



FLAGSHIP

ASSET MANAGEMENT

Quarterly Telescope Q2/2021

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 benchmark-beating returns 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.



Performance to June 30, 2021

Global Flexible Strategy	AUM	YTD	1 Yr	Annualised			
				3 Yr	5 Yr	10 Yr	S.I.
Flagship International Flexible Fund (USD)	\$36.1m	7.2%	39.3%	12.4%	10.7%	11.0%	3.4%
Composite Benchmark (50% equity, 30% bonds, 20% cash)		5.0%	17.6%	8.2%	7.3%	10.6%	3.9%
Outperformance vs. Benchmark		2.2%	21.7%	4.2%	3.4%	0.4%	(0.5%)
Flagship IP Worldwide Flexible Fund (ZAR)	R488m	4.5%	12.9%	10.8%	7.9%	11.7%	11.8%
Composite Benchmark (60% equity, 20% bonds, 20% cash)		5.8%	8.2%	8.7%	7.4%	11.1%	9.4%
Outperformance vs. Benchmark		(1.3%)	4.7%	2.1%	0.5%	0.6%	2.4%
Global Equity Strategy	AUM	YTD	1 Yr	Annualised			
				3 Yr	5 Yr	10 Yr	S.I.
Flagship Global Icon Fund (USD)	\$13.7m	9.8%	%	%	%	%	38.8%
Benchmark (MSCI ACWI in USD)		12.3%	%	%	%	%	32.3%
Outperformance vs. Benchmark		(2.5%)	%	%	%	%	6.5%
Flagship Global Icon Feeder Fund (ZAR)	R32.8m	7.2%	%	%	%	%	10.7%
Benchmark (MSCI ACWI in ZAR)		9.1%	%	%	%	%	5.8%
Outperformance vs. Benchmark		(1.9%)	%	%	%	%	4.9%
Global Fund of Funds Strategy	AUM	YTD	1 Yr	Annualised			
				3 Yr	5 Yr	10 Yr	S.I.
Flagship IP Worldwide Flexible FoF (ZAR)	R319m	4.8%	4.3%	9.3%	8.8%	13.9%	13.8%
Benchmark (SA CPI + 5%)		5.2%	10.5%	9.2%	9.6%	10.3%	10.4%
Outperformance vs. Benchmark		(0.4%)	(6.2%)	0.1%	(0.8%)	3.6%	3.4%

Note: All performance is net of fees. 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. Collective Investment Schemes in Securities (unit trusts) are generally medium to long term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily a guide to future performance.



Introduction

In this quarter's Telescope, **Pieter Hundersmarck** discusses how our portfolios navigated the second quarter of 2021 as well as how the funds are currently positioned. **Kyle Wales** discusses why active funds might be set to outperform passive funds. **Jonathan Brink** concludes with our Flagship Primer on the **Global Payments** ecosystem, and the investment case for **PagSeguro** - a high-quality Brazilian bank and payments processor that the Flagship strategies have a large position in.



Pieter Hundersmarck

Pieter is the co-manager of the global funds at Flagship and has been investing internationally for over 14 years. Prior to Flagship he worked at Coronation Fund Managers for 10 years and also co-managed a global equities boutique at Old Mutual Investment Group. Pieter is a dual Dutch and South African citizen, and he holds a BComm (Economics) from Stellenbosch University and an MSc Finance from Nyenrode Universiteit in the Netherlands.



Kyle Wales CA (SA), CFA

Kyle is the co-manager of the global funds at Flagship and 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 South African citizen, a qualified chartered accountant and CFA charter holder.



Jonathan Brink CA (SA)

Jonathan is an equity analyst on the global team at Flagship. Prior to Flagship he spent 3 years at Deloitte. During his articles he predominately serviced the asset management sector and gained great exposure to the industry. Jonathan graduated from Stellenbosch University with a BA (Accounting) with Honours in 2016 and qualified as a chartered accountant in 2020. He is currently a CFA level III Candidate.

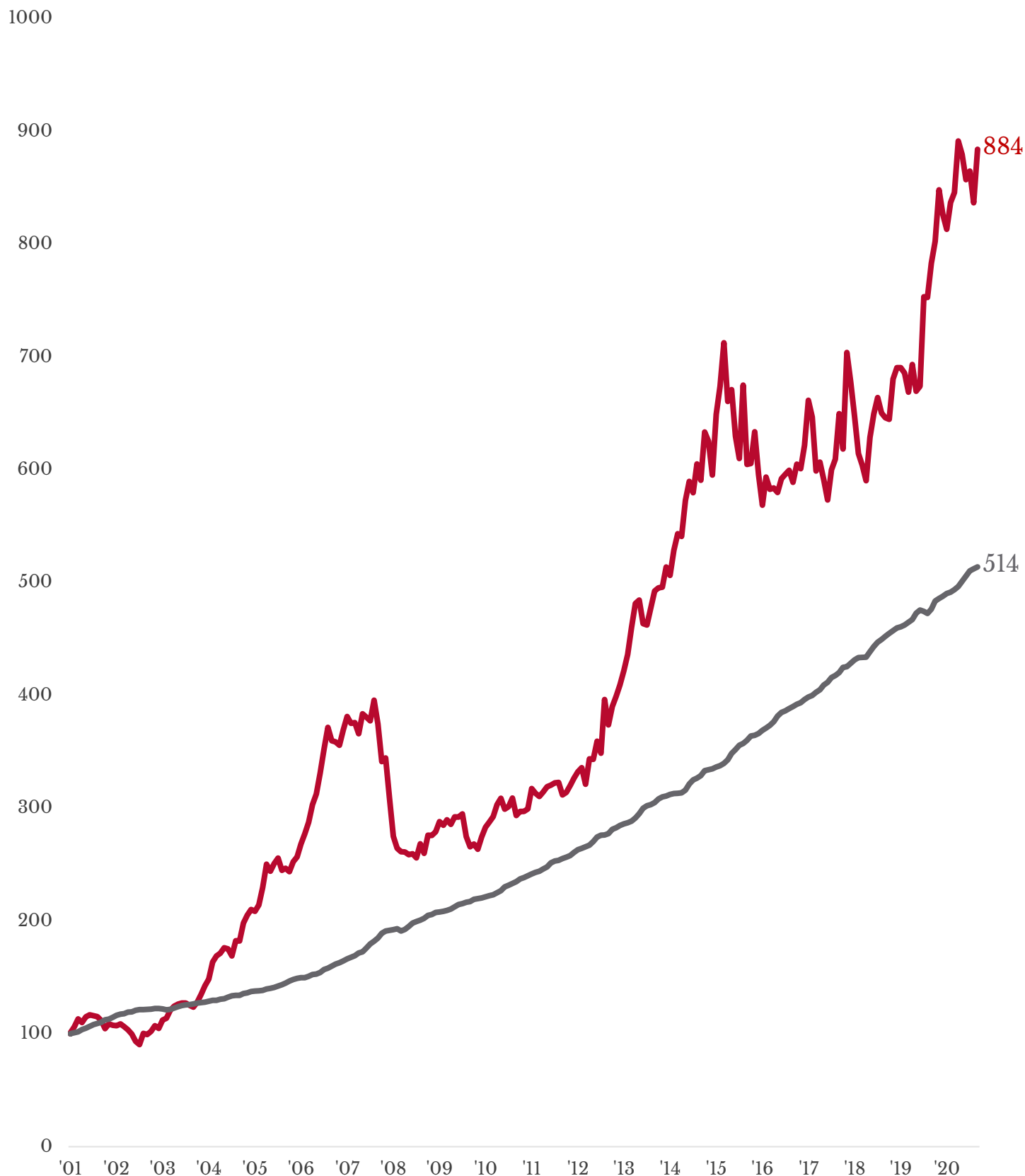
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The Power of Long-term Compounding

The **Flagship IP Worldwide Flexible Fund** (net of all fees) vs. SA CPI +3%

from 1 October 2001 to 30 June 2021 (19 years and 9 months)





Q2: A Noisy Quarter

Predicting rain doesn't count, building the ark does.

- Warren Buffet

The second quarter of 2021 lapped the effects of the COVID19 lockdowns in the prior year. While enormous progress has been made in protecting lives and livelihoods across the globe, the uncertainty of further waves – as well as the slow pace of vaccination in emerging markets – presents risk to sentiment and growth prospects.

The media is awash with the large percentage gains that stock markets, employment statistics and GDP figures have shown in Q2 versus this time last year. We see much of this as mathematical changes from a depressed base, and would rather look at the two year stack of these figures where things do not look as rosy.

Despite this, money is pouring into the US stock market at the fastest pace since 2015, even as valuations sit close to all-time highs and investors worry that higher inflation could push the US Federal Reserve to tighten monetary policy. Since February, US equity funds have experienced net inflows of \$189bn.

Investors seem uncertain of where to allocate these inflows. The first quarter saw a rally in 'value' stocks while the second quarter saw 'growth' stocks rebound strongly, with the Nasdaq up +9.7% and the World Value Index (made up of some very un-value like stocks) up +4.9%. Year to date the Value Index is two percentage points ahead of the Nasdaq.

Much of this uncertainty on stock archetypes is reflected in other asset classes. Conviction on key macro variables such as inflation and commodity prices are as weak as we have seen in some time. There seems to be a cheery consensus that copper, oil and platinum group metals are best placed in the commodity complex. We don't disagree, but are keenly aware that the cheery consensus is not always the place where outperformance is found.

One of the most pressing questions we face is the cadence of the rapidly improving global landscape with the increasing EPS expectations across Wall Street. If the growth rebound can be maintained, stocks are the place to be. If earnings fall short, stocks will correct. Our flexible strategy has tools to benefit from either outcome.

Inflation fears ticking up

US CPI rose by 5% in May compared to the prior year, while core inflation over the period was up 3.8%. As we say on page 7 (Asset Allocation), we are firmly of the view that the inflation we are currently seeing is a logical consequence of the supply and demand imbalances created by the pandemic 12 months ago.

While our expectation is for a resumption of powerful deflationary forces post this brief inflationary shock, we remain cautious that in the event we are wrong, the consequence of materially higher inflation should ultimately lead to higher US rates. As evidenced by our bearish bond view, this is an outcome we are also beneficially positioned for.

Conviction on key macro variables such as inflation and commodity prices are as weak as we have seen in some time



Geopolitical risk is rising

Chinese President Xi Jinping struck a bold tone in a speech marking the Communist Party's 100-year anniversary, calling China's quest to gain control of Taiwan a "historic mission" and warning Beijing's adversaries to avoid standing in the way, this in a speech from Tiananmen Square. He called the move to unify China and Taiwan "an unshakable commitment" and vowed "resolute action to utterly defeat any attempt toward Taiwan independence."

Although the language is similar to what party leaders have said in the past, the comments come amidst escalating tensions with its neighbors. We expect calls for more action from the U.S. to help defend the democratic government in Taipei, as well as the strategic semiconductor industry upon which much of US industry relies.

Regulatory scrutiny on tech is now a global issue

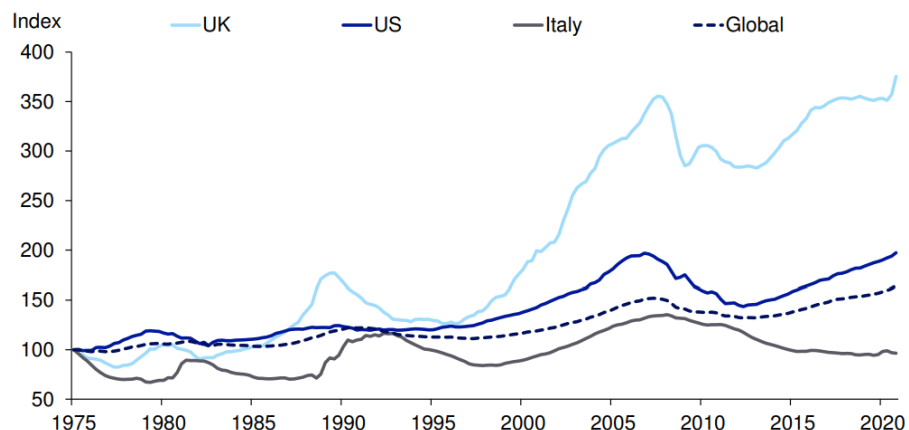
Regulatory pressures are rising on the global tech giants. Germany's antitrust watchdog has launched a probe into Apple regarding market dominance just as the EU launches a formal investigation into Google's advertising business regarding market dominance. China has started probes into all its large tech titans.

We welcome the scrutiny, despite the near-term uncertainty it brings. History shows us that tech companies thrive with greater regulatory certainty, and we expect a minimal impact on the business model profitability of the tech stocks we own (Facebook, Amazon and Microsoft) in all but the most draconian regulatory environments.

House prices are rising

House prices across the globe have risen in the last 12 months. Since housing can often be a bell weather for leverage and risk in the global economy, it is worth monitoring.

As the chart from Deutsche Bank below shows us, US real prices have doubled over the last 45 years. However, between 1907 and 1997 US real house prices were flat, meaning it's only been in the last couple of decades where housing has made "sustainable" real gains. Of more concern is the UK, which has seen a debt fueled housing boom like no other in recent decades.



Note: The authors acknowledge use of the dataset described in Mack and Martínez-García (2011).
Source : FRB Dallas International House Price Database, Deutsche Bank

The transmission of risk from the housing sector to the real economy typically occurs via the banking sector, and is triggered by rising interest rates. If inflation fears pan out and rates rise, we could be seeing the start of the next asset bubble and resultant recession on the horizon.



...we are not
managing money for
the next quarter or
even year – we are
managing it to
protect and grow
wealth over decades.

Conclusion

We know that the future will mirror the past in many ways. As Morgan Housel (author of *The Psychology of Money*) iterates, we expect the stock market to drop 30% or more once or twice a decade, we expect interest rates will rise from their lows and we expect that financial crises will continue to be a feature of the landscape that we participate in. We don't claim to know when these things will happen.

Our expectations are informed by history and the repeating patterns of human behavior. When you expect something to happen, it can't surprise you when it does. This is a powerful tool for psychological resilience as well as portfolio construction.

Forecasting (tying a specific point in time to an expectation) is a foolish and disappointing endeavor, as even professional forecasters will agree. Rather than forecast, we use our expectations to shape the type of assets we own on behalf of our clients (resilient, high quality businesses) as well as the price we pay for them (less than what we believe they are worth).

The two features above are of utmost importance when it is understood that we are not managing money for the next quarter or even year – we are managing it to protect and grow wealth over decades. With this in mind, one can only construct portfolios that will be resistant to serious drawdowns that *will* happen – without a shadow of a doubt.

Successful management of your portfolios during these downturns (the GFC, the taper tantrum, the oil price crash of 2015, the Coronavirus Pandemic and others) is our goal, and our portfolios are constructed to meet that goal.





Strategy Performance

The largest contributors in the second quarter in both our Global Equity as well as our Flexible Strategies were **Tinkoff Credit Systems** (+51%), which has been profiled in our [Q1 2021 Telescope](#), **Zalando** (+23%), profiled in our [Q2 2020 Telescope](#), and **Endava** (+34%), an IT services provider focused on the two fastest growing subcategories in IT services, being digital adoption and near-shoring.

The largest detractors in the second quarter were **Antofagasta** (-13.3%), **Ubisoft** (-8.5%) and **Square Enix** (-10.8%).

The stand-out performer during the second quarter in our Global Fund of Funds Strategy was Sands Capital Global Growth, which rose +10.7% in USD. The worst performer was the iShares MSCI World Value ETF which fell -1.1% in USD. The performance of the Fund of Funds as a whole was very pleasing, delivering a gross quarterly return of +7.3% versus the MSCI ACWI index return of +3.7%.

During the second quarter we added **Huuuge Games** and **US Foods** to the portfolio and sold out of **Global Payments** and **Quilter PLC**.

Huuuge Games is a Polish developer and publisher of casual casino games. Its games show remarkable retention and profitability, with current monetisation at over \$50 average revenue per user per day, with very high retention rates. The Company has ambitions to grow its current franchises and build or buy new ones. Despite considerable growth opportunities, it is our view that Huuuge is currently priced as an ex-growth stock.

IN

Huuuge Games
US Foods

OUT

Global Payments
Quilter PLC



Play Together.

US Foods is the second largest food services company in the United States and a direct beneficiary of an end to lockdowns. We believe it is the most technologically enabled company in its sector which will help it to take significant market share from its competitors. As it gains scale, there is significant scope for the company to expand its operating margins as its investments into growth recede.



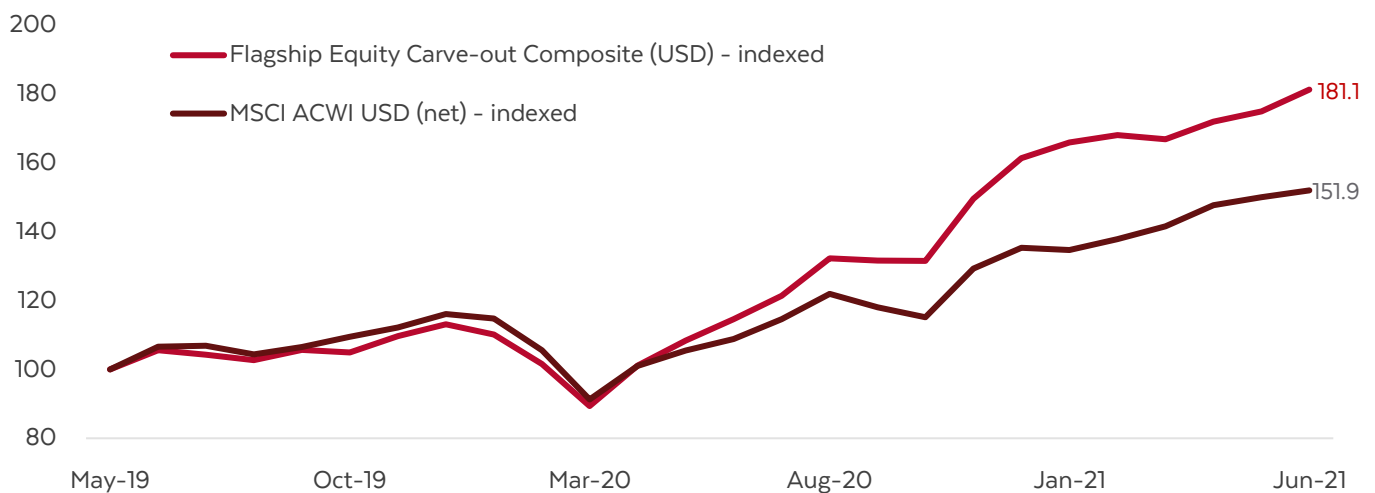
All the positions we exited were due to their share prices reaching our estimate of their fair value.



As we enter Q3 it is worth reflecting on the performance of Flagship's equity selection over the tumultuous past two years. As regular readers know, we run concentrated portfolios and our investment universe is small, consisting of roughly 400 high-quality businesses that the portfolio managers know well.

Our focus on high-quality businesses leads to desirable portfolio outcomes, being higher profit margins, faster profit growth and less susceptibility to cyclicality. It is pleasing to see that these outcomes are borne out by the performance of our equities over the past two years versus the index, as the chart below shows.

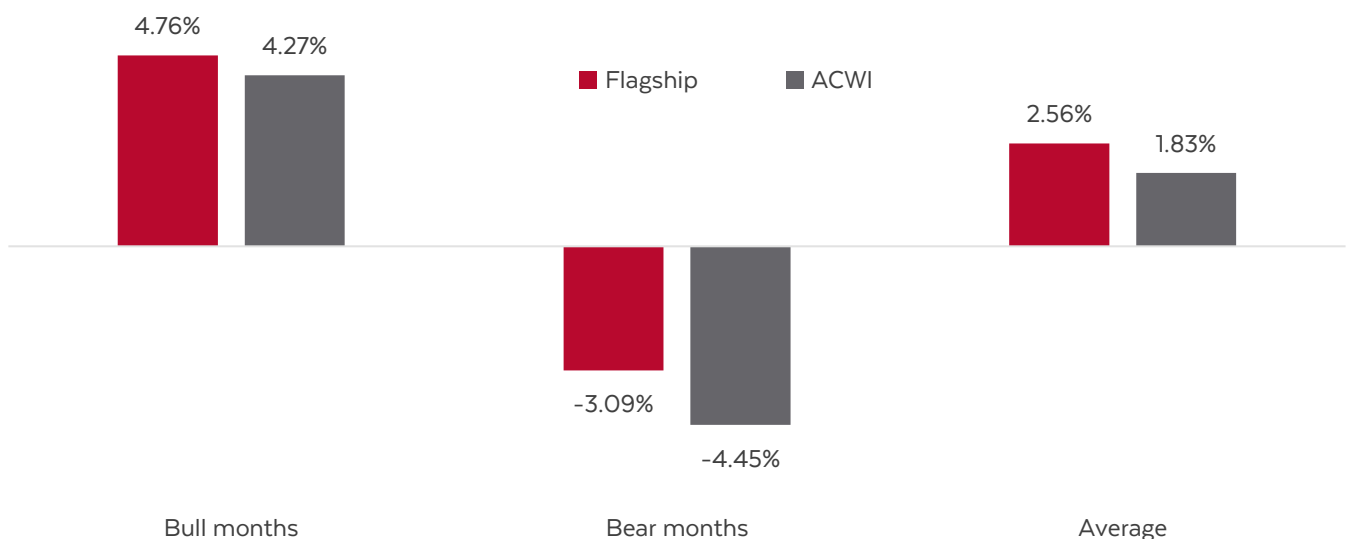
The Flagship Equity Composite Gross Returns vs the MSCI All Country World Index (USD)



Outperformance in both bull and bear markets

In addition to the cumulative outperformance, the resilience of the Flagship equity portfolio in bull markets and bear markets is shown in the chart below. Bull and bear months are defined as months where the benchmark moves up (bull) or down (bear). The average return that Flagship has achieved during bull months (+4.76%) is higher than the same average months for the index, and the average performance during bear months (-3.09%) is superior to the index average of (-4.45%).

Flagship Equity Composite in Bull and Bear months since June 2019 – Outperformance in up and down markets





Asset allocation

The first panacea for a mismanaged country is monetary inflation, the second is war

- Ernest Hemingway



Pieter Hundersmarck

Flagship asset allocation was little changed in the quarter. Despite above average valuation levels for equities as a whole, we continue to find considerable value in a cohort of 25 high-quality shares that make up the majority of the net asset value of our flexible strategy. As a reminder, the Flexible Strategy will always exhibit a bias towards equity as an asset class in order to achieve its mandate of growth ahead of inflation.

Our bear thesis on global bonds has finally begun to bear fruit, with bond prices falling since the start of the year and now firmly underperforming equities. The falling bond prices have been driven by higher inflation expectations in the near term.

While we are factually seeing higher inflation come through in the monthly data, opinions on the extent and duration of inflation differ. We are firmly of the view that the inflation we currently see is a logical consequence of the supply and demand imbalances created by the pandemic 12 months ago. The evidence suggests that global production chains were halted on the expectation of far lower demand in the coming 12 months, when in fact demand has surged due to government handouts and recovering employment and investment.

Recall that inflation is a persistent rise in price levels, driven by dislocations in supply and demand, and heightened by tight factor markets, including labour. Technology has enabled enormous advances in supply-side scalability for many businesses, removing the late 1960s 'infrastructure capacity' constraints that lead to persistently higher inflation. We see the deflationary impact of technology persisting for a while longer.

The effect of inflation on high-quality equities is divergent. On the one hand we expect to see the companies that we own fare better during inflationary times due to their ability to pass price increases on to clients, while also managing their costs. On the other hand, the cost of capital increases via the rise in interest rates associated with higher inflation. This means the discount rate for long-dated growth stocks rises, diminishing the present value thereof. On balance we remain convinced that a focus on high quality stocks is the correct approach.

On the currency front, there have been ominous views expressed about a potential debasement of the US dollar, and what will happen if foreigners are no longer willing to support US issuance. We believe that a discussion of the currency must include the reality that the Fed has many tools to mitigate such debasement, foremost among them being interest rates to fight rising inflation. The recent Fed announcement that rates would rise sooner than anticipated caused an initial flurry, but this dissipated towards the end of the quarter.

Commodity prices seem range bound, but we have little doubt that resource demand remains robust and supply (for the most part) is constrained – particularly for copper and oil. We remain bullish on the prospects of both, and note that any delay in Fed tightening – accompanied by a commensurately weaker dollar – will lift commodity prices further.



Pieter Hundersmarck

Investors can be fooled into buying stocks on a low P/E without taking into account the much lower growth prospects that these stocks offer

Stocks trading at the same price earnings multiple are not the same

In a bull market, stocks are priced using PEG ratios, and in a bear market they are priced on PE ratios.

Both are useful. The PE ratio compares the price of a share to the earnings that share is expected to generate over the following twelve months. It illustrates the relationship of a share price to its earnings generation capacity (in this case earnings per share).

Price to earnings multiples can tell us what the market thinks of a business. If stock A trades at 12x earnings per share and stock B at 24x earnings per share, the market believes that the earnings per share of Stock B is worth twice that of Stock A. The two main reasons for this are the quality of those earnings and the growth rate of those earnings.

PEG ratios (the price earnings ratio divided by the EPS growth rate) can be a useful sanity check on valuations. It combines the PE ratio with the expected growth trajectory of earnings per share (EPS), allowing us to compare 2 shares that have the same P/E multiples, but different growth profiles.

In the table below I've averaged the next two year's EPS and used next year's PE (all Bloomberg consensus) for a range of popular 'blue chip' consumer stocks.

Consumer Stocks	1 Year forward P/E Ratio	Expected EPS growth (2 year)	PEG Ratio
RECKITT BENCKISER	19.1x	8.3%	2.3x
COLGATE PALMOLIVE	22.9x	6.2%	3.7x
PROCTER & GAMBLE	22.5x	6.5%	3.4x
UNILEVER	18.6x	5.7%	3.3x
L'OREAL	38.4x	8.8%	4.3x
ESTEE LAUDER	42.0x	16.4%	2.6x
NESTLE	22.9x	7.2%	3.2x
MONDELEZ	19.6x	7.2%	2.7x
Median	22.7x	7.2%	3.3x

All of these companies are undoubtedly high quality. They own top quality brands, have geographically diverse operations, deliver high profitability, attract the best management teams and generate large amounts of free cash flow. They have also been around for a long time (although in different form) implying a high level of resilience.

But how many of these high-quality traits are unknown by the market? We would wager very few. The median price earnings multiple of 22.7x (higher than their long run average) tells us that their quality attributes are no secret.



The PEG ratio is useful here. The median growth rate in EPS for the selection of consumer names in the table is 7.2%. When comparing the PE multiple to the growth rate we arrive at median PEG of 3.3x.

Below is the same table, but this time using online gaming businesses instead of consumer stocks. The median PE ratio of 23.4x is very similar, but the expected growth rates are far greater, leading to a median PEG ratio of 1.5x – nearly half the 3.3x offered by the consumer names.

Online Gaming Stocks	1 Year forward P/E Ratio	Expected EPS growth (2 year)	PEG Ratio
ELECTRONIC ARTS	23.7x	11.2%	2.1x
ACTIVISION BLIZZARD	21.4x	11.4%	1.9x
TAKE-TWO INTERACTIVE	29.7x	17.8%	1.7x
TENCENT	26.9x	23.3%	1.2x
NETEASE	23.1x	17.6%	1.3x
UBISOFT	23.9x	12.4%	1.9x
SQUARE ENIX	20.2x	23.0%	0.9x
HUUUGE	15.3x	40.9%	0.4x
Median	23.4x	17.7%	1.5x

The PEG tells us that for the same price, you can buy double the growth. But what of the quality of earnings? Is the quality of the earnings of the online gaming companies lower to account for this differential in the PEG?

Not so in our view. The online gaming companies are also of undoubtedly high quality. They own top quality gaming franchises, deliver even higher profitability, attract the best management teams and generate even larger amounts of free cash flow than consumer companies. They have also been around for decades and operate in much faster growing markets than the afore mentioned consumer companies.

As the example shows, investing purely on the basis of PE can be treacherous

Using the PEG ratio is a good barometer of what is expensive or cheap relative to growth. Anything valued higher than a 1.5x PEG needs a good reason for being so, and anything trading below 1.5x looks cheap relative to its growth prospects. As we've shown, it's also a useful metric to compare stocks to each other.

Consumer names are extremely expensive versus their own history, as well as their growth prospects. Not only are they expensive, they are highly negatively correlated to rising bond yields. The same cannot be said of a selection of high-quality online gaming stocks.



Kyle Wales

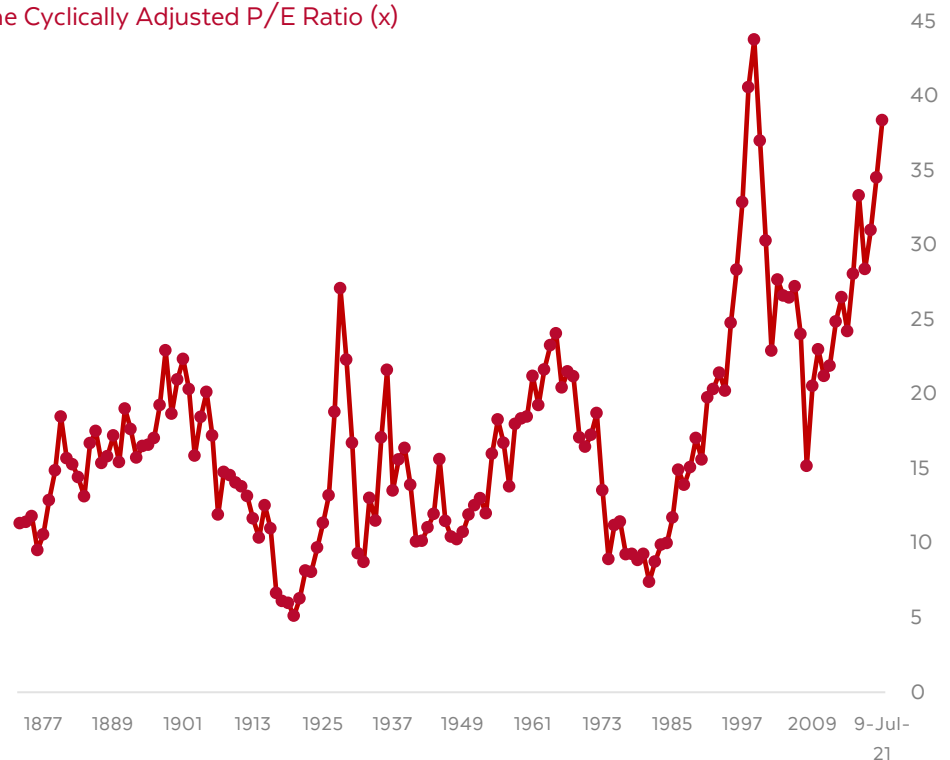
Active managers are more likely to outperform at market inflections

While commonly held wisdom holds that passive investment strategies will always be better than an active strategy (due to the fee differential), this is simply not the case. This is particularly true at market inflection points like the one that potentially lies ahead.

Market inflection points typically arise when markets appear expensive or cheap. A useful measure of the equity market's valuation, the cyclically adjusted P/E (or "CAPE") ratio for the S&P 500, tells us that the risks of a correction are building.

The CAPE ratio is calculated by taking the current price of the S&P 500 and dividing it by the average inflation-adjusted earnings over the last ten years to adjust for cyclicity. It is currently at its second-highest level over the last century. The only time the market has been more expensive than today was at the peak of the dot com bubble of the early 2000s.

The Cyclically Adjusted P/E Ratio (x)



Many managers claim to be active managers, but their portfolios resemble the benchmarks they are paid to outperform so closely that they are virtually guaranteed to underperform.

The ability to outperform passive investment strategies is best demonstrated in multi-asset flexible funds, which can use a variety of different asset classes as well as asset allocation to generate returns. It is much harder to craft an index that does this effectively.

While the benefits of active and passive management have been given a lot of airtime, questions that are raised less frequently are: If I commit a portion of my funds to an active asset manager:

- How do I choose the right active manager?
- When is the best time to buy or increase my allocation to the right active manager?



At Flagship we run concentrated portfolios that by default will look nothing like the index they are benchmarked against.

Active managers in aggregate outperformed the S&P 500 in both 2001 (after the dotcom bubble) and 2009 (after the global financial crisis).

Choosing the right active manager

Choosing the right active manager is essential if you want to achieve returns that outperform the market. Firstly, investors need to select an active manager that is truly active, and not simply tracking the benchmark. Many managers claim to be active managers, but their portfolios resemble the benchmarks they are paid to outperform so closely that they are virtually guaranteed to underperform. The reason for this is that the extra fee they charge is unlikely to be offset by the potential outperformance that their portfolio can generate.

Signs that a manager is guilty of this practice (referred to as “index hugging”) are that they hold a diluted portfolio with many small positions. Their portfolios exhibit a low tracking error, with the fund performance closely matching the benchmark, and a low active share, where the portfolio looks very much like the benchmark weightings (being the sum of the absolute values of the differences of each holdings weight in managers portfolio versus benchmark weight). The last two measures show how different the manager’s portfolio is from the market as a whole.

The second key consideration should be whether an active manager has demonstrated their ability to outperform over extended periods and done so by following a consistent philosophy and process. This is essential because it indicates that the portfolio manager’s performance is more due to skill than luck.

When is the best time to increase my allocation to an active manager?

While certain active managers have proved their ability to outperform the market consistently over time, there are certain times when active managers in aggregate have outperformed the market. According to the SPIVA Report, published by S&P Global annually, active managers in *aggregate* outperformed the S&P 500 in both 2001 (after the dotcom bubble) and 2009 (after the global financial crisis).

The reason why active managers tend to outperform during these times of massive dislocation is because index funds are, by their nature, procyclical. The nature of indexing forces the passive investor to buy more of the shares that are becoming more expensive and to sell the shares that are becoming cheaper.

This is the opposite of what active investors, who believe that every asset has a *fair* price, try to do. They aim to buy assets for below what they are worth and sell them when their prices get ahead of themselves.

Could we be sitting at such an inflection point today?

Perhaps. Post the COVID crisis sell-off in the first quarter of 2020, the S&P 500 is now up 43% over one year, up 67% over three years and 125% over five years to end June 2021. The current expansionary cycle has lasted more than ten years, twice as long as the typical expansionary cycle.

It is at moments such as these that an actively managed equity fund can provide one with protection because even though the market *as a whole* may appear expensive, there are always individual stocks that are under-priced relative to their long-term growth prospects.



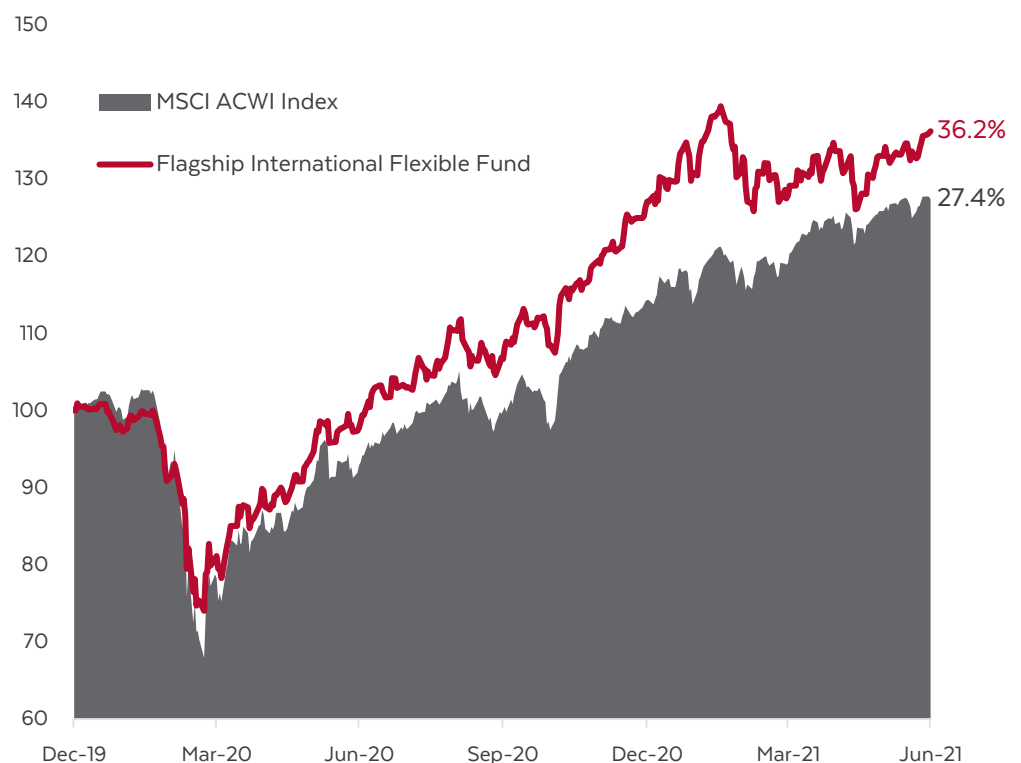
Flexible Funds are the correct vehicle for savings in these environments

Multi-asset flexible funds have a broad range of tools at their disposal from which to offer investors a suitable risk-adjusted return proposition at market inflection points. Because of their flexibility, the full benefit of active management should, arguably, be brought to bear in flexible funds.

In Flagship's Flexible Strategy, significant value was created for clients during the COVID led sell-off by adding aggressively to our equity allocation as market prices fell. The chart below shows the performance of the Flagship International Flexible Fund versus the MSCI All Country World Index, both normalised to 100 on January 1, 2020.

Two things stand out. The first is how the Fund experienced a lower drawdown than the index in March 2020 (specifically a 26% fall vs a 32.1% fall in the index) to March 23, and secondly, how equity selection *as well as* asset allocation has allowed the fund to continue outperforming the index while being only 75-80% invested in equities.

Flagship International Flexible Fund vs the MSCI ACWI Index (Jan 2020 – June 2021)



Going forward, rising inflation and higher interest rates will create a greater dispersion in returns than the last ten years of constantly rising equity and bond prices. Managers that are able to calibrate their funds to take advantage of these moves will be able to add far greater value than any passive strategy.

Conclusion

To be a “winner” in active asset management, you have to add something unique and valuable that passive strategies cannot provide. At Flagship, our Global Equity Strategy offers a unique, concentrated selection of stocks that cannot be replicated by an index. Our multi-asset flexible strategy offers asset allocation skills that have historically produced superior results to their benchmarks at market inflection points.

Both of these strategies have a firm place in client portfolios.



Flagship Primers: Payments

“Your assumptions are your windows on the world. Scrub them off every once in a while, or the light won’t come in.”

Isaac Asimov



Jonathan Brink



Summary

1. The Global Payments Industry is large, lucrative and growing. Estimates are that the total volume of payments growth will exceed 10% per annum over the next five years.
 2. The Global Payments ecosystem consists of a wide range of service providers that provide specialised expertise to ensure that transactions are executed and cleared in the swiftest possible time with the lowest possible risk.
 3. The traditional players in the payments chain have been large financial institutions, as well as the card networks (Visa, Mastercard, etc.). As new services develop and ecosystems unfold, these incumbents face meaningful challenges from disruptors.
 4. These new disruptors include (amongst others) Adyen, PayPal, Stripe, Apple, Shopify, Google and Amazon. These firms typically offer some combination of higher functionality (e.g., trading, Buy Now Pay Later), lower fees, higher security, or ease of use to their clients.
 5. Often, as is the case with Shopify (an e-commerce business), the size of their client and merchant ecosystem is a powerful motivator to adopt payments processing in-house rather than outsource to a third party.
 6. In times of disruption there are opportunities to generate meaningful returns from equities that fail to properly discount the prospects of these disruptors. Over the past twelve months, the Flagship Equity funds have taken positions in **Global Payments**, **PayPal** and **PagSeguro** to take advantage of what we see as multi-year growth stories that are not properly valued by the market.
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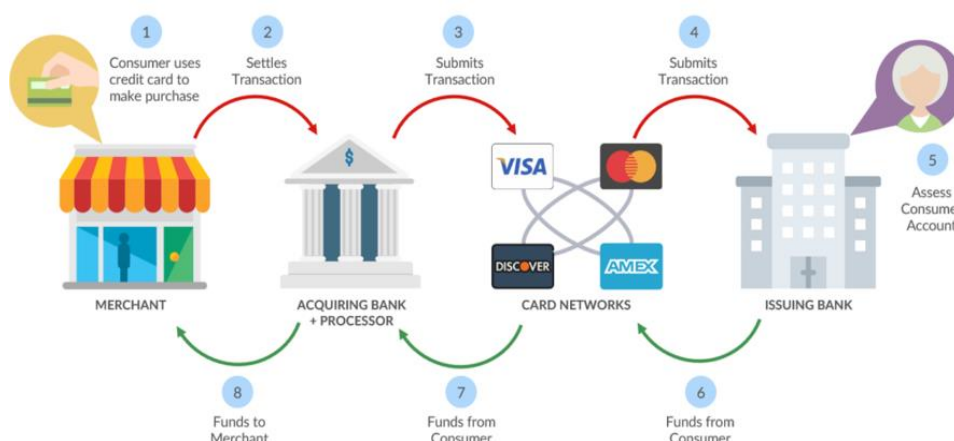


Visa processes 150 million transactions a day

Bitcoin, blockchain, digital wallets, central bank digital currencies (CBDC) and accelerated cash to card conversion. These are words you may be familiar with even though you may not know what they mean. The world of payments is an intricate one, with multiple institutions and intermediaries playing a key role in facilitating the safe and secure purchase of your next morning coffee or meal with friends.

When you “tap” your card at a point-of-sale machine, your transaction is authorized in under 3 seconds. While this is a seamless and elegant payment experience, have you ever wondered what is happening behind the scenes? What data is being exchanged, between which institutions and at what price, all in the blink of an eye? Probably not, but if I told you that authenticating these transactions generated more than \$500 billion in fees globally every year, you might be a little more interested.

When you purchase your morning coffee using your bank card, your personal information is exchanged between multiple institutions in order to validate the transaction. Validating these transactions comes at a price and a company like Visa processes 150 million transactions a day. There are 3 steps to assess whether you have sufficient funds in your account and a further 3 steps to relay that back to the merchant as seen below. The diagram below from Infincept shows how each intermediary plays an important role:



Card networks: These are the backbone of the electronic payments system and provide infrastructure and facilitate transactions on their card networks. They transfer data securely between the various participants in the chain.



Acquiring and Issuing banks: These are regulated financial institutions such as Standard Bank and must comply with the networks’ rules and regulations. The issuing bank services the consumer (you) and the acquiring bank services the merchant (coffee shop). The issuing bank settles transactions (funds) with the acquiring bank after a transaction has been completed.



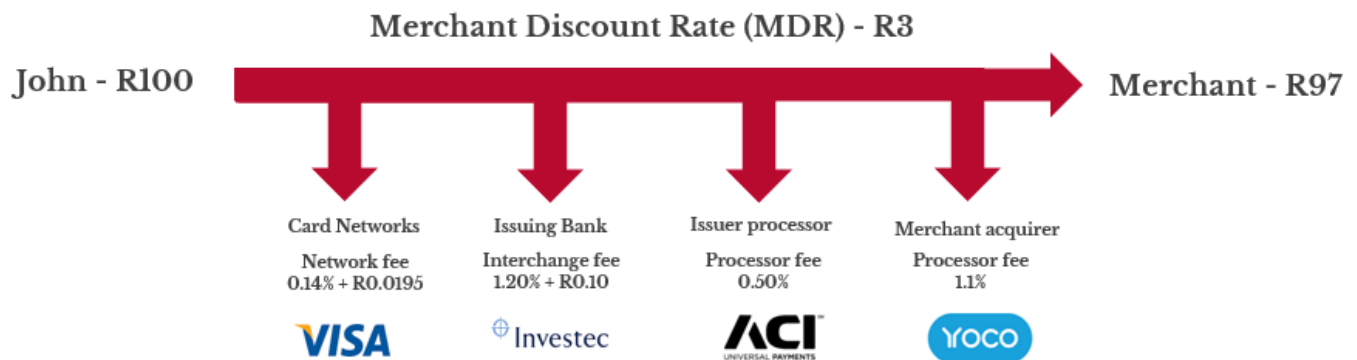
Acquirer processors: In South Africa, this service is typically provided by the larger banks, however, in the US (for example) institutions specialize in this. Acquirer processors allow merchants to accept card payments by providing point-of-sale machines to the merchant (e.g., a coffee shop) which communicate with the network to authorize consumer transactions. Acquirer processors are the back offices of acquiring banks.



Issuer processors: These intermediaries connect directly with the network and issuing bank to provide a system of record, manage issuance of cards and authorize transactions for issuing banks. Issuer processors are the back offices of issuing banks.



As a consumer, you are likely to be fairly indifferent about the costs of these transactions as they are borne by the merchant. If you were to make a purchase of R100, the merchant would receive R97, with R3 being shared amongst the various intermediaries as a “fee” for processing the transaction. This R3 fee is known as the “merchant discount rate” (MDR). As the name implies, it is the discount/fee that is applied to the original purchase price of R100 before the merchant receives the discounted amount of R97.

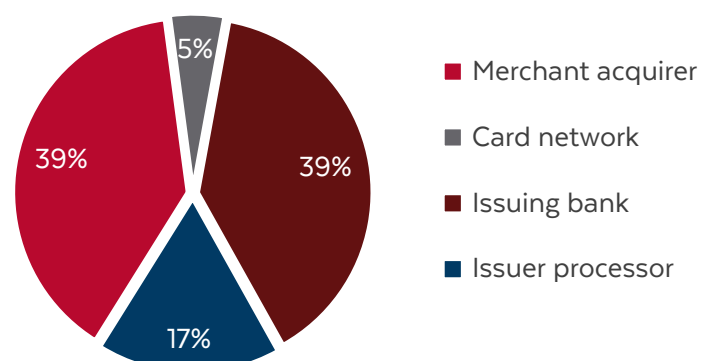


The MDR varies according to whether the purchase is made on debit or credit (amongst other factors). For example, purchases made on your credit card will cost the merchant 2.9% of the transaction value, compared to less than 1% using a debit card. The rates differ to account for the credit and fraud risk borne by your bank depending on the type of payment (debit or credit).

Purchases made using debit cards (cash) are considered “pre-authorized” by the customer. This is because the customer has the available funds in his/her account and thus the transaction amount is simply deducted from what is readily available. There is little risk borne by the issuing bank and thus the processing fee is lower. This is not the case for credit cards as the customer does not have the physical funds and the issuing bank extends credit on the customer’s behalf.

Merchants expect payment upfront, thus when a customer makes a purchase using a credit card, the issuing bank will settle the bill upfront with the merchant. The issuing bank is remunerated for this risk by receiving what is known as the “interchange fee” on credit transactions. This fee makes up a large proportion of the total MDR and highlights the profitability of credit card transactions for issuing banks (and why new age products like Buy Now Pay Later are a threat to credit card issuers – a discussion for another day). The chart below depicts how the R3 transaction processing fee is split amongst the various intermediaries.

Transaction Processing Fee Split

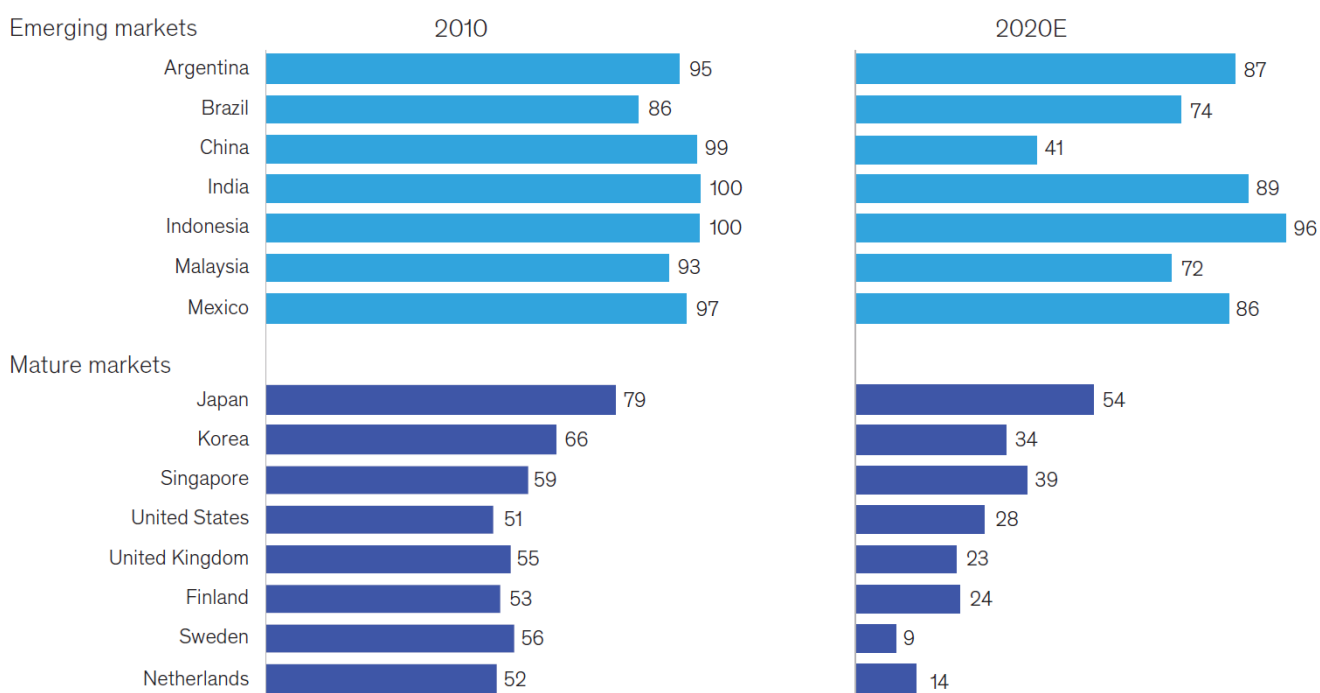




With its many nuances, why is this sector of the market so attractive?

Over the past 10 years the use of cash has steadily declined. This is especially evidenced in mature markets as the charts from McKinsey (2020) shows below. Technological innovation has made the process of paying “digitally” quick, seamless and convenient. Contactless payments and digital wallets have resulted in hundreds of billions of dollars in physical currency being replaced with digital spend. Thus, from a secular perspective, payment processors have been well positioned to capture this conversion over time. Covid-19 accelerated this conversion significantly as consumers around the world avoided using physical currency due to its associated health risks.

Cash usage by Country - % of cash used in total transaction by volume, %



Technological innovation has made the process of paying “digitally” quick, seamless and convenient

The growth of payment processors is correlated to growth in the economy but in recent years has been growing faster than the economy due to rising levels of card penetration. The most attractive hunting grounds for potential investments are therefore in emerging markets as they have high levels of cash usage (and therefore low credit card penetration).

To complicate matters even further, within this space there are not only incumbent players who work within the ambit of Visa/Mastercard networks but also disruptive players (like PayPal) which are attempting to create their own two-sided network, replacing the need for intermediaries. We have at times held both in Flagship funds but are more excited about the disruptive players.

We find that the Brazilian market is particularly attractive today and we hold a disruptive Brazilian acquirer processor, PagSeguro, in the funds. We will delve further into the investment case of PagSeguro in the next article.



Investment Case: PagSeguro



Summary

PagSeguro is located in Brazil, a country with very high cash usage and a population of 210 million. Our research has found that Brazil is on the brink of massive change, driven by the following catalysts:

1. Firstly, Covid-19 accelerated the digital conversion of cash to card in Brazil by 3 years.
2. Secondly, recent technological advances in Brazil have led fintech companies to offer a viable digital alternative to cash that is safe, cheap and efficient.
3. Thirdly, traditional incumbent banks in Brazil have been largely bureaucratic and fragmented, falling short of meeting consumer's needs. This has been especially prevalent in lower income groups. As a result, 60 million people are considered unbanked in Brazil. These 60 million people move nearly \$205 billion of the country's economy per year.

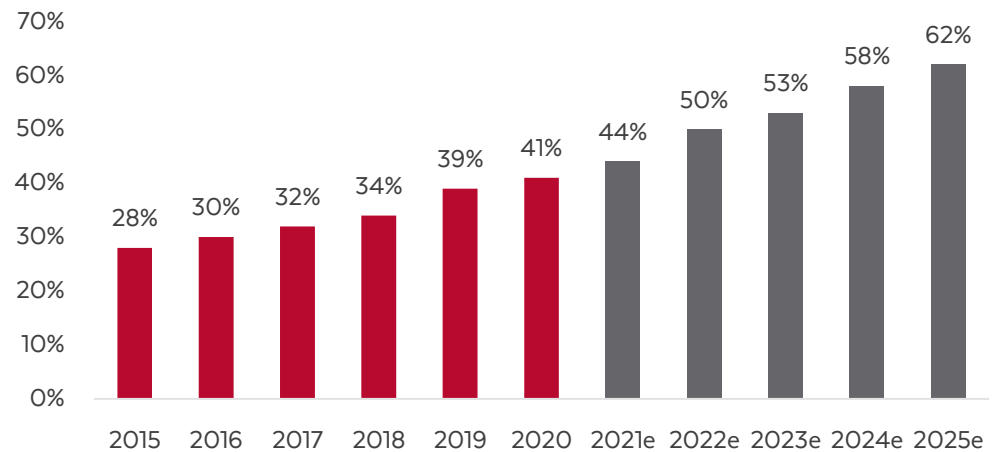
PagSeguro is navigating this landscape successfully and developing a solution to bank the unbanked and capturing a fortune at the bottom of the pyramid.



Brazil is on the brink of massive change

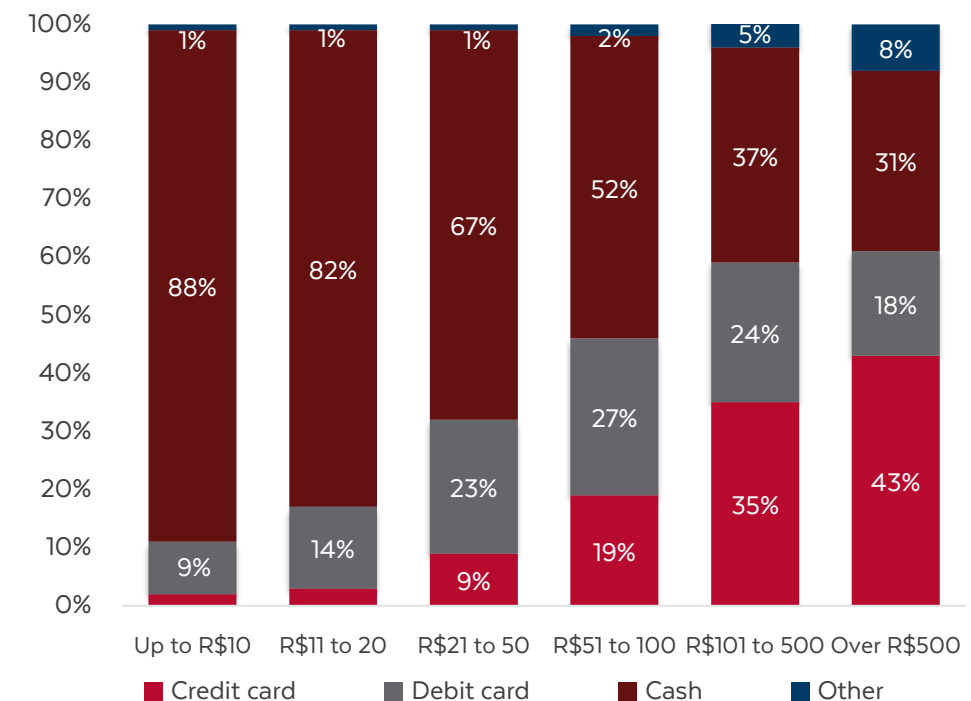
Brazil's high levels of cash usage can be seen in the chart below. According to Mckinsey, card penetration in Brazil is a mere 41% versus 74% in the US. Brazilian consumers thus use cash to make purchases nearly 60% of the time. Looking forward, card expenditure in Brazil is expected to increase significantly over the next 5 years, from 40% of personal consumption expenditure (PCE) in 2020 to 62% in 2025. Payment processors in Brazil are well positioned to benefit from this conversion.

Brazilian card expenditure as a % of PCE



As seen in the chart below, cash is still used in a large number of transactions in Brazil that would be card based in mature markets. This high cash usage for small transactions is partly attributable to the incumbent bank's inability to service the 60 million unbanked people that move nearly \$205 billion of the country's economy per year. For sake of reference, a movie ticket in Brazil typically costs R\$30 and a 500ml beer costs R\$7, which would fall within the first 2 bars in the below graphic.

Most frequent payment instrument by size of transaction



Card expenditure in Brazil is expected to increase from 40% of personal consumption expenditure (PCE) in 2020 to 62% in 2025.



Merchants using
PagSeguro can
sign up faster and
at better rates

Thus, a candidate for inclusion in the global portfolio would be a business in Brazil that offers the following:

1. Payment processing services to the Micro and SME market who are more likely to be unbanked
2. Attractive banking products and services never before offered to the unbanked (60 million consumers to monetize).
3. Strong moat around key aspects of the business.

This led us to one of our core holdings in the fund, PagSeguro. Founded in 2006, the company began its operations as a merchant acquirer providing typical payment processing and other value-added services to micro-merchants and SME's. Fast forward the clock 15 years to 2021 and the company is a hybrid of a bank and a tech company, building a compelling two-sided network with a mission to disrupt and democratize financial services in Brazil. The company has grown its revenue from R\$1.1 billion in 2016 to R\$6.8 billion in 2020 and the number of merchants using its payment processing services has grown from 1.4 million to 7.1 million. Over this period, EBITDA has grown from R\$70 million to R\$2.2 billion. Most importantly, PagSeguro is not showing any signs of slowing down.

Similar to the disruption being caused today by disruptive payment processors like Square ("SQ") in the US and Adyen ("ADYEN") in Europe, PagSeguro has followed the same playbook in Brazil by aggressively stealing market share from the incumbent players. The incumbent payment processors in Brazil are owned by five major Brazilian banks (representing 70% of the acquiring market in 2020). These incumbent players serviced the SME space poorly and merchants were frustrated with a number of issues such as:

1. The process of opening up a bank account could take weeks as merchants were required to fill in volumes of paper work to satisfy banks' underwriting models and receive regulatory approvals. This resulted in merchants being unable to accept card payments leaving customers frustrated.
2. Signing up with one of the incumbent merchant acquirers was an expensive process. Merchants were charged a fixed fee and faced hefty early cancelation fees. Additionally, hardware costs (point-of-sale machines) were prohibitively high as there was no cheap viable alternative to payment processing hardware. As a result, merchants were locked in at higher rates and lacked flexibility (which is often needed for SME's).

PagSeguro was quick to act and alleviated a number of these headaches. Merchants can now sign up quicker and at a much more affordable rate than previously offered by the traditional incumbents. The proof is in the pudding and PagSeguro has the largest point-of-sale base in the Brazilian SME market today.

However, PagSeguro's success as a merchant acquirer is only half the story and it is PagSeguro's more recent transition into a completely new area that excites us most. This new area is banking and its latest undertaking, PagBank.

Established less than 24 months ago, PagBank is already the 3rd largest digital bank in Brazil, and the exponential growth in its client base is expected to continue.



Merchants are more concerned about their cash flow needs than they are about early settlement fees.

Will PagBank succeed? We think so. Let us dig a little deeper into the investment case.

It is important to understand how the Brazilian consumer buys products and services to contextualize how PagSeguro has disrupted payments.

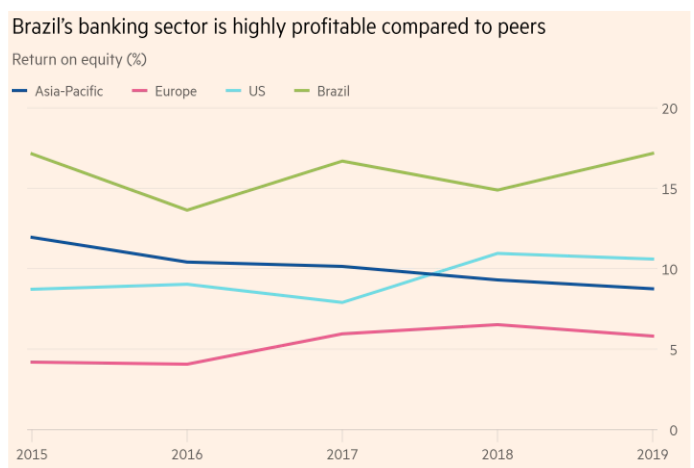
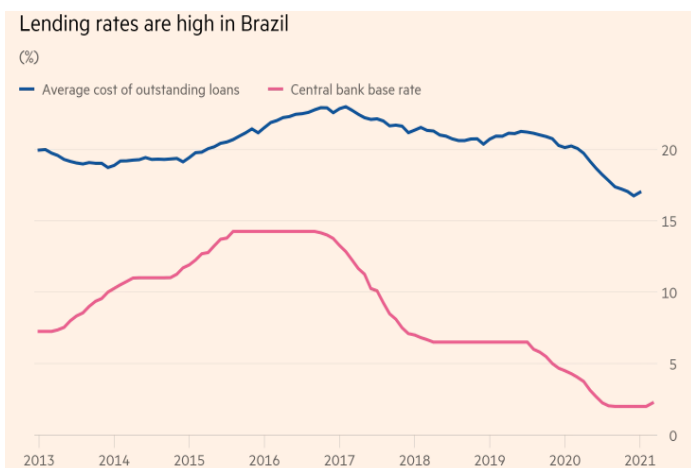
In Brazil, consumers expect the merchants (not the banks like the rest of the world) to grant them credit when making a purchase. The purchase amount is then paid off interest-free in multiple monthly instalments. This is the case for 60% of all credit card transactions in Brazil.

Thus, a merchant will make a sale and only receive the revenue after the respective monthly instalment has been paid. This has created working capital nightmares for merchants as they may only receive full settlement up to 6 months later.

PagSeguro was quick to identify the issue and began offering merchants a receivable prepayment option for a fee. Under this option, PagSeguro settles the receivable due to the merchant on behalf of the consumer and the underlying receivable is then owed to PagSeguro by the credit card issuers. PagSeguro charges a finance fee in the form of a discount to the lump sum receivable. The merchant is paid the amount of the receivable less the prepayment fee. PagSeguro learnt that merchants were more concerned about their cash flow needs than they were about paying a fee for early settlement. This created a win-win as the early prepayment of receivables created a working capital alternative for merchants whilst also generating incremental income for PagSeguro.

PagSeguro used to finance these prepayments using debt that had been extended to it by banks, often at very unattractive rates. As the charts below from The Financial Times illustrates, Brazilian banks have historically charged extremely high interest rates and the spread between the retail lending rate and the central bank rate is amongst the highest in the world.

Traditional Brazilian banks are amongst the most profitable banks in the world



Thus, PagBank was born. Instead of borrowing money from the traditional banks to finance the prepayment receivables, PagSeguro was able to fund the receivable prepayments at a materially lower rate by becoming a bank and taking deposits from customers. By having 15 years of experience in the micro and SME market, PagSeguro understands the LSM consumer and is one of the only players that can effectively price for risk in this segment.



The total addressable market for PagBank is 17x the size of PagSeguro's merchant acquiring business.

PagBank set out to build a compelling two-sided network with a mission to disrupt and democratize financial services in Brazil

PagBank set out to build a compelling two-sided network (acquirer on one side and a bank on the other) with a mission to disrupt and democratize financial services in Brazil which was up to then a concentrated, underpenetrated and high interest rate banking market. In less than three minutes and 100% online, merchants and consumers can open up a free PagBank digital account with a wide range of offerings, operating as a regular checking account.

PagSeguro hopes to create an ecosystem where consumers will use PagBank as their preferred choice for storing and spending funds, whilst merchants will choose PagSeguro to process their payments. PagSeguro retains important information relating to its customer (spending habits, credit availability etc.) and can cross sell a range of products accordingly.

Let's look at a number of practical examples of how having PagBank can benefit PagSeguro:

1. PagBank notices a consumer having excess cash sitting in his/her digital account. PagBank advises client to earn interest on his/her balance by investing in one of PagBank's Certificate of Deposit (CD).
2. PagBank uses proceeds from CD to finance prepayment of receivables for their merchants.
3. If the receivable prepayment made to a merchant is relating to a PagBank customer, PagSeguro will have the ability to recoup the amount directly from the customer (instead of from the issuing bank) and have full insight into the customer's ability to make repayments.
4. PagBank will generate an additional revenue stream on 3rd party transactions by acting as the card issuer for consumers (recall the interchange fee from earlier).
5. Transactions that take place within PagSeguros' two-sided network, the MDR fee does not need to be shared between various intermediaries, resulting in a more profitable transaction.

PagBank is still small in PagSeguro's life. As at FY20, PagBank revenue only accounts for 8% of its total revenue. It is not expected to remain small, however, as the total addressable market for PagBank is 17x the size of PagSeguro's merchant acquiring business. Management has provided guidance for a PagBank revenue target split of 30% by 2024.

Given that millions of merchants already use PagSeguro as a payment processor and 60 million consumers are unbanked, there is a long runway for growth ahead and substantial upside to the share price.



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.

Flagship funds own a selection of businesses that we believe to be of unusually high quality, and will prove to be financially resilient whatever the prospects of the global economy. We expect the value of these businesses to rise at an attractive rate over the coming years, and that owning these businesses at a discount to what they are worth will make an additional contribution to your returns.

While we believe that Flagship funds will continue to outperform over longer-term periods, there will inevitably be shorter-term periods over which our funds will not outperform. 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.

Warm Regards,

The Flagship Global Team





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