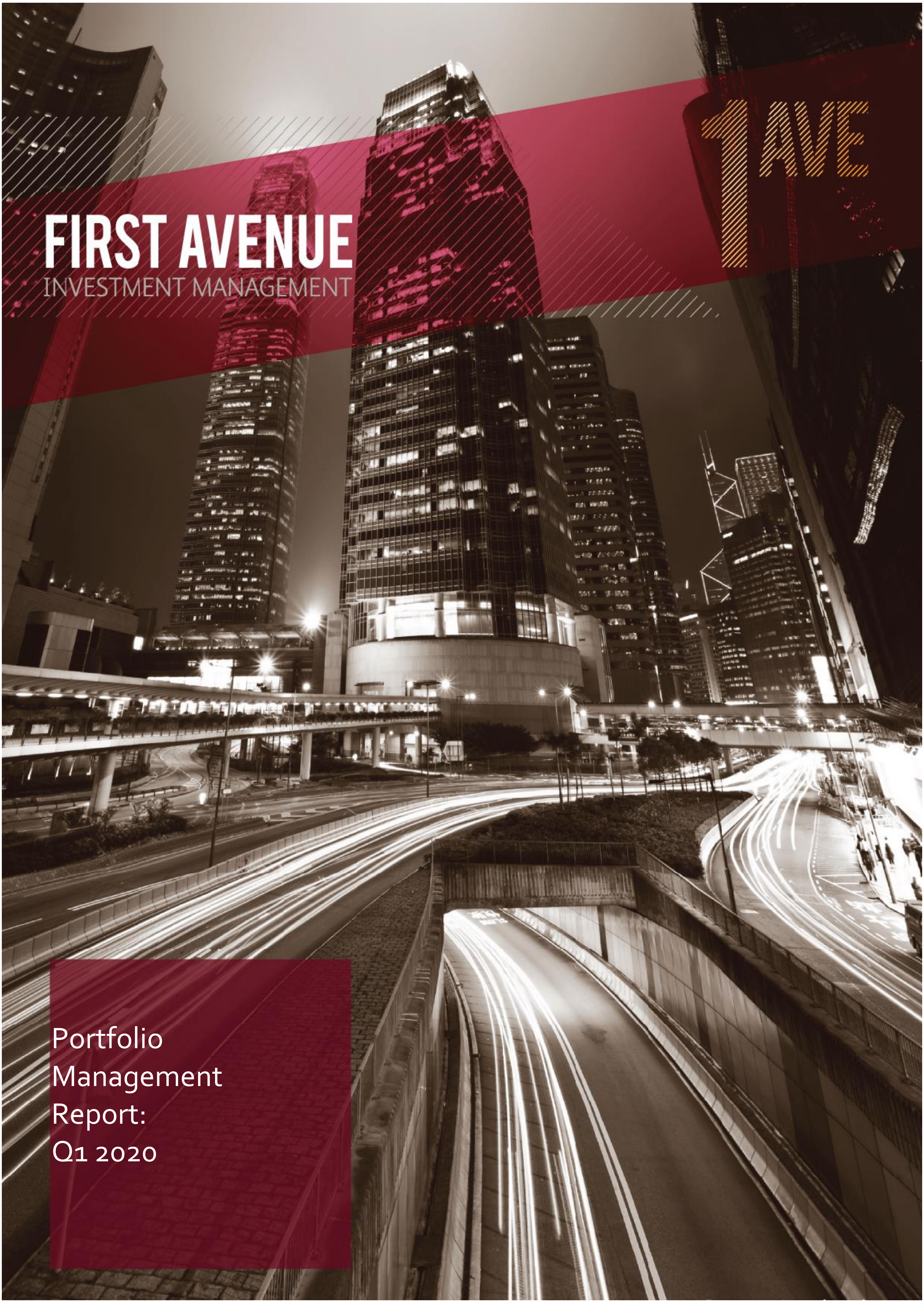


FIRST AVENUE
INVESTMENT MANAGEMENT

Portfolio Management Report: Q1 2020

The Covid-19 Crash – Q1 2020 Results: The Most Defensive Fund in the Land

Market crashes are seminal moments in the lives of investors and clients. Investment outcomes during these moments either confirm or refute the intention of your investment decisions. No moment is more apt to teach you about yourself –who you really are – than a market crash. Managers find out about their clients and clients find out about their managers.

Clients and prospects already knew about our unwavering commitment to Quality Investing. Now, they have also evidenced the efficacy of Quality investing. The table below shows showcases how admirably our South African equity strategies performed relative to the ASISA General Equity unit trust universe. Commensurately, it implies how much Momentum strategies were left wanting during this demanding period.

Figure 1: Table of Quarterly Performance: First Avenue Strategies vs. Peers

Ranks					
	1m	**3m**	**6m**	**12m**	**24m**
Select Focused Strategy (Local + Global)	5	6	8	10	31
General Equity Strategy	75	71	122	106	150
Focused Equity Strategy	57	55	108	105	155
Total Number of Funds	***170***	***170***	***170***	***168***	***163***

Percentiles					
	1m	**3m**	**6m**	**12m**	**24m**
Select Focused Strategy (Local + Global)	3%	4%	5%	6%	18%
General Equity Strategy	44%	42%	72%	62%	88%
Focused Equity Strategy	34%	32%	64%	62%	91%

Quartiles					
	1m	**3m**	**6m**	**12m**	**24m**
Select Focused Strategy (Local + Global)	1	1	1	1	1
General Equity Strategy	2	2	3	3	4
Focused Equity Strategy	2	2	3	3	4

Source: First Avenue, Morningstar

The 3 months in which we gained much needed ground on the General Equity universe weren't just any three months. They were the three months active managers live for. The only known condition in which an active manager is forgiven for lagging the market is if she is in fact avoiding the risk of adverse outcomes as a system scales in size. For the past four years, we simply refused to take the risk that cyclical companies will NOT succumb their leadership of the market in the event of material disruption to the economic system. One does not need to know and identify the source of risk (though we think our concerns on global debt levels came to pass) for one to manage money with diligence and care rather than fear of missing out on market momentum. Quality investing endows a portfolio with the necessary care and diligence to withstand systemic risks.

We have not spoken about our local with offshore strategy yet. This strategy should really be the piece that solves the puzzle for you about how competent First Avenue really is. Our General and Focused Equity strategies invest exclusively in South African equities. They are at a natural disadvantage relative to most unit trusts who invest both locally and (up to 30%) globally. We compounded that disadvantage by precluding highly cyclical companies (property, furniture, construction), including global cyclicals such as mining stocks-- basic materials and precious metals-- from our investment universe. So often, clients ask us what a fair benchmark would be to evaluate our competence in managing money. The real question is what is a 'fair fight' -- what represents an apples and apples comparison – with regards to your competence (as opposed to which referee do you want in the ring)?

The local with offshore strategy is our apple and it compares outstandingly. As you see in Figure 1, the strategy ranks in the first quartile for all periods shown and, now ranks in single digits (5^{th} and 6^{th}) in the General Equity universe over the past quarter. The strategy maximised its offshore allocation at inception and this allocation hovers around 40% today through market movement. As with all our strategies, we are often fully invested in what we consider to be the best combination of long-term value and Quality. So, what this strategy has, which S.A. Only strategies do not, is exposure to two things, namely, (i) our best ideas globally and (ii) hard currency (USD, Euros, GBP, Swiss Franc, Japanese Yen, South Korean Won). It has not been difficult at all for both (global assets and hard currencies) to outperform their South African counter parts. South Africa has been a cesspool of systemic risk, dragging both assets and currency down with it. We discuss this topic in detail in our latest thought piece on The Role of Government[1].

Figure 2: Top Ten Holdings Local with Offshore Strategy: March 30, 2020

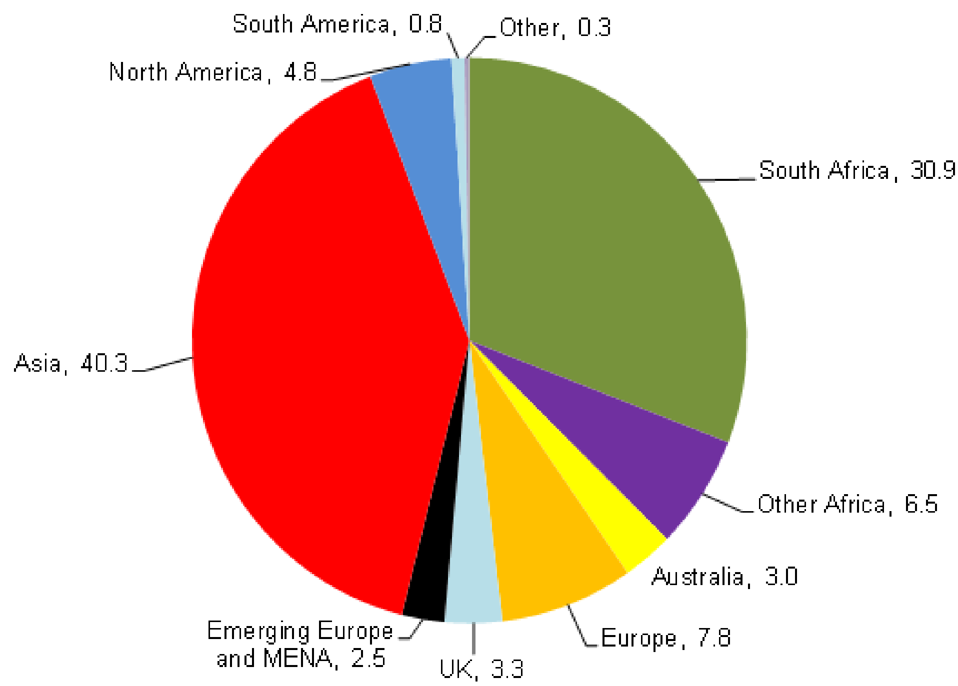
Stock	Sector	%
Naspers	Software & Computer Services	13.3%
Clicks	Food & Drug Retailers	5.5%
Bidvest	General Industrials	4.6%
Clorox	Household Goods & Home Construction	4.2%
AVI	Food Producers	3.6%
Life Healthcare	Healthcare Equipment & Services	3.6%
Anheuser-busch Inbev	Beverages	3.5%
Kao Corporation	Personal Goods	3.2%
Standard Bank	Banks	3.2%
Roche	Pharmaceuticals & Biotechnology	3.2%

Source: First Avenue

[1] https://firstavenue.co.za/wp-content/uploads/2020/04/The-Role-of-Government-12042020.pdf

This discussion only serves to illuminate how, in the absence of South Africa's ability to manufacture good economic news, currency plays a far more important role in beating the local market than clients may realise. You either hold foreign assets alongside local assets (30/70) or you hold local assets with hard currency revenues. Doing neither is begging to be written off! Based the most recent set of published financial results, 70% of the Top 40 of the JSE had offshore exposure to its revenues and 30% was S.A. related. The chart below is, again, based on last reported numbers. Given that the currency has weakened significantly just in the last month, real time estimates of the % offshore would be much higher!

Figure 3: Geographical Split of Revenue Generation of Top 40 Companies on the JSE



Source: RMB Morgan Stanley Securities

The resilience of Naspers (NPN) and Prosus (PRX) in Q1 have held up the JSE's skew to foreign earnings. It is not altogether unreasonable that, unless South African assets begin participating in the effort to manufacture the future, JSE companies will have a greater and greater proportion of earnings from outside the country. Companies solely exposed to local revenues will follow the fourth law of thermodynamics and entropy away, or they will try as hard as they have been to diversify their business into other countries. This is a tough choice for a corporate manager to be faced with: face increased prospects of muscle atrophy or take on new competitors on their turf.

As fraught with error and danger as offshore expansion is, just imagine if the JSE did not have the success that is NPN (and PRX). The quality of these two businesses (not to mention the resilience of their earnings), which together account for 30% of the SWIX as at the end of Q1 2020, materially lowers the probability of misestimating earnings numbers for the overall market. This is in fact the key reason why the JSE's earnings aren't negative in the coming year. If their earnings stay resilient, and the currency weakens again, NPN and PRX not only grow in proportion to the JSE, but they underpin the market's earnings growth. It is remarkable that the economy can feel so bad, but index earnings won't reflect that because of this composition issue! NPN's expansion offshore is worth the failure of so many corporations to replicate its success. That's how important currency is folks!

Before we examine what to do with pure S.A. mandates if you don't want to run the aggravated cyclical risk related to investing in resources, let's illustrate our competency when given free rein to access global assets and the hard currencies that they are priced in; Global Equity. We manage a segregated global equity fund focused on high quality family-owned businesses listed around the world. This strategy compares incredibly favorably to the Global Equity unit trust universe in South Africa. So, taking out the advantage currency gives you in South African equity, our capability is highly compelling purely based on stock picking and portfolio construction relative to MSCI World.

Figure 4: First Avenue Global Equity Strategy vs. MSCI World: Inception to end Q1, 2020

Ranking of Global Family Fund vs SA Global Equity Unit Trusts	
Period	**Quartile**
Since Inception (Feb, 2017)	1
2018	4
2019	4
Q1 2020	1

** Note: Rankings based on gross returns*
Source: Morningstar, First Avenue

Figure 5: Global Equity Strategy Top Ten Holdings: Q1 2020

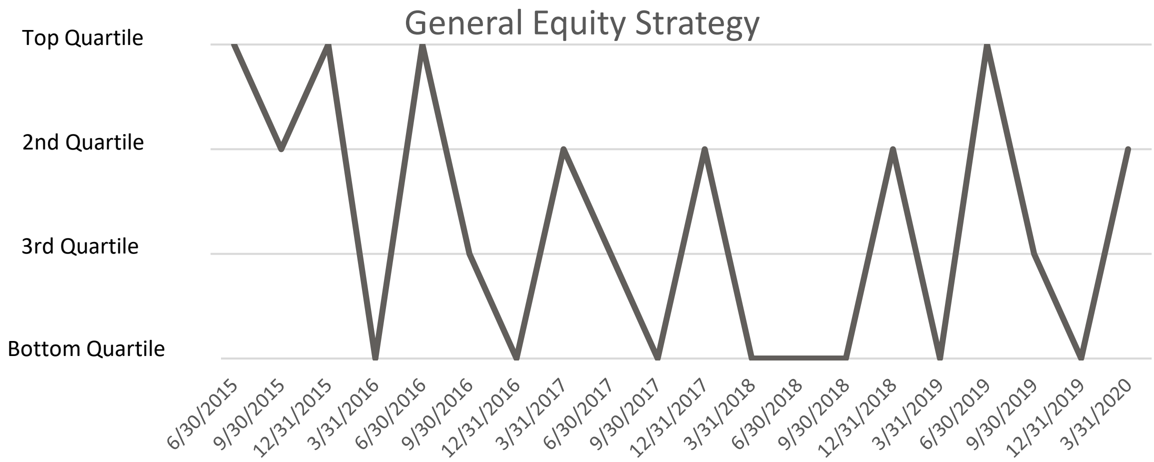
Stock	Sector	%
Amazon	General Retailers	9.7%
Roche	Pharmaceuticals & Biotechnology	8.1%
Walmart	General Retailers	8.0%
Alphabet	Software & Computer Services	7.0%
Tencent	Software & Computer Services	6.4%
Heineken	Beverages	6.1%
Facebook	Software & Computer Services	5.9%
Remy Cointreau	Beverages	5.6%
Robertet	Chemicals	4.6%
Hermes	Personal Goods	4.4%

Source: First Avenue

Now, let's return to the vexing question of currency in a pure S.A. equity strategy if you don't want to gorge on highly cyclical companies (e.g. resources). Most clients and managers have and there is no way out. They have concluded, after careful consideration I might add, that the pragmatic solution is to dilute domestic Quality with global cyclicals (resources). They also think that we must be dogmatic to refuse to come to the same conclusion. We do not blame them. The nuance between dogma and commitment is so fine as to miss it completely. Yet, we think the solution to dilute Quality with resources in order to capture the currency effect solves the wrong problem – a benchmark problem. Most clients have responded to the runaway success that is Naspers by either switching to Capped benchmarks or limiting its weight within the SWIX or ALSI. As a result of benchmark cognisance (or tracking error), managers have also capped their exposure to success. This is the real problem. Outlawing success leads you down a cyclically dangerous path.

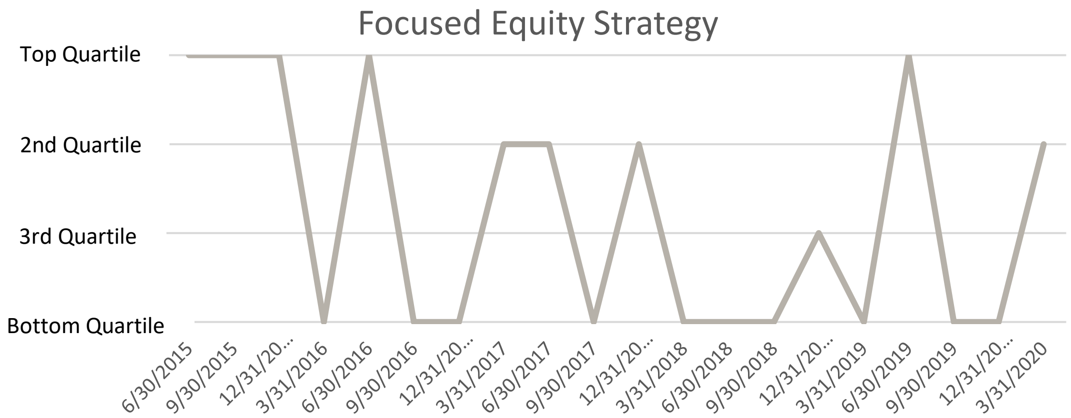
At First Avenue, we must have amongst the highest holding of NPN and PRX amongst local managers regardless of benchmark (capped or uncapped). Through NPN and PRX, we have pure access to global growth and hard currency without compromising on Quality. Global growth does not need to be cyclical. In the current downturn, global tech has proven its ability to scale to business volumes with strength! Amazon's share price, a holding across our strategies that can own global stocks hit new highs this quarter. Likewise, NPN and PRX are now above their pre-crash levels. This is the success that benchmarks have capped in the name of risk management. We have obviously re-assumed that risk to cover for a lack of resources in both good times (upswing) and bad times (market crash). And how it worked in the downturn! Our objective in pure SA equity is to keep up with a market led higher by cyclicals (resources, property) in a virulent upswing and outperform the market and cyclicals in a deep correction.

Figure 6: Performance Snap Back in Q1 2020: S.A. General Equity Strategy vs. Peers



Source: Morningstar, First Avenue

Figure 7: Snap Back of Performance Q1 2020: S.A. Focused Equity Strategy vs. Peers



Source: Morningstar, First Avenue

Figure 8: Top Ten Holdings S.A. General Equity Strategy: March 31, 2020

Stock	Sector	%
Naspers	Software & Computer Services	19.9%
Prosus	Software & Computer Services	10.3%
Standard Bank	Banks	5.8%
Firstrand	Banks	5.2%
AVI	Food Producers	4.1%
British American Tobacco	Tobacco	4.0%
Anheuser-Busch Inbev	Beverages	3.8%
Vodacom	Mobile Telecommunications	3.5%
Clicks	Food & Drug Retailers	3.4%
Bid Corp	Food & Drug Retailers	2.9%

Source: First Avenue

Figure 9: Top Ten Holdings S.A. Focused Equity Strategy: March 31, 2020

Stock	Sector	%
Naspers	Software & Computer Services	27.9%
Mondi	Forestry & Paper	6.0%
Firstrand	Banks	5.8%
Bidvest	General Industrials	5.5%
Anheuser-Busch Inbev	Beverages	5.3%
Standard Bank	Banks	5.2%
AVI	Food Producers	4.8%
Vodacom	Mobile Telecommunications	4.3%
British American Tobacco	Tobacco	4.0%
Life Healthcare	Health Care Equipment & Services	4.0%

Source: First Avenue

To some it may appear foolish (in that we run significant business risk) that we insist on safety rather unadulterated greed that global cyclicals endow a portfolio with. They just have never “seen kids not come back from the store”, that is, companies that have performed spectacularly for you on the way up, can fall or fade away permanently.

Often, market corrections caused by economic dislocations (in this case the supply shock caused by COVID 19) render global cyclicals value traps or even bankrupt at worst. That is, we would not have ordinarily expected Cyclicals to rebound as strongly as they have since the last week of March. However, as Cyclicals rebounded hard in the early going in April, we have not changed our defensive posture. The impact of Covid-19 induced economic dislocations will be felt mostly by Cyclicals in the months and years ahead, and investors will recalibrate their early enthusiasm for risk as an outcome. The market has rebounded only because central banks have induced a fresh round of risk taking which global cyclicals, namely basic materials, have so far reacted positively to.

Two different set of expectations are being baked into share prices by investors:

- Cyclicals have rallied because investors think the recovery from Covid-19 economic dislocations will be V shaped, thus allowing cyclicals to return to their pre-crisis profitability seamlessly.
- Quality investors such as First Avenue, are more concerned with the endurance of both business model and balance sheet to meet any eventuality, including a U or L shaped recovery.

Most investors miss a crucial development – China's role in nursing both the Asian region and World GDP back to health this time pales in comparison to the role it played in the Asian Financial Crisis of 1997-98 (also known as the Emerging Market Crisis) and the Great Recession of 2009 caused by the Global Financial Crisis in 2008. During the Asian Financial Crisis, China was still booming, on its way to becoming the factory of the world and its biggest exporter. Investment was pouring in as membership to the World Trade Organization beckoned. During the global financial crisis, China undertook massive stimulus that buttressed regional activity. The Asia Pacific region eked out an average growth rate of 1.3% during the Asian financial crisis and 4.7% through the Great Recession.

Now Beijing shows little appetite for budget-busting stimulus. Its fiscal steps in response to the pandemic account for about 3% of GDP, according to Bloomberg Economics. That's tiny relative to the 10% and 20% unveiled by Washington and Tokyo, respectively. And while the central bank continues to nudge borrowing costs lower, its steps appear restrained compared with the array of tools being deployed around the world.

What explains this reluctance? China turned to open-slather spending after the global financial crisis. That spree fueled a rebound and buttressed Asia, but it also saddled banks and companies with huge debts. Total debt to GDP, including the financial sector, ballooned to about 300% in 2019 from about 173% in 2008, according to the Institute of International Finance. All this means the rest of the region can't expect much to trickle through. Before the pandemic, China largely succeeded in pulling back some of the practices that fueled its debt buildup, which naturally led to slower growth. But few observers were ready for very low single-digit numbers — the kind not out of place in the U.S. or Europe — to come so soon. Among the scenarios the Organisation for Economic Cooperation and Development (OECD) sketched out for the world in 2060 was the prospect that growth rates in the U.S. and China would start converging in 2030, averaging at just under 2% a year. The report was written in 2018. The coronavirus will only bring forward this outcome.

China's transformation over the past four decades from Mao-era basket case to the world's second-largest economy has been a vital ingredient in Asia's rise, especially after Japan's ascent stalled in the early 1990s. To say the Covid-19 pandemic halted this in its tracks is an understatement. China's future has arrived, and Asia and world GDP will be weaker for it.

Whichever side one takes in debate concerning the speed of the recovery, one should not invest in a way that hinges solely requires a V shaped recovery for their investments to do well. This is where we as First Avenue are, and we are very patient with your and our money riding alongside yours. We are not going for broke. If the world experiences a V shaped recovery, we will lag the market but still stay within striking range of the index and our peers. If the recovery shows up in any other shape (U or L), we will do far better than the index and our peers. To illustrate, while the proportion of pure Rand Hedge stocks in our portfolio is lower than in the benchmark (27.5% vs. 34.4%), it is much higher in Quality (durability of both business model and balance sheet). We fully expect our pure rand Hedges (NPN and PRX) to outlast and outperform basic materials such as KIO, IMP, AGL, etc. should the world economy take longer than desired to heal.

In summary, we are very confident that the market has hit an inflection point from the previous cycle which will require companies to exhibit Quality (rigorous demands by a myriad of stakeholders) to withstand rapid change in business processes (e.g. digitization), consumer behavior (e.g. e-commerce), environmental regulations (e.g. acceleration in adoption of alternative energies), and socio-economic requirements (e.g. telemedicine and Artificial Intelligence to help reduce costs of healthcare and improve access). Our underweight in mining, steel, and cement and overweight in healthcare, TMT, consumer goods, as well as consumer services positions us very favourably for what's on the other side of this Covid-19 induced inflection point."

Conclusion

The fund has continued to retain its hallmark of defensiveness-through-Quality in proportions that far exceed the benchmark (72% vs. 56%). While this position has looked labored in the long up-cycle we have just come out of, it proved the value of active management by outperforming the benchmark during the month of March, the epicenter of the market drawdown. The reason why the benchmark experienced a deeper drawdown than the fund is because of the higher weight of Cyclicals (43.8% vs 26.8%). This side of the COVID 19 inflection point, global cyclicals will meet with either additional costs to operate (regulations related to the environment), materially altered consumer behavior, and or slower economic growth. We think Quality companies have been dressing up for this moment!

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