



FLAGSHIP
ASSET MANAGEMENT

Navigate Safely Forward

QUARTERLY TELESCOPE Q3 / 2020

01

Flagship Asset Management

Flagship is a specialist global asset manager founded in 2001.

We are 100% independent and fully owned by staff and directors.

Our mission is to be the navigators and global authority of your complete investment future, wherever it may lead.

02

We manage global portfolios in three distinct strategies

Global Equity | Global Flexible | Global Fund of Funds

Our longest running strategies have track records spanning nearly two decades, and have generated returns of between 11.5% - 14.5% per annum since inception.

03

We believe in long-term valuation-based investment

Our investment approach is process-driven and rigorous, and our definition of quality is demanding and exclusive.

Our equity portfolios are focused. We own a maximum of 25 shares, diversified across geography and sector.

About the cover image:

The word *yacht* originates from the Dutch word *jacht*, (or "hunt"), and originally referred to light, fast sailing vessels that the Dutch used to pursue pirates around the shallow waters of the Dutch coast. Modern yacht design is complex, and focuses on considerations such as seaworthiness, performance, and sea kindliness (an indicator of steering, directional stability and quelling of motion induced by wind and waves). The fastest speed ever achieved by a sailing yacht was in November 2012, off the coast of Walvis Bay in Namibia, when the *Vestas Sailrocket 2* was clocked at an astonishing 65.45 knots (121km/h).



Contents

The reflation trade continues [page 2](#)

Launch of the Flagship Global Icon Feeder Fund
[page 4](#)

Asset allocation in Q3 [page 6](#)

Revisiting the Value of Quality Shares [page 8](#)

Four common misconceptions about offshore
investing [page 10](#)

South Africa - What's cooking in the country
kitchen? [page 11](#)

Trupanion – Innovative Pet Insurance [page 13](#)

Conclusion [page 17](#)



Introduction

Welcome to our latest **QUARTERLY TELESCOPE**. We hope these quarterlies provide you with greater insight into our thoughts on global assets as well as how your global assets are being managed.

In this quarter's Telescope, **Kyle Wales** discusses how our portfolios navigated the third quarter, as well as how the funds are currently positioned. **Pieter Hundersmarck** revisits the importance of investing in high quality businesses, and **Bruce Anderson** shares his thoughts on South Africa. Finally, Kyle takes us through the investment case for **Trupanion**, a leading pet insurer in the United States and Canada.



About Kyle Wales

Kyle has been investing internationally for over 12 years. Prior to Flagship, he worked at Coronation Fund Managers for 9 years in the Global and Global Emerging Markets teams and also co-managed a global equities boutique at Old Mutual Investment Group. Kyle is a qualified chartered accountant and CFA charter holder.

Performance

All performance is net of fees. Periods longer than one year are annualized.

to 30 September 2020	AUM	YTD	1 Yr	3 Yr	5 Yr	10 Yr	S.I.
Flagship IP Worldwide Flexible FoF (ZAR)	R298m	26.0%	22.6%	12.5%	9.4%	14.3%	14.3%
Benchmark (SA CPI + 5%)		6.6%	8.4%	9.4%	9.9%	10.4%	10.4%
<i>Outperformance vs. Benchmark</i>		19.4%	14.2%	3.1%	-0.6%	3.9%	3.9%
Sector average		10.4%	11.6%	6.7%	6.6%	10.8%	10.4%
Flagship IP Worldwide Flexible Fund (ZAR)	R458m	23.5%	19.7%	9.9%	6.8%	11.6%	11.9%
Composite Benchmark		10.4%	10.4%	7.9%	7.6%	11.0%	9.4%
<i>Outperformance vs. Benchmark</i>		13.1%	9.3%	2.0%	-0.8%	0.6%	2.5%
Sector average		10.4%	11.6%	6.7%	6.6%	10.8%	10.4%
Flagship International Flexible Fund (USD)	\$28.6m	6.6%	11.6%	4.4%	4.1%	7.2%	1.6%
Composite Benchmark		2.6%	6.7%	4.8%	5.8%	9.2%	3.1%
<i>Outperformance vs. Benchmark</i>		4.0%	4.9%	-0.4%	-1.7%	-2.0%	-1.5%

Note: The Flagship IP Worldwide Flexible Fund (ZAR) and the Flagship International Flexible Fund (USD) are managed as one strategy ("The Flagship Flexible Strategy") since April 2019 with the only difference being the Fund's domicile and pricing currency.



Q3 2020 – The reflation trade continues

- Global equities continue to perform well as market participants look through the weak economic data from Q2 and Q3
 - Technology and internet related business models have been clear beneficiaries of the COVID pandemic, and continue to outperform
 - Flagship portfolios have benefitted from both strong equity selection and asset allocation in the year-to-date. We continue to assess the investment cases for our 25 shares on a stock-by-stock basis and remain confident in their long-term prospects
 - Equity exposure in the flexible strategy remains at mid-cycle levels, and gold remains a core holding at 10% exposure
 - The Fund of Funds strategy continues to benefit from superior manager selection, outperforming the ACWI and its inflation +5% benchmark with much lower equity exposure
-

In contrast to the violent swings of the first two quarters, the third quarter of 2020 was mild. Share prices on the world's major exchanges continued to drift upward, supported by continued loose monetary policy and in stark contrast to improvements on the ground. Year-to-date, the S&P 500 is up 5.6% and in the third quarter alone up 8.9%. The MSCI ACWI, the benchmark we track our performance against, returned slightly less, but is still up for the year, having recovered all its pandemic/Covid induced losses. Gold, a core holding in our flexible strategy, rose 5.9% in the quarter, bringing its year-to-date return to 24.3%.

Our flexible funds returned between 3.5% and 5.8% in ZAR over the quarter bringing their year-to-date returns to 23.5% for the Worldwide Flexible Fund and 26% for the Flexible Fund of Funds. The USD returns over 1 year have been 8.8% and 11.4% for the two funds respectively. Despite holding far less equity than the MSCI ACWI, both funds have outperformed the index year-to-date.

Despite the quarter-on-quarter improvement in macroeconomic indicators currently being reported, the world still finds itself in vulnerable territory. The September unemployment figures for the United States provide a stark example of this: while the unemployment rate in the US improved from 8.4% in August to 7.9% in September, only half the jobs lost since the outbreak began have been regained.

In the UK, the likelihood of the two parties missing the 31st of October deadline for reaching a post-Brexit trade deal has increased enormously and this will provide a further setback to an economy still struggling to recover from Covid. Predictably, this has been negative for the pound which is down 2.6% against the dollar year-to-date, in contrast to the Euro and the Japanese Yen which have strengthened.

Portfolio construction continues to reflect a cautious stance towards equities. We remain vigilant to the underlying themes discussed in previous Telescopes, being monetary debasement, artificially low interest rates and rising political tensions between China and the US. Gold remains our chosen vehicle to guard against the potential of inflation due to the monetary issuance by the world's central banks.

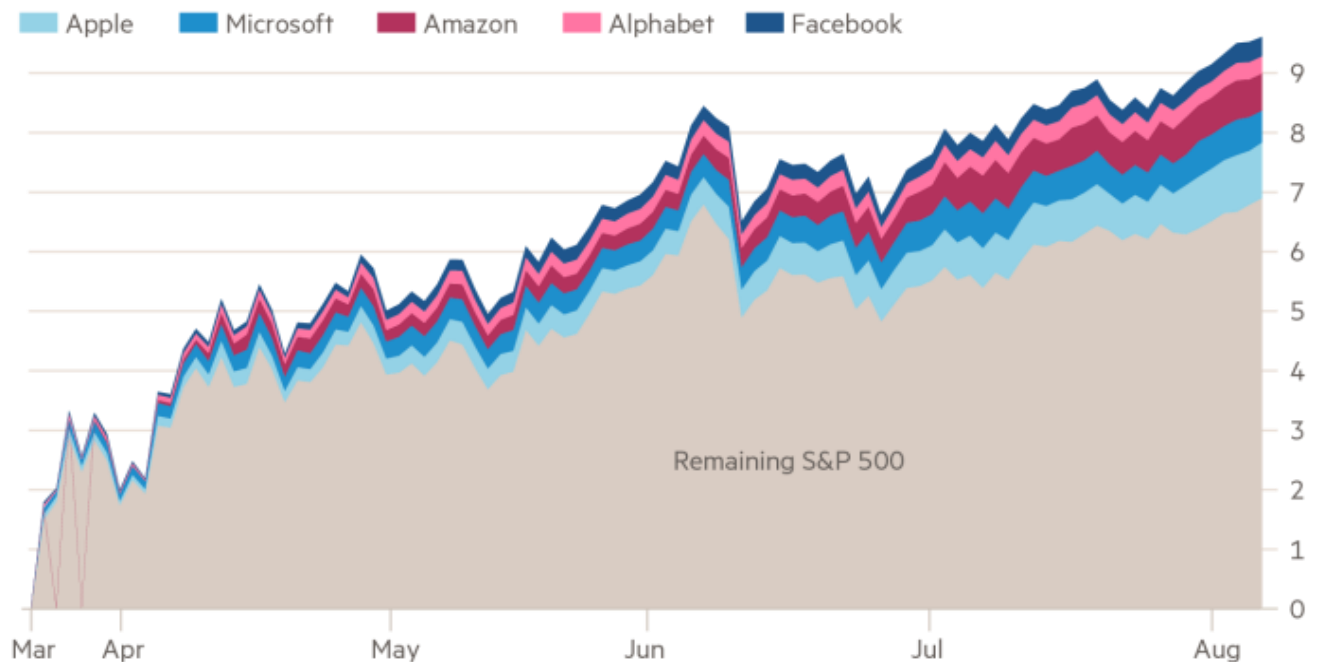
Despite the quarter-on-quarter improvement in the macroeconomic indicators being reported, the world still finds itself in vulnerable territory



The broad-based index moves have disguised how uneven the recovery in stock prices has been. The share price moves in technology and internet related stocks have far outpaced the moves in the rest of the S&P. This has been a concern for some, but in contrast we believe that there is a very strong fundamental underpin for this outperformance. Co-portfolio manager on the global funds, Pieter Hundersmarck, unpacks our arguments [here](#).

Top five stocks power market rally

Market capitalisation growth from March 23 (\$tn)



Source: Bloomberg, FT Calculations
© FT

While the terms “FANG” which stands for “Facebook, Amazon, Netflix and Google”, “FAANG” (if Apple is included as well), or “FANG+” (for a broader composite of technology stocks including Microsoft and others) have become by-words in the media, we shouldn’t forget that each of these companies has its own characteristics with its own fundamental business drivers. It is inappropriate to lump these disparate businesses together, and similarly not appropriate to hold the FANGs indiscriminately.

We make the same argument for other acronyms, most notably the ‘BRICS’ moniker which grouped together such disparate economies as India, Brazil and South Africa. Having invested in these countries for over a decade we can assure you they are fundamentally different investment propositions.

At Flagship we construct investment cases for stocks on an individual basis, and thus find some of these stocks attractive - but not others. For this reason, at the end of the quarter we owned Facebook, Amazon and Microsoft and didn’t own Apple, Netflix or Google. Time will show whether this was the correct decision, although you can be sure that we have applied our minds to the investment cases of each stock.



Launch of the Flagship Global Icon Feeder Fund

The largest development at Flagship in the third quarter was the launch of the Flagship Global Icon Feeder Fund on the 28th of July. The Fund was seeded with over R100m from Flagship clients and employees.

We are tremendously excited to be able to offer this solution to our clients. We strongly believe the appropriate investment approach for South Africans in these times of increased market and economic uncertainty is one that invests *in a concentrated selection of businesses that have the hallmarks to thrive in even turbulent global growth scenarios*, and is 100% offshore in order to protect against ZAR weakness and local inflation (which we believe are set to continue and even accelerate).

Our newly launched Flagship Global Icon Feeder Fund addresses this:

- The fund is managed on a clean-slate, benchmark agnostic basis
- 100% offshore
- Access to our top 25 best ideas, diversified across geography and sector
- Accessible via two entry points, onshore (ZAR) and offshore (USD)

The fund will only own shares in businesses that have 'Iconic' attributes, being:

- A large addressable market
- A hard-to-replicate competitive advantage
- Recurring revenue streams
- Lower sensitivity to the economic cycle
- Cash generative and a capital light balance sheet

The fund's top holdings, as well as their various attractive attributes, are shown below:



Table 1: Top 10 holdings of Flagship Global Icon Feeder Fund (30 September 2020)

Name	%	ROE%	5 Yr ROE%	FCF conversion	Net debt/EBITDA
Zalando	6.2%	NM	NM	77.5%	net cash
Alibaba	6.0%	28.5%	25.0%	>100%	net cash
Netease	5.3%	39.8%	27.8%	>100%	net cash
Microsoft	5.3%	44.2%	26.2%	99.3%	net cash
TSMC	4.4%	27.8%	24.0%	82.0%	net cash
Facebook	4.2%	21.9%	20.1%	>100%	net cash
Global Payments	4.1%	5.0%	7.2%	>100%	3.2x
Heineken	4.1%	14.3%	13.9%	88.9%	2.7x
Pag Seguro	3.9%	17.5%	22.0%	>100%	net cash
Amazon	3.9%	8.8%	56.1%	97.6%	4.0x
Total top 10 as % of fund	47.4%				



Stock selection has been a major driver of Flagship returns over time. Our Global Equity and Global Flexible Strategies seek to provide our investors with growth, and we know of no better asset to provide that than equities. The fact that stock returns in the long-run have surpassed other financial assets through market peaks and troughs attests to the resiliency of stocks in all economic and financial climates.

The table below shows how the stock selection (equity only) portion of our flexible funds has performed over the recent turbulent periods.

Table 2: Performance of the equity selection within the Worldwide Flexible Fund and Fund of Funds

to 30 September 2020	Sept	YTD	3m	6m	1 Yr
Flagship Worldwide Flexible Fund (Equity Only)	-2.0%	36.8%	9.6%	36.0%	35.1%
MSCI All Country World Index	-4.6%	21.0%	3.8%	20.8%	21.5%
<i>Outperformance vs. Benchmark</i>	<i>2.6%</i>	<i>15.8%</i>	<i>5.8%</i>	<i>15.1%</i>	<i>13.6%</i>
Flagship Worldwide Fund of Funds (Equity Only)	-3.0%	29.8%	4.9%	24.5%	26.1%
MSCI All Country World Index	-4.6%	21.0%	3.8%	20.8%	21.5%
<i>Outperformance vs. Benchmark</i>	<i>1.6%</i>	<i>8.8%</i>	<i>1.1%</i>	<i>3.7%</i>	<i>4.7%</i>

As with our flexible funds, the Flagship Global Icon Feer Fund will invest with the same Flagship DNA:

- **Specialization.** We are focused on a very small number of strategies where we have the skill and experience to add value to our client's lives
- **Concentration.** We concentrate our equity exposure to our best ideas, ensuring that capital is most efficiently applied to generate the highest possible return
- **Global experience.** Our portfolio management team is highly experienced across global asset classes
- **Independence.** We are owner-managed, and we pride ourselves on being able to apply an independent, global perspective to our portfolios

Can you invest in the Icon Fund as well as our flexible strategies?

Yes. Flagship is best known for its award winning Global Flexible Strategies, where we conduct both asset allocation and stock selection on behalf of our clients. *Asset allocation* is deciding which asset classes to own (for example bonds, equity or cash), while *equity selection* is deciding on which individual equities to own, within the available universe of equities.

Consequently, there has been an unmet need for clients who are happy to do their own asset allocation but want us to select stocks on their behalf. This need has finally been met with the launch of our Fund which is our first pure global equity fund.



Gold remains a substantial position at 10% of fund

We have increased our exposure to payments processing, an area we believe has a considerably bright future

Asset allocation in Q3

The third quarter saw very few changes to our asset allocation. Our unhedged equity exposure drifted slightly higher from 75% of fund to 80% of fund, although we continue to hedge a significant portion of this using futures as well as a zero-cost collar. Our net equity exposure (after deducting hedges) is appropriate for the mid-point of an equity cycle i.e. when stocks are neither too expensive, nor too cheap.

Some might challenge us that equities appear expensive currently. This argument might hold if one looked at equities in isolation, but our job in our flexible strategy is to make a call on the relative attractiveness of equity as an asset class, and equities offer the most value (by far) when judged against either bonds or cash. We believe it is appropriate to keep some powder dry should there be another sell-off which is why we sit at only a mid-cycle exposure to equities.

Gold remains a substantial position at 10% of fund. We have explained our reasons for holding gold before. We believe that against the current uncertain backdrop it is appropriate to hold some safe-haven assets, but we believe that the traditional safe-haven asset of choice for most investors – short-dated Treasuries – is at risk of seeing its real value eroded on account of the enormous amounts of money being printed by central banks globally.

Equity selection

How can institutional investors hope to outperform the market . . . when, in effect, they are the market?

—Charles D. Ellis

As a reminder, Flagship Equity portfolios look very little like the index, and very little like our competitors. We favour concentration, and only hold a maximum of 25 positions that we know well.

A consequence of running concentrated equity portfolios of only 20-25 stocks is that when a new share is added to the portfolio, we have to sell another. During the quarter we added four shares to the portfolio (**PagSeguro, Global Payments, Booking Holdings, Taiwan Semiconductor**) and sold out of four shares (**Mondelez, Reckitt Benckiser, LVMH, Alphabet** (Google)).

Two of the four companies we added (Global Payments, PagSeguro) are merchant acquirers. A merchant acquirer is the link in the electronic payments chain that sits between the point-of-sale machine at a retailer and the credit card networks like Visa and Mastercard. In South Africa this link is usually performed by a bank, but elsewhere in the world specialist players fulfil this role.

We believe these two stocks offer the best trade-off between growth and valuation that we have seen in a while. Global Payments, the more mature of the two, is expected to grow its EPS over the next 5 years at roughly 14% p.a. but trades at only a 20X P/E multiple. The less mature and Brazilian domiciled PagSeguro is more expensive, but this is more than compensated for by growth rates in its core merchant acquiring business which are well north of 20%, as well as its nascent lending business which has the potential to be many multiples of its current size.



Booking Holdings, another new holding, owns the online travel agency Booking.com and sold off heavily with the Covid-induced lockdowns which brought worldwide travel to a halt. While the business faces headwinds in the near-term, it has a very robust business model and offers compelling upside for those willing to take a longer-term view.

The final stock we added was Taiwan Semiconductor, the largest semiconductor pure-play foundry in the world. A pure-play foundry makes semiconductors for its clients based on its client's designs. The beauty of this model is that its client concentration risk is reduced versus an integrated device manufacturer which only makes designs for itself. Taiwan Semiconductor has also recently leapfrogged Intel's lead in nodes which means it can pack its chips with a greater density of transistors than any of its competitors. This has benefits from both a chip performance perspective as well as an economical perspective (cost per unit performance).

Our primary reason for the sale of the four companies mentioned is that their stock prices have reached our estimate of their value, or the investment case has changed and we feel the proceeds could be applied more productively elsewhere. In the case of Alphabet, which we sold out of this quarter, the merits of an antitrust case being made against the company by the US Department of Justice (as Alphabet has a near-monopoly in web-based search) seem well constructed, and will create meaningful headwinds. Similarly, we fail to see the benefit to shareholders in the increasingly acidic exchanges between LVMH and Tiffany, and find better risk reward elsewhere.

OUT	Why?
Alphabet	Valuation and regulatory concerns
Mondelez	Valuation
Reckitt Benckiser	Valuation
LVMH	Tiffany debacle stokes material governance concerns
IN	Why?
Pag Seguro	Excellent prospects in payments processing and credit in Brazil
TSMC	Best in class foundry for western tech, attractively priced
Global Payments	Payments giant, with considerable moat in the smaller enterprise space
Booking Holdings	Opportunity to buy a high-quality business model that is under temporary strain



Revisiting the Value of Quality Shares

"Everybody wants to try to call the market, or predict where interest rates or the price of oil or whatever will go. What a pathetic waste of time this all is – it's a great distraction in your hunt for 100-baggers."

"You need a business with a high return on capital with the ability to reinvest and earn that high return on capital for years and years."

–Christopher Mayer, 100 baggers: Stocks that Return 100-to-1 and How to Find Them

We recognize that to achieve substantial, long term appreciation of our investors' capital we need to get two things right. The first is to keep our eyes firmly on the horizon, and only adjust portfolios when the long-term outlook fundamentally changes for the shares we own.

Despite its banality, the mind-set of long-term investing is more than an adage or a space filler for these pages: in fact our investing 'edge' at Flagship can be explained *almost entirely* by maintaining a long-term time horizon. Since we focus on where companies will be in 5-10 years' time, rather than next year, it allows us to look at their valuation with different eyes. Often it allows us to pay up for shares that seem optically expensive on short term metrics.

The second factor to get right is to restrict our investable universe to shares we consider to be of the highest quality. This rationale can be likened to the game of tennis.

In tennis the players compete by making as few mistakes as possible. In his 1975 article for the Financial Analysts Journal¹, Charles Ellis recalled *"Winners had a particular style of play. Their goal was to keep the ball in play long enough for the other person to make a mistake."* He went on to note that *"the amateur duffer seldom beats his opponent, but he beats himself all the time. The victor... gets a higher score because his opponent is losing even more points."*

Put simply, mistakes create opportunities for the opposing player to capitalise upon, so good players focus on avoiding mistakes, keeping the ball in play, and waiting for their opponent to slip up.

Repeatedly getting the ball across the net, and waiting for your opponent to slip up, can win the day. However, if you manage to do so while also placing your opponent under pressure, you have managed the best of both worlds. Winners tend to accomplish both these tasks.

Like great tennis players, we believe that great investors succeed by making as few mistakes as possible. For example, for all their skill, the famed investors behind the Medallion Fund of Renaissance Technologies profit on barely more than 50% of their trades. Warren Buffet's process has kept him away from the large mistakes that have been the downfall of other investors.

At Flagship we equip ourselves to manage risk by following a number of processes that mitigate mistakes. These include the use of a proprietary asset pricing model that uses conservative long-term assumptions, scenario analysis to stress test our investment cases, and the insistence on a margin of safety prior to taking positions.

There is no investing truth of greater consequence than the long-term mindset

¹ *The Loser's Game* by Charles Ellis, published in The Financial Analysts Journal 1975



When you run concentrated portfolios of between 20-25 stocks, you simply can't afford to own junk

However, the most important part of our risk management process is the focus on high-quality businesses, and the fund concentration that this allows us to execute. This is important for two reasons.

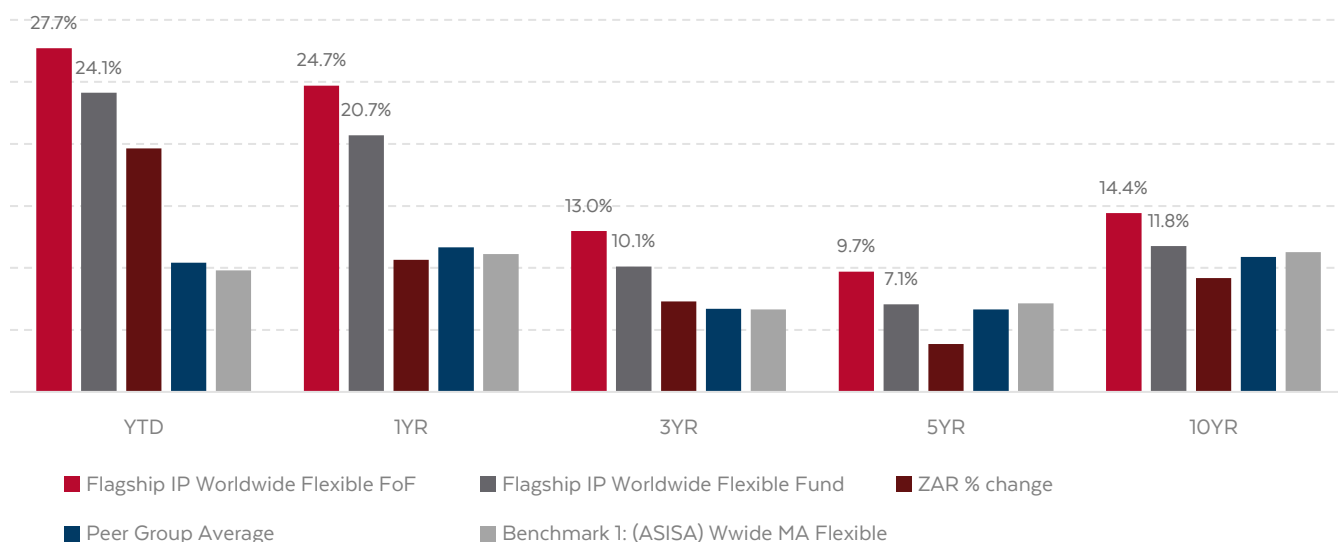
It focuses our attention. Success in any endeavor requires focus. Narrowing our universe to high quality businesses allows us to focus deeply on these business models and the risks that they present. We have applied our nearly two decades of global investing experience to whittle down the over 60,000 investable global equity instruments to a few hundred that we define as our investable universe.

It lessens the chances of capital loss. We focus on a company's future revenues, earnings and cash flow, and this is more difficult to analyse or forecast for low quality businesses. We have found that the earnings trajectory of lower quality businesses (ones without durable brands, intellectual property, high margins or a moat of some depth) tend to resemble a random walk. This type of earnings trajectory is completely incompatible with the type of long-term outperformance we seek to achieve.

It is promising that our selection of 25 equities continues to outperform the broader market. Our aim is that the separate asset classes that we use in our flexible fund to always outperform. However, it is in times of underperformance that we hope to use asset allocation to achieve our investment goals.

While it is valuable to have outperformed, it is even more valuable to outperform *consistently* as the chart below shows.

Chart 1: Flagship Funds vs peer group, ASISA Worldwide Flexible benchmark and ZAR (annualized)





Four common misconceptions about offshore investing

Over the years we have fielded a number of queries regarding our views on global investing, and specifically our views on South Africa (shared in our Q2 Telescope found [here](#)). We felt it necessary to address a selection of these queries by demonstrating that offshore investing is simply a question of diversification and risk management, rather than a decision to ‘un-invest’ from South Africa. In a nut shell, your South African portfolio needs to be appropriately sized. Many investors are still far, far too exposed to South Africa and South African shares.

01

“I already get substantial offshore exposure on the JSE via the large dual-listed stocks which comprise a substantial portion of the opportunity set.”

The JSE continues to become smaller, more concentrated and less investable. Offshore exposure on the JSE is concentrated in 6 areas: Naspers (essentially Chinese tech), tobacco, mining, beer, property and luxury goods. There is no need for local investors to limit themselves to these sectors. Opportunity exists in growing global sectors (software, technology, payments, media, apparel, gaming and e-commerce) that are available to local investors via unit trusts or using their offshore allowance. Flagship is one such provider with dual entry points for offshore investors.

02

“But South Africa Inc. is cheap!”

Yes, it is, and it also comes with risk. The question that arises is how much money would you put behind a cheap and risky asset? For example: We often find ‘cheap’ assets to buy in Russia and Brazil: but neither on a personal nor professional level would we place more than 20-30% of our or your wealth into either high-risk region. Why do South African’s insist on doing this?

Many South Africans have well over half their wealth sitting in South Africa (see Kyle’s article [here](#) and [here](#)), which is far too high for a country that has the risk reward profile that South Africa does. We argue the discussion is about asset allocation: South Africa should occupy an appropriate part of your portfolio for a small, troubled emerging market on the tip of Africa. Over 50% allocated to this market is highly inappropriate.

03

“Things are improving locally, so local shares will pop and my portfolio will be fine.”

This can indeed occur. However, the discussion is about asset allocation and risk, not timing your buying and selling decision. Once the improvement is priced in, we will once again be in the position to judge whether or not we should now allocate more offshore. This is a timing decision, and not a long-term allocation decision. We argue that a substantial portion of your investments towards one country or region is highly risky, and that a balanced global asset allocation is far more suitable for the long-term investor.

04

“Offshore returns are far lower than the 8-12% I’m used to from the JSE.”

Much of the aforementioned high returns that South Africans have gained from the local market have simply been negated by currency weakness and inflation. A small number of excellent local asset managers have managed to provide both rand protection as well as USD returns to their investors over long periods of time.



South Africa - What's cooking in the country kitchen?

*Last quarter we shared our thoughts on South Africa as a suitable destination for your long-term retirement savings. We concluded that while your day to day life may be tied to South Africa, your investments needn't – and arguably shouldn't – be. This quarter **Bruce Anderson**, portfolio manager at Flagship, shares his take on the local environment.*

A seminal month in South Africa with the first serious arrests in a number of cases of alleged bribery and corruption. I am not sure whether what was served up will turn out to be a damp squid, given that the tentacles have spread throughout the system, or there awaits a full tender roast that will get to the real meat of the matter. But if the quid pro quo for supping from the gravy train is a stint behind bars with cold gruel and mealies, I am pulling up a chair and ordering the Full House Robbing Island Special to go with the popcorn (... and no squabbling over my squibbling scribbles).

The Zondo Commission, for all its slumbulatory benefits, has allowed the grilling of a number of miscreants (and Agrizziants) who have added colourant and substance between the dots of the media and editorial reports into our corrupted state. The naivety and candor of the likes of Nomvula Mokonyane and Zandile Gumede, who both intimated that the giving and receiving of large sums of dough were simply considered standard perks of the(ir) job(s) or simply favours among friends, were more than mouth wateringly tasty morsels for the evidence gatherers. (Would that my mates chip in the R2,2 million deposit on an Aston Martin for my birthday). They amongst others, may have talked themselves out of the frying pan and into the fire. As this salivating dish of extravagant fishy tales was being served, arrests relating to the saga at VBS (Very Basic Stealing), where a few minnows were netted, was a taste tester that met with little resistance. All very pleasing on the palate indeed!

Then followed the arrests relating to the Free State asbestos tender scandal and more small fish hit the fryer where, no doubt, when the heat is turned up, they will start to sing for their supper through gaping mouths. Hopefully this live bait will help hook a few of the real fat fish so we can progress through the menu and end with a main course of flambéed Zuma Rump with a Gupta Trotter glaze (freshly imported from the UAE).

The asbestos contract case is interesting. Is it the vulture circling, the chum in the water to draw in the prime catch, the clearing of the saplings to make way for the felling of a big tree? As with the VBS case (Malema, Shivambu), there appear to be a number of obviously implicated individuals that have been overlooked (one F...ACE springs to mind). Can we hope that the strategy is sound, the evidence solid and that the dominoes soon begin to fall? Will this taste of success spur on confidence?

The contract was awarded to a self-proposed company (Blackhead Consulting), headed by the debonair Edwin Sodi who counted many political friends amongst its supporters and the approximately R230 million paid out was simply passed on and peeled like an onion until the actual contractors were paid R21 million to do the actual job, (which, in any event, they failed to complete).

*Would that my
mates chip in the
R2,2 million deposit
on an Aston Martin
for my birthday...*



The level of internal political instability and underlying heartbeat of corruption within the ruling party not only introduces instability into the fabric of the country but undermines confidence

The tragedy is that the Democratic Alliance tried to interdict the award due to its lack of compliance with state procedures and the courts ruled the application was not urgent, a ruling the ANC enthusiastically interpreted as a green light to rush through the balance of moolah in a matter of days. Would that the courts opened their eyes and considered the public interest as much as they worried about technicalities.

But perhaps there was more to it. Try as they might, the mounting murders /assassinations amongst ANC representatives on opposite sides of the corruption coin in KZN is evidence that there is more than a passing problem, despite Thabane Nyawose dismissing concerns by stating "...ANC is moving away from political killing and revenge narrative". (That's very nice of them (don't we think)).

The real concern is that there are an increasing number of violent threats and acts against witnesses, investigators and the judiciary, with the recent assassination of Lieutenant-Colonel Charl Kinnear in broad daylight outside his home being the highest profile, brings the high stakes of turning the tide against corruption sharply into focus. In March 2019 Kinnear had submitted a fifty-page report motivating the prosecution of a number of senior police officers involved in crime (including weapons dealing) and additionally disclosing threats made against him. This report went to the National Commissioner of Police and the head of IPID, amongst others. Although two senior officers were assigned, the investigation simply died. Now Kinnear is dead. Should the National Director of Police General Khehla Sitole, as a start, not be charged with criminal negligence? Why not?

This is not helped by the allegations that Western Cape Judge President John Hlophe arranged with an ex-police member (in jail awaiting trial on murder charges) for a hit on a fellow judge ... sounds far-fetched ... but does it? There has been a rancid smell around Hlophe for many years and there is rarely smoke without a braai.

The level of internal political instability and underlying heartbeat of corruption within the ruling party not only introduces instability into the fabric of the country but undermines confidence. This, coupled with poor policy choices, excessive state interference and the collapse of key state-owned enterprises that should provide backbone services, has significantly hindered South Africa from achieving its full potential. As a developing nation we should be reflecting economic growth closer to India and China and not to that of Japan.

We have all the necessary ingredients in the pantry, we simply refuse to follow a proven recipe. No great meal has ever been prepared without a recipe or, at least experienced chefs in the kitchen.

Until such a time that we get the right chefs in the right places (and the crooks out of the kitchen), we will simply continue to make a meal of things.



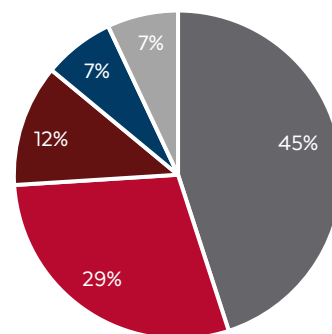
Trupanion – Innovative Pet Insurance



Trupanion is the largest monoline¹ provider of pet insurance for cats and dogs in North America and the second largest provider of pet insurance in North America amongst all insurance providers.

Pet insurance is rising in popularity because it helps pet owners avoid large, unbudgeted veterinary expenses when their pets become injured or sick. Trupanion is a direct beneficiary of the need for this insurance protection.

Chart 1: US Pet Insurance Market Share (2019)



■ Nationwide ■ Trupanion ■ ASPCA ■ PetPlan ■ Other

What distinguishes the pet insurance market in North America is its low penetration rate versus most other developed countries. Only between 1–2% of cat and dog owners in North America have pet insurance (versus 25% in the UK and 40% penetration in Sweden), the sole reason being the earlier adoption of pet insurance in these markets versus the US. If we consider the starting point, and where pet insurance could likely settle at in the US and Canada, Trupanion has many years of growth ahead provided it continues to serve its customers and channel partners well.

*Trupanion is the
largest monoline
pet insurer in
North America*

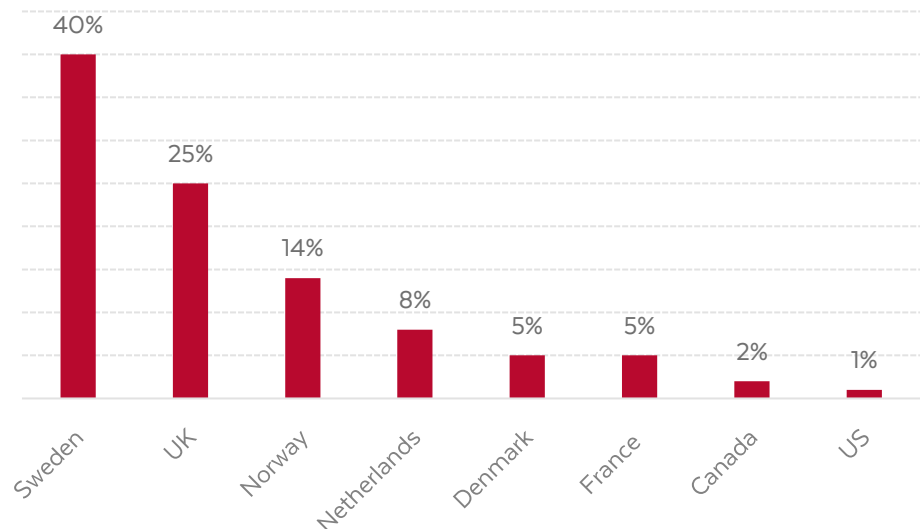


Only 1-2% of pet owners in North America have pet insurance

Trupanion is an excellent example of a stock where being prepared to take a long-term view, as we do at Flagship, can confer one with a competitive advantage.

When a company's growth runway is as long as the one facing Trupanion, it is necessary to forecast the company's revenue growth further out than the typical 1-2 years favoured by the investment banks. Notably, of the seven analysts covering Trupanion, there are only two earnings estimates going out more than two years! We project Trupanion's growth out a decade, although we adjust our discount rate upwards to account for the declining accuracy of longer-term forecasts.

Chart 2: Pet Insurance Penetration Rates (2019)



What sets Trupanion apart?

Trupanion was founded 20 years ago when its founder and CEO, Darryl Rawlings, took out a policy against his adopted dog, Monty. Today it has 530,000 pets on its books. There are a few elements which have enabled Trupanion to be as successful as it is:

An innovative distribution strategy. Trupanion's distribution strategy is through referral relationships with veterinarians. This is powerful due to the trust placed by pet owners in vets, who are seen as best equipped to explain the benefits of coverage to potential Trupanion customers. Trupanion has "territory partners" whose job it is to forge new vet referral relationships within their territories. Vets are not remunerated for referrals but "territory partners" earn commission for each policy sold. This distribution model is in contrast with many of Trupanion's competitors who attempt to sell pet insurance directly to pet owners through expensive online advertisements and through placements in traditional media.

A clear value proposition. When it comes to its customers, Trupanion has a policy of never allowing the portion of premiums that it pays as claims to dip below 70% (in insurance parlance, it maintains its "claims ratio" at 70%) by reinvesting any surplus from underwriting improvements towards reducing its premiums. This ensures its value proposition towards its customers improves over time. In contrast, the "claims ratio" of its average competitor is 50%.



Successful underwriting is the hallmark of a high-quality insurer.

High pet acquisition costs disguise the long-term profitability that Trupanion can exhibit

Excellent service to its referral network of veterinarians. Similarly, Trupanion treats its vets well. Though it does not pay a commission to the vets with whom it has referral relationships, its product has evolved to benefit them in other ways. The most important of these is that it has developed and installed software at a substantial number of vets which enable the customer to pay only his co-payment to the vet directly and Trupanion reimburses the vet immediately for the outstanding amounts owing. The benefit for those vets that take insurance pay (as opposed to cash-based practices) is that they don't have to go through a cumbersome reimbursement process or expose themselves to credit risk (the risk that the customer doesn't pay if the claim is rejected by the insurer). It also benefits vets who operate cash-based practises because this reimbursement method is more popular with customers, and the vets don't have to pay credit card fees on the portion reimbursed by Trupanion.

A history of successful underwriting. Unlike many of its peers, Trupanion does its own underwriting. This means the portion of the total premium that would have been the underwriter's margin can be used to enhance the value proposition for Trupanion's clients. Over many years, underwriting has become a key competitive advantage for Trupanion as their underwriting dataset has expanded to cover over 1.2 million categories of pets, each of which has a slightly different risk profile. This means that there is less subsidizing of "bad insurance risks" by "good insurance risks."

It's all about the margins

Any insurance analyst will tell you that a growing insurance company incurs new business strain because it has to pay commissions upfront for acquiring new policies (Trupanion refers to these as "Pet Acquisition Costs"), but these new policies only generate revenue and profits over a number of years. In Trupanion's case, where the policy count is growing very quickly, this new business strain can be particularly severe.

A misunderstood aspect about Trupanion is the fact that even though the company is making a good primary underwriting margin before pet acquisition costs are taken into account, most of this primary underwriting margin is spent on pet acquisition costs. The pet acquisition costs have also been increasing when measured on a per pet basis, leading some to question whether the business will ever make money.

On the contrary, because of the very high rate at which it is growing its policy count, the long-term return on the cost of acquiring clients is highly favourable. In fact, given the fact that the company earns a very high internal rate of return on incremental new business written (estimated to be 45% p.a. in the half year to end of June 2020) and the degree to which its market is under-penetrated, it makes sense for Trupanion to spend as much as possible on winning new business regardless of the impact it has on short-term profits. As its business scales up it can also spend more on pet acquisition costs on a per pet basis because its fixed costs per pet decline.

The dynamic of high pet acquisition costs offsetting its primary underwriting margin should reverse with time as the growth rate in the company's policy count slows to offset natural attrition and grows a percent or two per annum to be compatible with our terminal growth assumption. When this happens, gross acquisition costs will decline from almost 10% of sales to under 3% of sales on a steady-state basis. At this point Trupanion will be generating very substantial profits and cash flow.



Trupanion: A growing, high ROIC business with excellent long-term prospects

Trupanion is one of those businesses that firstly generates very high incremental returns on capital and, secondly, can invest almost all the capital generated in growing its business. It is not often that we find businesses that have both these characteristics. Most businesses either have: (1) very high returns on capital but do not have growth opportunities in which to reinvest the incremental capital generated or are forced to veer from their circle of competence in order to do so, or (2) have low returns on capital and are forced to reinvest this capital just to keep their businesses ticking over.

Finally, we think the growth trajectory for Trupanion is also best measured in decades as opposed to years which means that it should not run out of a glidepath for growth for years to come.



In conclusion

For many of you, we are the caretakers of a large portion of your global investments. We would like to use this opportunity to thank you for the trust you place in us, and emphasize how deeply committed we are to the responsibility you have placed in our hands.

Your funds continue to perform well. While we believe that Flagship funds will continue to out-perform over longer-term periods, there will inevitably be shorter-term periods over which our funds will not out-perform. This is the nature of markets – one's alpha (or excess performance relative to one's benchmark) is lumpy and doesn't accrue in a straight line.

As co-investors in all Flagship funds alongside our clients, we will not permit good performance to lead to complacency. We thank you for your support and we hope that you and your families continue to be healthy in this strange time.

Warm Regards,

Kyle Wales and Pieter Hundersmarck



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