FLAGSHIP
ASSET MANAGEMENT

Quarterly Telescope Q3/2021

Flagship Asset Management · Constantia, Cape Town · +27 (0)21 794 3140 · info@flagshipsa.com

01

We are a global specialist investment boutique

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 are long term investors who manage concentrated portfolios

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 September 30, 2021

Global Flexible Strategy	AUM	YTD	1 Yr	Annualised 3 Yr	5 Yr	10 Yr	S.I.
Flagship International Flexible Fund (USD)	**$33.1m**	**-1.6%**	**17.3%**	**8.4%**	**7.9%**	**11.5%**	**2.7%**
Composite Benchmark (50% equity, 30% bonds, 20% cash)		4.0%	11.8%	7.2%	6.6%	11.9%	3.8%
Outperformance vs. Benchmark		-5.6%	5.5%	1.1%	1.3%	-0.4%	-1.1%
Flagship IP Worldwide Flexible Fund (ZAR)	**R474m**	**1.2%**	**3.5%**	**8.1%**	**7.5%**	**11.1%**	**11.4%**
Composite Benchmark (60% equity, 20% bonds, 20% cash)		7.8%	9.1%	8.6%	8.1%	11.1%	9.4%
Outperformance vs. Benchmark		-6.6%	-5.6%	-0.5%	-0.6%	0.0%	2.0%

Global Equity Strategy	AUM	YTD	1 Yr	Annualised 3 Yr	5 Yr	10 Yr	S.I.
Flagship Global Icon Fund (USD)	**$13.3m**	**-1.0%**	**19.6%**	**-**	**-**	**-**	**25.1%**
Benchmark (MSCI ACWI in USD)		11.1%	27.4%	-	-	-	30.9%
Outperformance vs. Benchmark		-12.1%	-7.8%	-	-	-	-5.8%
Flagship Global Icon Feeder Fund (ZAR)	**R33.8m**	**2.2%**	**7.8%**	**-**	**-**	**-**	**5.6%**
Benchmark (MSCI ACWI in ZAR)		14.1%	14.9%	-	-	-	10.7%
Outperformance vs. Benchmark		-11.9%	-7.1%	-	-	-	-5.1%

Global Fund of Funds Strategy	AUM	YTD	1 Yr	Annualised 3 Yr	5 Yr	10 Yr	S.I.
Flagship IP Worldwide Flexible Fund of Funds (ZAR)	**R335m**	**9.0%**	**4.8%**	**8.6%**	**10.1%**	**13.6%**	**13.8%**
Benchmark (SA CPI + 5%)		8.4%	10.2%	9.4%	9.7%	10.4%	10.4%
Outperformance vs. Benchmark		0.6%	-5.4%	-0.8%	0.4%	3.2%	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.

Contents

The Flagship Global Investment Team

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 13 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.

JJ Brink CA (SA), CFA

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

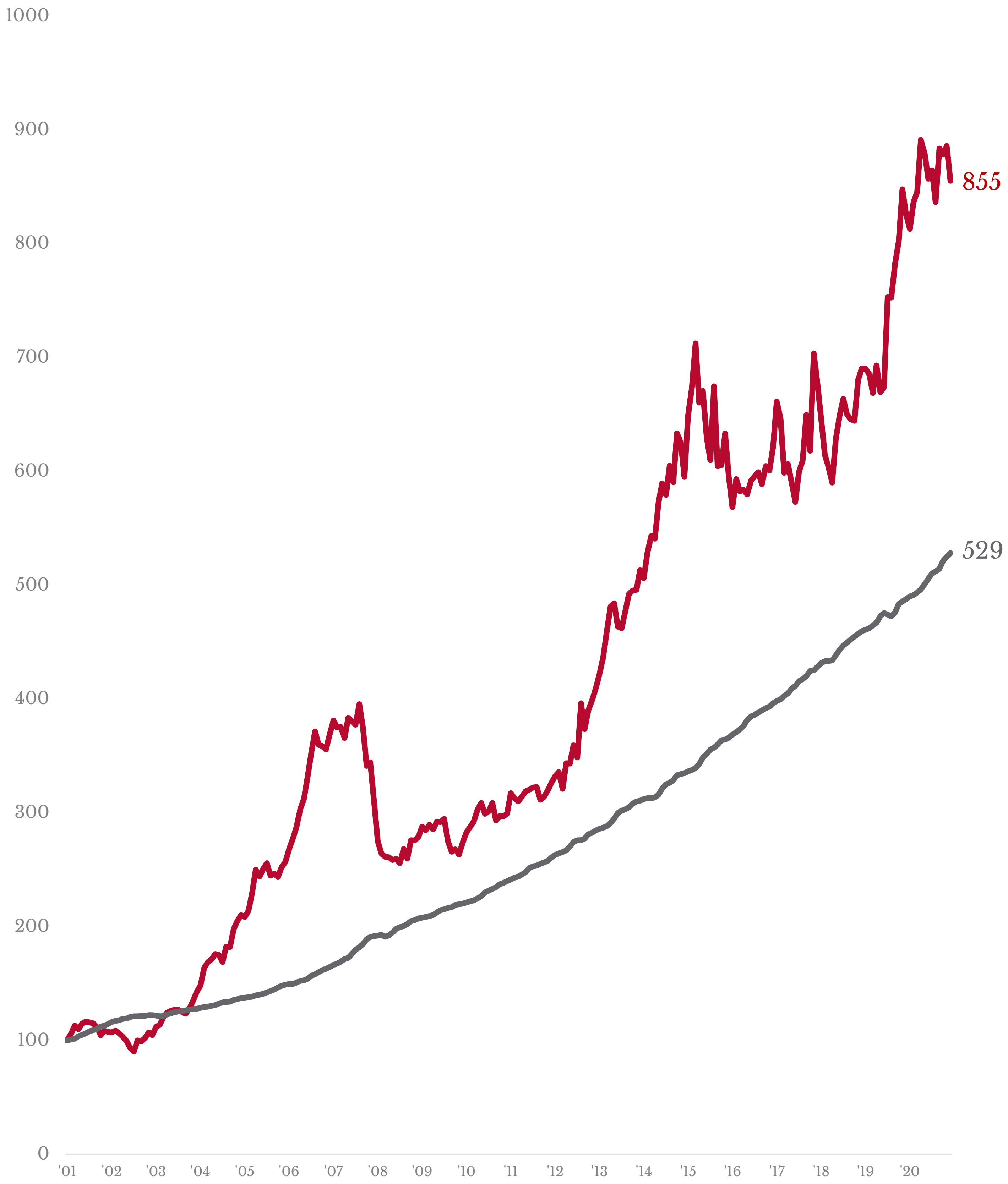
JD Hayward (B.Eng.)

JD is an equity analyst on the global team at Flagship. Prior to Flagship he worked as an engineer and also spent 2 years at an Edu-tech startup in Cape Town. JD graduated from Stellenbosch University with a B.Eng. (Civil) in 2016 and is currently a CFA level III Candidate.

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 September 2021 (20 years)



Turbulence 湍流

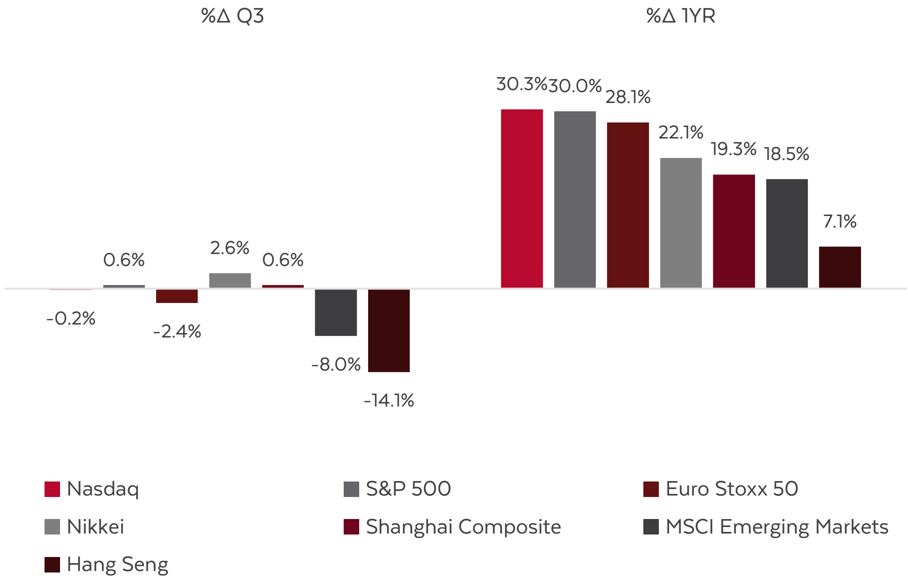
The greatest danger in times of turbulence is not the turbulence; it is to act with yesterday's logic.

- Peter Druckers

Pieter Hundersmarck

Equity indices were weak in the third quarter, with the Hang Seng down 14.1% in USD and MSCI Emerging Markets down 8%. There is a knock-on effect here. Most of the Chinese technology counters that were impacted by regulation are listed on the Hang Seng, which, in turn, makes up a large proportion of the Emerging Markets (EM) index.

Performance of Equity Indices in USD



By far the greatest impact in the quarter has been the change in the regulatory environment in China, to which we dedicate the most time in this quarter's Telescope.

The third quarter had equal doses of noise and signal which we outline below. By far the greatest impact in the quarter has been the change in the regulatory environment in China, to which we devote the most time in this quarter's Telescope.

US Government Shutdown & the Debt Ceiling

We see little material risk around the US government shutdown capers, and would remind readers that we have seen this situation in the past under the Obama and Trump administrations. The debt ceiling presents more technical risks, as the Republicans are clearly using this as a bargaining chip for their interests in the big infrastructure bill, but it is likely that they will eventually resolve the issue.

China's Crypto Crackdown

The recent bout of Chinese hostility towards cryptocurrencies is clearly meant to pave the way for the Digital Yuan. Alternative crypto currencies (outside of Chinese control) are intolerable as they pose a direct threat to the communist party's ability to conduct monetary and fiscal policy in the Chinese economy. Outside of China, we believe it is appropriate that cryptos be regulated to allow for wider adoption and – perhaps – less volatility. Their use as an asset class for the wider investor community is still nascent, although the applications of the Ethereum blockchain seem to be cementing a strong use-case, and if so, a value.

Evergrande

Investors are divided on the potential financial impact of the Evergrande saga. Some believe that this is China's "Lehman moment", which will lead to contagion and ultimately severe instability in China. We disagree, and believe the Chinese government will not permit an Evergrande default to translate into systemic instability. Furthermore, the country's largely state-controlled financial system endows it with counterintuitive resilience to manage this type of shock.

Inflation

In the second half of September the Federal Reserve met and confirmed that they stand ready to act in the event that inflation proves more "substantial" than forecast, and reiterated the Central Bank is "close" to beginning to scale back its $120bn asset purchase program. While it may be a while until we see rising interest rates, the glide path has been set, and in the absence of another macro shock (war, pandemic, etc.) we should expect rates in late 2022 and onwards to be higher than today. With higher rates we should expect continued pressure on bonds and bond proxies (property and credit). Shares in high quality companies provide the greatest defense against inflation over time, and they will remain our preference in asset allocation, discussed on page 7.

Changes in the Chinese regulatory environment

As we shared in our Q3 webinar (click here to view, 35 minutes) the change in Chinese regulations were a meaningful signal during the quarter. While we found most of the regulations clear and indeed laudable, the manner in which they were enforced created considerable uncertainty. Before we discuss Chinese regulations specifically, we feel it is imperative to set the scene.

Firstly, emerging market investments have been and will remain core opportunities for our global strategies. As global managers who began our careers in emerging markets, we feel adept at pricing specific emerging market stocks. Since May 2019, positions in various emerging markets have contributed a net +9.84% to Flexible Strategy performance, coming from TCS (Russia) +299.8%, Pag Seguro (Brazil) +23.0%, HDFC Bank (India) +49.2%, Cartrack (SA) +94.1% and Netease (China) +95.6%. Even after the major sell off this year, it is worth noting that our Chinese positions have continued to contribute positively to fund performance. As investors who believe the greatest risk we face is 'losing money', this is a pleasing result.

Secondly, there is no 'hiding' from China in the investment arena. China is an inescapable part of the global investing landscape that investment managers need to learn to price correctly. As a large, growing economy, China will grapple with its own regulations and societal goals, just as all other developed and emerging markets. Is the investing landscape in China more fraught than other EMs? Here we can point to South Africa, where investors buy shares in Platinum companies despite enormous risks to their equity issuance due to BEE, and a looming risk of their expropriation without compensation. Global perspective on emerging markets is helpful in this sense.

Thirdly, we are - and have always been - selective about what we own in China. In our careers we have found only a very small number of Chinese companies that we deem high quality enough to be investable. This is true for other emerging markets as well. Tellingly, 66 positions have been held by the Flexible Strategy since May 2019, and only four of these have been Chinese. Due to the latest crackdown, a number of other interesting Chinese businesses, like JD.com, have started looking attractive again.

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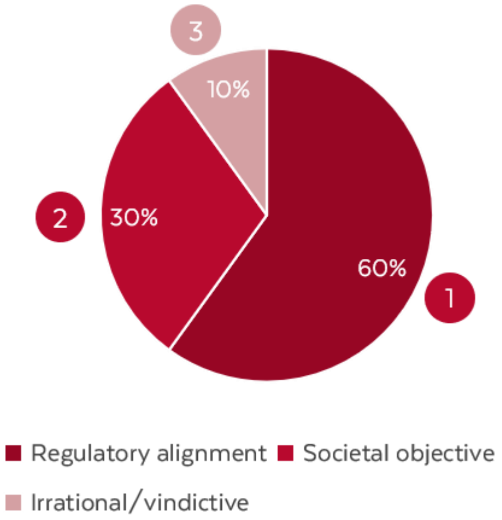
The goals of the regulations are, for the most part, laudable

Going through the recent regulations we find the objectives to be laudable and for the most part, sensible. We estimate that the news flow can be divided into three areas, as the chart below shows. The vast bulk of the regulations are aimed at aligning regulations with the West. A further third relates to achieving societal objectives in education and the impact of gaming on children. Only a small portion can be construed as irrational or vindictive in nature, where the targeted individuals and/or businesses seem to have attracted the ire of the ruling party through their actions (or their enormous success?)

Nature of Chinese newsflow



1 **Align regulations with the West**
- Increase of ANT capital requirements
- Fines
- Removal of Didi from app stores
- Labor regulations

2 **Societal objective**
- Ban profit on after school tutoring
- Common prosperity
- Computer gaming

3 **Irrational/vindictive**
- The disappearance of Jack Ma?
- The potential resignation of Didi founder?
- Macau?

Despite laudable goals, China-specific risk has undoubtedly increased

For over two decades China allowed market forces to drive their economy forward. Correcting the perceived failure of these market forces, in certain sectors, is behind this recent spate of regulations.

Correcting market failures must fall into a framework that allows investors to correctly price assets. Publishing changes to the education sector on a Communist Party website, and thereby wiping out the business model of for-profit education, is not such a framework. By following 'stroke of a pen' regulation, investors are forced to align their investment cases with the perceived good of society. This isn't easy, for a number of reasons.

By following 'stroke of a pen' regulation, investors are forced to align their investment cases with the perceived good of society. This isn't easy, for a number of reasons.

First of all, the goals of society – as stated by the Communist Party – are vague. 'Common prosperity' is one such vague goal. This can be achieved through a number of ways, with very different consequences.

Secondly, achieving societal goals can involve difficult compromises. The online video gaming sector is one such example. Video gaming prevalence amongst Chinese is incredibly high. Chinese children, in part due to this, have some of the highest incidence of myopia in the world, at 70%, which has fueled calls to label video gaming as 'addictive'. The Chinese government has responded by limiting play for children under the age of 18 to 3 hours per week.

However, the tendency to discuss video gaming in isolation is dangerous. Video gaming is only one form of entertainment amongst many that the Chinese are 'addicted' to.

According to Zenith Online, a consultancy, China leads the world in short form video consumption with the average person spending 105 minutes a day online, closely followed by Russia (102 minutes) and the UK (101 minutes). While stats for under 18's aren't available, it would be strange if there was a marked difference in the high levels of consumption seen in Chinese society as a whole.[1]

In the US, over 295 million Americans watch an average of 5.5 hours of TV per day. Studies typically find that US video gamers, a much smaller subset of the population, game less than 10 hours per week (and mostly with friends).

This raises many questions. Is video gaming the culprit to be regulated? Or short form videos? Will the government continue to favour Douyin (TikTok in China), YouTube and other video apps to the detriment of gaming? And can this perceived ill be extended to another type of entertainment or an undesirable spending habit, such as consuming luxury goods? To whom will the Communist Party decide to give, and from whom shall it take?

To whom will the Communist Party decide to give, and from whom shall it take?

Furthermore, the goals of society are not static. At the moment a societal goal in China is to make childcare more affordable, and hence to encourage child-birth, but we note that not long ago the goal was the exact opposite (the one-child policy). Using market forces (and moving decidedly away from state involvement in the economy) was one of the cornerstones of previous Communist Party leader Deng Xiaoping's economic policy when China opened up in the late 1990's. This unleashed enormous innovation, which will now undoubtedly be curbed. When will this change again?

Taking everything into account, we conclude with the following on China

- The new regulations are both sound and, in most cases, laudable. China is responding to what it perceives to be the failures of market forces across the education, property and technology industries. Many of the policies will assist in the creation of a larger middle class, which is desirable.
- However, some of the regulations run counter to the thrust of many of China's most powerful economic trends of the past four decades: entrepreneurial activity, a thriving start-up culture, private-sector dynamism, and innovation.
- If the greater good can be achieved, sacrifices will be made. The implementation of socialist policies will have winners and losers, as well as unintended consequences that equity holders may suffer from.
- Uncertainty in policy application can only reduce the multiple that is applied to Chinese businesses, and hence their upside. Investors will be forced to avoid sectors that have little relation to state priorities, however compelling their valuations may be.

Note 1. In fact, it likely understates the issue. In a quirk perhaps unique to Asia, more than 28% of streaming viewers choose not to watch content at its original speed — particularly those under the age of 20. In that age group, a full 40% chose to watch content at double-speed.

Strategy Performance

The largest contributors in the quarter in both our Global Equity as well as our Global Flexible Strategies were Endava, TCS and Microsoft. The largest detractors in the quarter were Alibaba, Zalando and Netease.

In our Global Fund of Funds, the top contributors to our total return of +3.9% for the quarter were Artisan Global Discovery and Sands Capital, while the largest detractors were Guinness Global Innovators and Lindsell Train.

During the third quarter we added **Applied Materials, Rakuten** and **Wilson Bayley Homes** to the equity portfolios and sold out of **TSMC, Adobe and Tencent.**

OUT
Taiwan Semiconductor
Adobe
Tencent

IN
Applied Materials
Rakuten
Wilson Bayley Holmes

Applied Materials (AMAT) is the largest supplier of semiconductor capital equipment globally. The US based company offers the broadest range of products within the capital equipment space, but is particularly strong in both deposition and etch – sub segments we believe will benefit disproportionately in the years to come. The company has consistently delivered strong growth, and is showing excellent execution on its stated goal of growing its earnings at 2x revenue, while returning close to 100% of FCF to shareholders.

Based in Japan, **Rakuten** is a business investing in change. The Company has two well established businesses that are funding Rakuten's bold expansion into mobile telecommunications. Using a cloud centric approach, Rakuten is laying the infrastructure for next generation 5G, which will be lower cost than competitors once it is scaled up. With the addition of mobile, Rakuten has a diverse product range and a compelling ecosystem that encourages cross-usage and a large monetization opportunity. We believe Rakuten offers in excess of 100% upside from the current price.

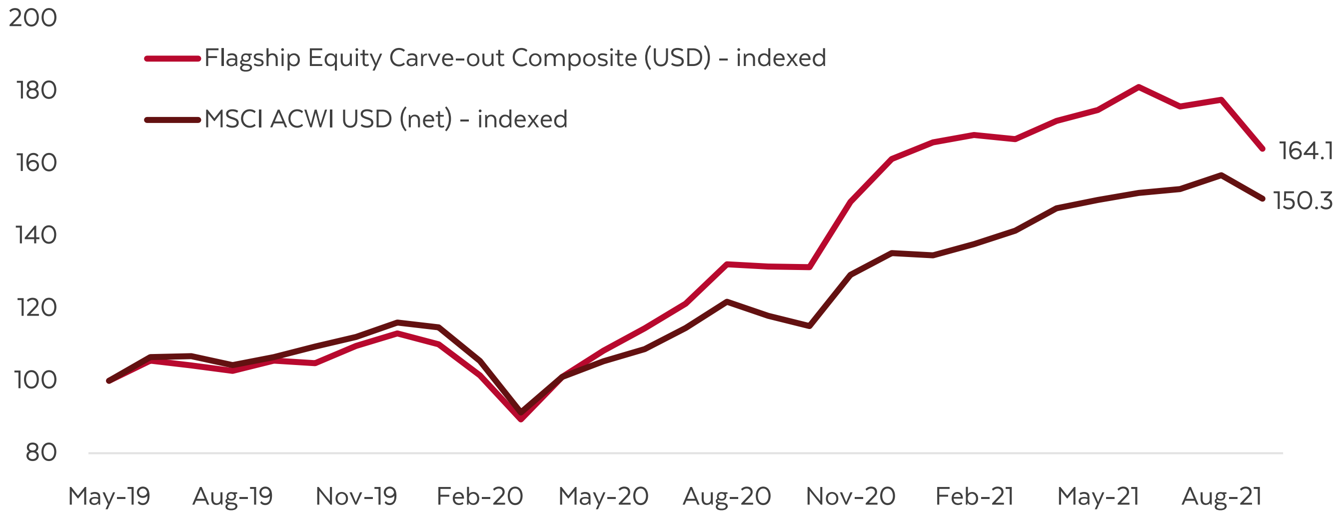
Wilson Bayley Homes is South Africa's largest building contractor and one of South Africa's largest players in roadworks and infrastructure. It also owns construction businesses in both Australia and the UK. It should benefit from a cyclical uptick from construction activity in all its geographies as the impacts of Covid roll over, increased investment in mining and infrastructure in South Africa, as well as reduction of once-off losses in its Australian business. It trades on a sub-5 normalized P/E ratio.

TSMC and Adobe were exited due to their share prices reaching our estimate of their fair value. Tencent was exited to redirect Chinese exposure in favor of other shares that we have higher conviction in.

As we enter Q4 it is worth reflecting on the performance of Flagship 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 500 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.

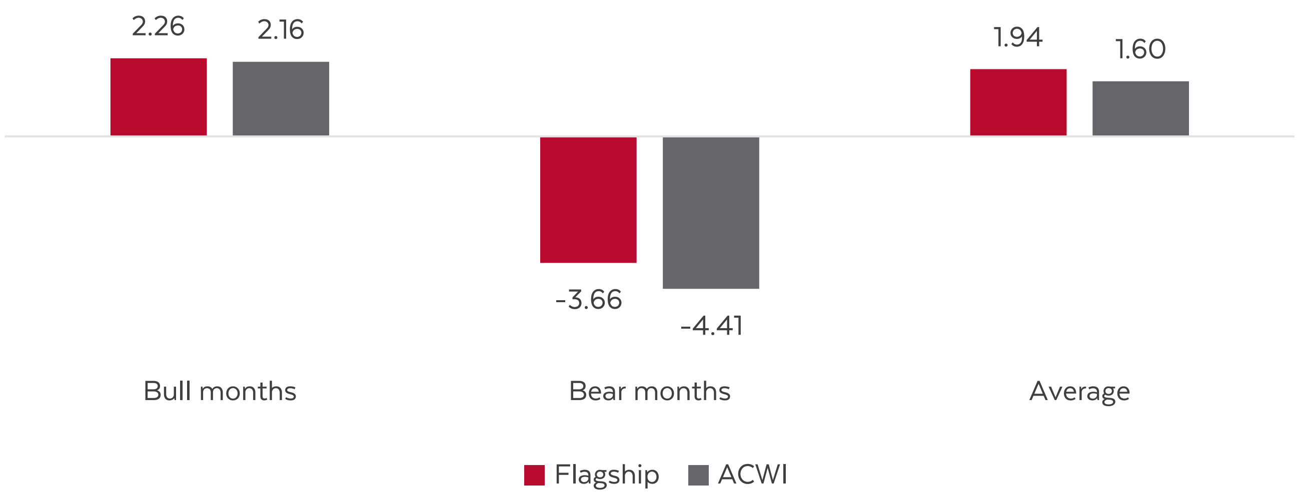
The Flagship Equity Composite Gross Returns vs the MSCI All Country World Index (USD) to September 2021



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 Index moves up (bull) or down (bear). The average return that Flagship has achieved during bull months (2.26%) is higher than the same average months for the index, and the average performance during bear months (-3.66%) is superior to the index average of (-4.41%).

Flagship Equity Composite in Bull & Bear months since June 2019 (%)



Note: The Equity Carve Out begins from the date that the Equities in the Flexible Fund transitioned to the selection determined by the current global team, on June 1, 2019. The carve out excludes trading costs, fees, and other fund expenses. From August 2020 the returns of the Icon Global Equity Fund Class "C" are used. The C class carries zero management fees, but incurs manco fees of 30bps annually.

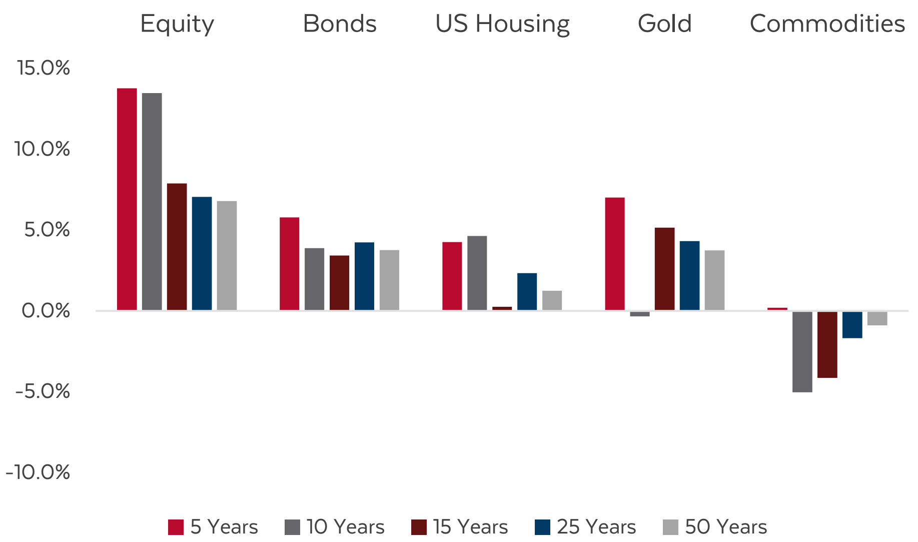
Asset allocation

Inflation is the parent of unemployment and the unseen robber of those who have saved.

- Margaret Thatcher

As we begin to experience inflation for the first time in many years, two questions emerge for asset allocators and investors. The first is "*what asset is the best to hold through periods of higher inflation*?" As the chart below shows, the answer to this question is relatively simple. Over all time periods since the dawn of fiat money in 1971, equities have delivered higher real returns than all other traditional asset classes.

Real Returns of different asset classes since fiat money in 1971 (Source: DB)



However, the second question "*What asset is the best hedge against rising inflation*?" provides a different answer. Why? Because as inflation rises, equities initially sell off. This is due to the discounting nature of the equity market. As inflation rises, equities need to be discounted at a higher rate to account for the expected rising inflation. High growth stocks – those trading on high multiples in relation to their earnings – sell off most acutely as the required return on their future earnings rises.

Only once inflation exhibits a declining trend can equities once again be discounted at a lower rate, allowing price earnings multiples to expand.

So as inflation begins to rise, we see three clear ways to inflation-proof our equity portfolio. The first is to focus on high quality companies that can pass the effects of inflation on to their customers. The second is to selectively invest in the shares of companies that produce the very commodities that cause higher inflation (such as oil and copper right now), and thereby hedge the source of rising consumer prices. The third is to ensure that we don't overpay for the stocks that we own.

The period from 1971 - 1980 is instructive in this regard. In our recent webinar we took our investors through the different time periods that equities and inflation performed during that decade. Click here to view the webinar.

When should you give up on a share?

Admitting defeat on a share is psychologically difficult. It helps to have a process of reviewing and selling when your original thesis changes.

Pieter Hundersmarck

The disposition effect relates to the tendency of investors to sell assets that have increased in value, while keeping assets that have dropped in value. Hersh Shefrin and Meir Statman identified and named the effect in their 1985 paper[1], which found that people dislike losing significantly more than they enjoy winning. Humorously, they called it '*disposition'* as shorthand for "*the predisposition toward get-evenitis*".

The disposition effect is one of the many biases that investors must face – and overcome – when managing long-term focused investment portfolios. It is one of the most difficult ones because it forces the investor to confront the most basic of emotions: pride, while simultaneously combatting our built-in reluctance to embrace loss.

Know what you own, and know why you own it

Early in my investment career a colleague told me to write down the reasons why you buy a share, and why you sell it. Writing down the reasons why you buy a share forces you to revisit your assumptions when the share price rises or falls.

I continue to do this to this day. Keeping records of your original investment case is a small disciplinary exercise with significant positive implications for your investment portfolio. For many investors, it can be the crucial reminder of when to let go of a losing position.

> The best advice on buying and selling is often to ask yourself, 'do I hold this share because I'm influenced by the losses that I wanted to recoup?'

A typical trading approach looks something like the following. You take a number of active positions, sizing them based on the risk and return you expect from each stock. Poorly defined limits mean you probably end up with more allocated to risky shares, because you estimated the profit opportunity to be higher. Some trades work out and can be sold at a profit. But for many investors, it is too difficult to take a loss, and they hold on to losing positions hoping that those losing stocks will eventually rebound.

Incorrect sizing, and hanging on to losers long past the time when you should have cut your losses, means the average investor *loses* money on the stock market, or at best the winning stocks compensate only slightly more than the losses from the losers.

It's tough to do, but the best advice on buying and selling is to ask yourself, 'do I hold this share because I'm influenced by the losses that I wanted to recoup?'

Process triumphs over Disposition

Good investors fight the disposition effect by following a process that provides a framework for buying and selling. Following a process allows them to combat human frailty – and pride is one of the biggest frailties in investments. Without a disciplined process there can be no significant long-term outperformance.

In some cases, the protection from disposition goes further. Not only should good investors not hang on to losers, but they should spend so much time evaluating the different outcomes in investment cases - and know them so well - that they can also opportunely add to positions when they fall.

Many asset managers, ourselves included, follow this practice. The example I often use is imagining for a moment that your house suddenly fell in value by 20% in the course of a week. Would you sell it? Probably not. There is very little that would derail the value of a property to such an extent over such a short period of time. In fact, you probably know your neighbourhood well enough to say that price fall was irrational: the neighbourhood is still attractive, near the school, spacious and close to a national park, for example, and none of this is reflecting in the price. You should actually be buying more houses in the neighbourhood.

Sell when your original thesis fails. Don't construct a new one.

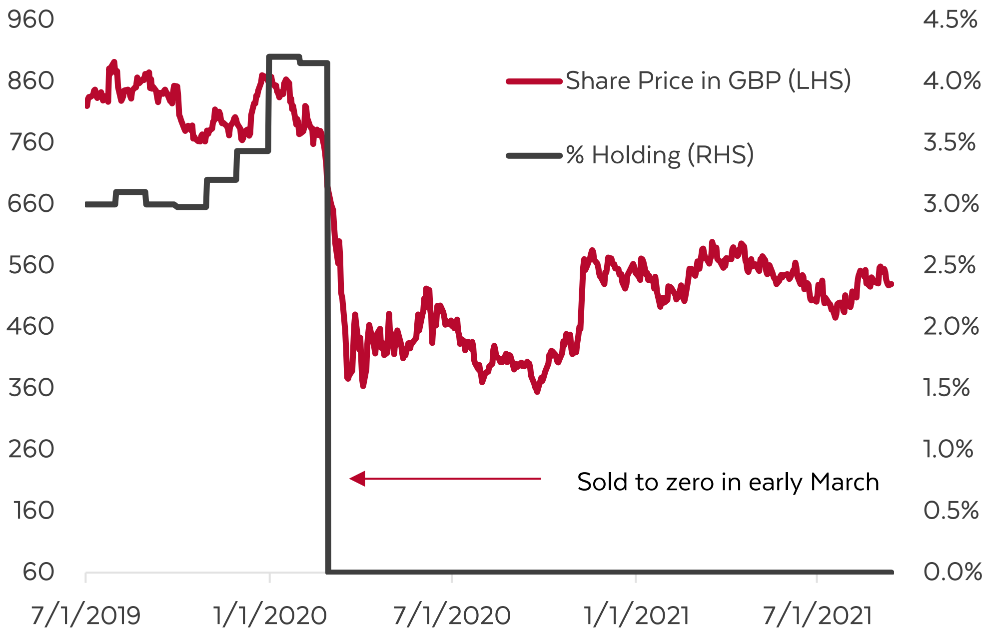
Recreating the narrative, once a stock goes against you, is an understandable response to a failing investment case. It's human. Pride often prevents even good investors from capitulating on a share.

The benefits of having a process are instructive here, which I can illustrate with two examples from our global stock selection in the past two years.

We've found that the answer is to follow a process or built-in procedure of reviewing and selling when your original investment case (the reasons you bought the share) are shown to be incorrect. The benefits of having a process are instructive here, which I can illustrate with two examples from our global stock selection in the past two years.

The first is Informa. Informa is a powerful marketing, business intelligence and in-person events platform business. The investment thesis consisted of a business growing its various revenue streams in excess of peers while increasing profitability, and in so doing garnering a higher multiple to earnings than its long-term average.

Chart 1: Informa PLC share price versus holding % in the Flagship Global Funds



As of February 2020, trade fairs and exhibitions generated almost two-thirds of Informa's operating profit. As the Coronavirus outbreak began to gather pace, Informa revealed that an increasing number of its shows were being postponed or cancelled. Its flagship health & nutrition show in the US - as well as a number of its important Chinese and Japanese trade fairs - were put on indefinite hold. We calculated that EPS could fall a material 30% in 2020, and between 40-50% in a bear case scenario, with little visibility thereafter.

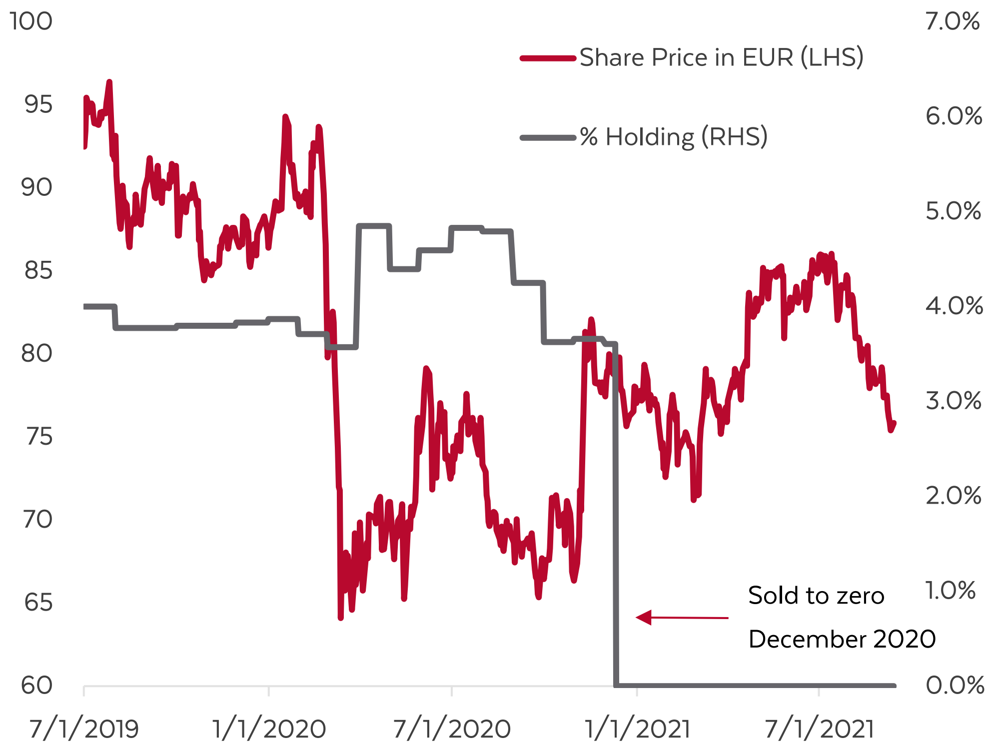
Our original thesis no longer held. Rather than attempting to construct a new thesis (which in this case would be a recovery play – an entirely different investment case) we sold the share at c.600 GBp.

Heineken is another example of selling when the initial investment case changed. Heineken is a high-quality consumer staple stock, which we bought to participate in the growth of beer volumes in emerging markets (particularly Vietnam, Mexico and Africa), as well as the steady increase in operating margins from the mid-teens to 20% longer term. This is a powerful algorithm which is not unfamiliar to long-term investors.

The pandemic changed this. Initially we expected the effects of global lock downs to be short term in nature, with minimal impact on Heineken's long-term volumes (and investment case). As the pandemic deepened and movement and celebrations across key markets were curtailed, the investment case changed. Currencies in key emerging markets dipped, and raw material costs saw massive inflation. Employees were laid off and new debt was taken on. By December 2020, we took the call that the facts on the ground were too far removed from our initial investment case.

Long term investors are often guilty of assuming critical impacts to their stock's investment case is simply 'short term noise.'

Chart 2: Heineken Holding share price versus holding % in the Flagship Global Funds



Conclusion

Long term investors are often guilty of assuming critical impacts to their stock's investment case is simply 'short term noise'. Often, this is a catchall for an investment case that has gone badly. The reluctance to embrace loss prevents many of us from admitting this to ourselves and making the right call, which is to sell. John Keynes' famous quote is useful here: "When the facts change, I change my mind. What do you do, sir?"

Is passive investing bad for markets?

Flagship's stand on Grupo Lala illustrates the shortcomings of passive investing

Kyle Wales

Two of the great investment themes today are, firstly, the trend towards greater Environmental, Social and Governance awareness (or "ESG" investing) and, secondly, the trend towards passive investing or "index" investing.

The former refers to investing in companies which try to minimize the negative externalities their businesses have on the environment ("E") and the communities in which they are based ("S") and, lastly, which try to balance the interests of all stakeholders, including minority shareholders, in the way that they are run ("G").

The latter refers to investing in an index which is representative of the market as a whole, rather than selecting individual stocks. The reason for this is that the average stock picker (although, note: not all stock pickers) will underperform the index due to the differential in fees they charge.

But are these themes always compatible with one another? As a portfolio manager (and admittedly as an active investor), I have recently come across an instance where passive investing is not only bad for the proper functioning of markets as a whole but that it is bad for ESG as well.

The stock involved was Grupo Lala, the largest manufacturer of milk and yoghurt in Mexico, and a stock which we have held intermittently in our funds.

The benchmark Mexican stock Index, the IPC Index, has performed poorly recently and Grupo Lala, along with many other Mexican shares, had begun to offer compelling value. Lala had become the classic case of a stock trading at a low price earnings "P/E" multiple on low earnings.

> As a portfolio manager (and admittedly as an active investor), have recently come across an instance where passive investing is not only bad for the proper functioning of markets as a whole but that it is bad for ESG as well.

Lala has two main businesses, a milk business in Mexico and a second one in Brazil called "Vigor". Lala's Mexican business was at a cyclical low, while Vigor offered long duration structural growth which was not accounted for in its valuation. In Brazil, not only is per capita milk consumption far lower than that of Mexico, but the milk yield per cow is far lower meaning that they could expand their margins dramatically if they could close this gap.

We were not the only ones who saw compelling value in the share. The controlling shareholders of Lala (who own 75% of Grupo Lala's outstanding shares) similarly saw value. In fact, on the 24th of May they made an offer to buy out minorities at 17.36 Mexican Pesos per share and delist the company. This was a premium to the share price immediately preceding the offer but far below what we considered a "fair" price.

We were not happy with this offer. In an instance such as this one, we believe it is the board's duty to conduct an independent valuation of the company to protect minorities when an offer undervalues the company. While minorities would not be forced to tender their shares, they would risk being caught holding an unlisted company if they didn't. This was the definition of a "head's I win, tails you lose" scenario.

The problem was that the majority of Lala's board consisted of appointees of the controlling shareholders.

We would not allow our rights to be violated without putting up a fight. We approached Lala's large shareholders to coordinate our efforts, although most of them had resigned themselves to the inevitable, and we ran a social media campaign to draw attention to the fact that we believed the offer undervalued the company. We also took aim at the independent directors, as we believe that they should have done more to defend the rights of minorities.

Throughout this process we were not able to rely on the support of the index funds, which featured prominently among Lala's largest shareholders.

The reason for this is simple: why would index funds vote against a low offer when they do not have an opinion as to the fair value of the shares?

We believe index funds are thus playing to the hand of opportunists (in this case the controlling shareholders of Lala) because they increase the likelihood that low, opportunistic offers such as this one are accepted – to the detriment of minority shareholders.

Throughout this process we were not able to rely on the support of the index funds, which featured prominently among Lala's largest shareholders.

Lala is only a small Mexican milk producer, but that does not preclude a situation like this one from happening again. The more money that flows into index funds, the more likely it is that situations like this will happen in the future and the more encouraged opportunists will become.

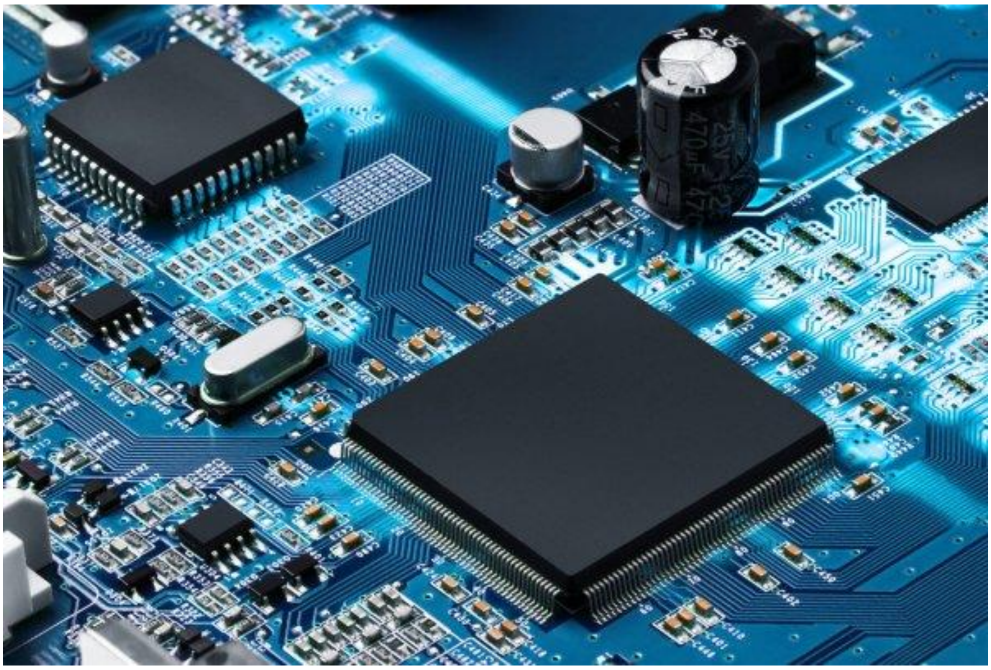
Passive investing has benefitted from overwhelmingly positive publicity up till now but it has its drawbacks. In instances such as these, those drawbacks are often not visible, reducing the returns of both passive and active investors alike. It is thus in the interests of everyone that commentary around the advantages – and disadvantages – of either style becomes more balanced.

Flagship Primers: Semiconductors

"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

JD Hayward



Summary

1) The global semiconductor industry is a $450 billion behemoth, and is expected to reach $1 trillion by the end of the decade. This means that an industry which took more than 40 years to reach its current size, will more than double within the next 10 years.

2) Semiconductors can broadly be divided into 2 segments – logic and memory: Logic is the ability to process information and make "decisions". Memory is the ability to store data, either over the long-term (NAND memory), or over the short-term (DRAM memory).

3) The industry is split into different participants depending on which part of the supply chain they operate in:

- Integrated Device Manufacturers (IDMs) – design, manufacture and sell their own devices. (e.g., Samsung, Intel)
- Foundries (fabs) – manufacture devices on a contract basis. They do not design and sell their own devices. (e.g., TSMC, GlobalFoundries)
- Fabless Designers – Design their own chips, but contract the manufacturing out to foundries. (e.g., Nvidia, Qualcomm, Broadcom)
- Semiconductor Capital Equipment Companies (semicap) – provide the semiconductor industry with the tools and machinery required to manufacture their products. (e.g., Applied Materials, ASML, LAM Research and KLA Corp)

4) Based on a number of drivers, we believe the capital equipment industry offers better long-term return potential than that of the overall semiconductor industry and we have chosen to hold one of those companies in the Flagship Strategies.

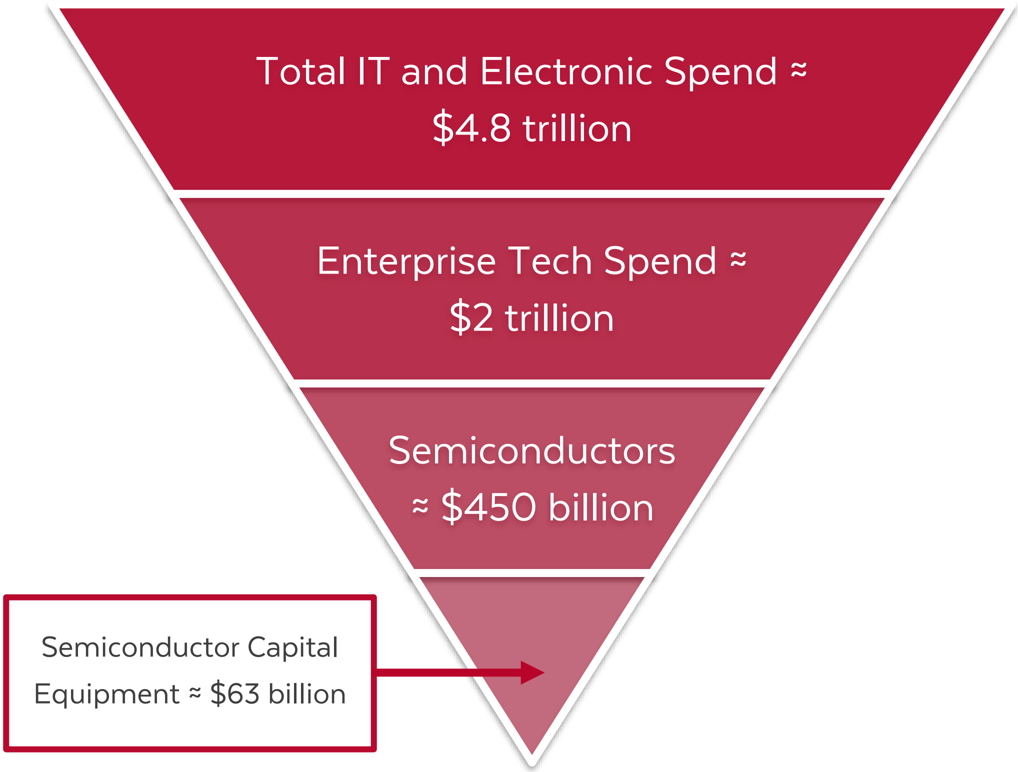
Deep moats. Deep pockets. Deep ultra-violet.

There is old adage on Wall Street – *"Semiconductors make the world go round."*

While most people are blissfully unaware of the fantastically intricate and seemingly impossibly complicated technology lurking beneath the covers of their electronic devices, semiconductors operate from the shadows – literally making the modern world work – to such an extent that the global tech-hotspot known as Silicon Valley has been named after it.

This is not an exaggeration. The entire ≈ $5 trillion electronic goods industry is built on the semiconductor industry, which in turn is built on the semicap industry. Semiconductors are found in every conceivable product, from cell phones and computers to automobiles, airplanes and advanced medical equipment.

Every second, the average beard grows roughly 8 nanometers; more than the size of a single leading-edge 5 nanometer transistor.



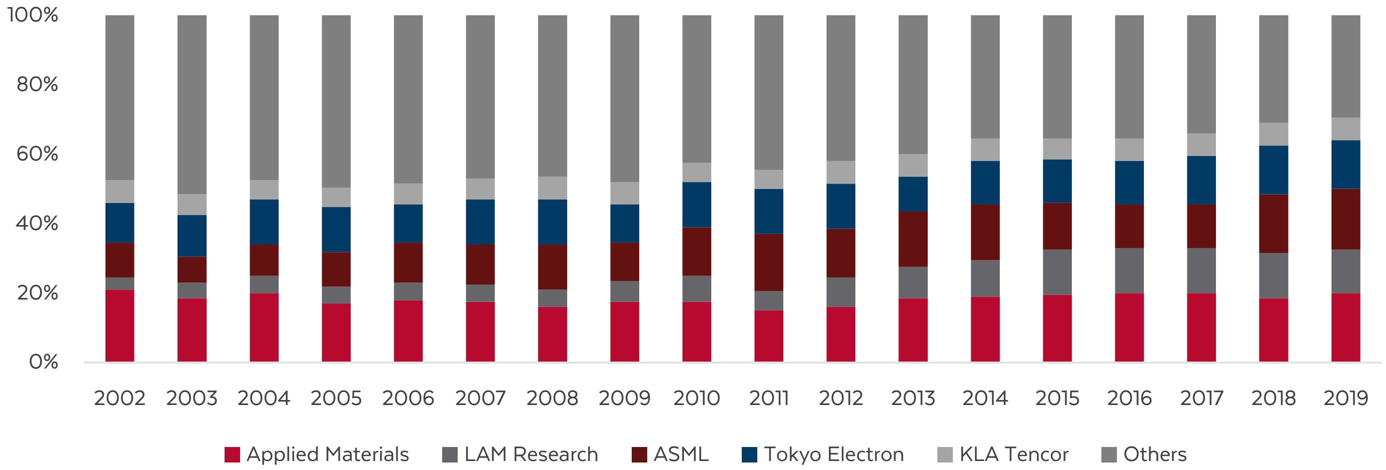
The word *semiconductor* loosely refers to any kind of microchip - the term by which they are more commonly known. It is named after the base material (typically ultra-pure silicon) that is neither a conductor, nor an insulator of electrical current. Instead, its conductive properties can be altered to a desired level, which allows for the flow of electrons. These electrons can be thought of as information travelling between transistors – microscopic switches communicating in binary code that are either on or off, 1 or 0 depending on the last performed action.

With the physics lesson complete, I will now explain how intricate microchips and the equipment producing them are – as this provides a better understanding as to why the industry enjoys such protective moats. Today's advanced microchips – such as those in our smartphones, are roughly the size of a finger nail, but they can contain *billions* of microscopic transistors.

Why then, is there no dedicated DSTV channel that celebrates what is arguably mankind's most intricate physical creation? Your guess is as good as mine...

The level of technical difficulty and capital intensity of this industry has led to a situation where the number of players in each space has dramatically reduced over the past 20 years – with anyone unable to keep up with the frenetic pace of innovation being knocked off the bandwagon. Nowadays, there are a mere 3 companies – TSMC (Foundry), Samsung and Intel (IDMs) who are able to produce chips at the very leading edge – compared to roughly 25 in 2000. Similarly, the market share of the top 5 semicap companies have increased from just over 50% to 70% during the past 2 decades.

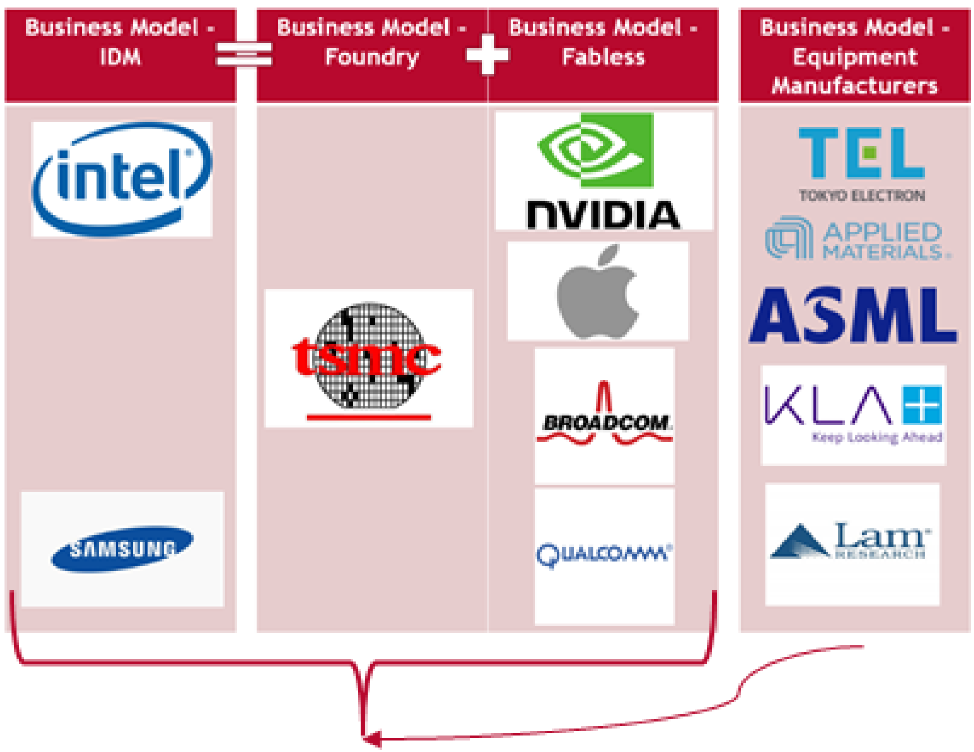
Market share of top 5 Semicap companies 2002 -2019 (Source: Bernstein)



Chips can require 1000's of steps to complete. For a 500-step process, with each step having a success rate of 99%, the overall success rate would be 6.57%. Foundries need this to be ≈ 100%. There can be no profit without precision.

There are only 2 players left at the leading edge of the IDM space, and only 1 in the foundry space. There are a number of companies that operate fabless models. They design and sell their own chips, but outsource the manufacturing to an outside company operating in the foundry space.

One can almost imagine an IDM being a combination of a Foundry and Fabless model. Important to note, though, is that the equipment manufacturers are a crucial cog in the wheel, and their tools are critically important to the IDM, foundry and fabless models.



Equipment Manufacturers operate in a number of complex processes, but it can basically be boiled down to the following:

- Depositing a substance onto a silicon wafer.
- Transferring blueprints onto a wafer using deep ultra-violet light.
- Removing selected sections of the previously deposited material.
- Controlling the process, measuring elements, and finding defects.

These steps are done over and over again, hundreds of times, until a thin silicon wafer is converted into a final product that contains many individual microchips, ready to be cut and individually packaged.

Conclusion

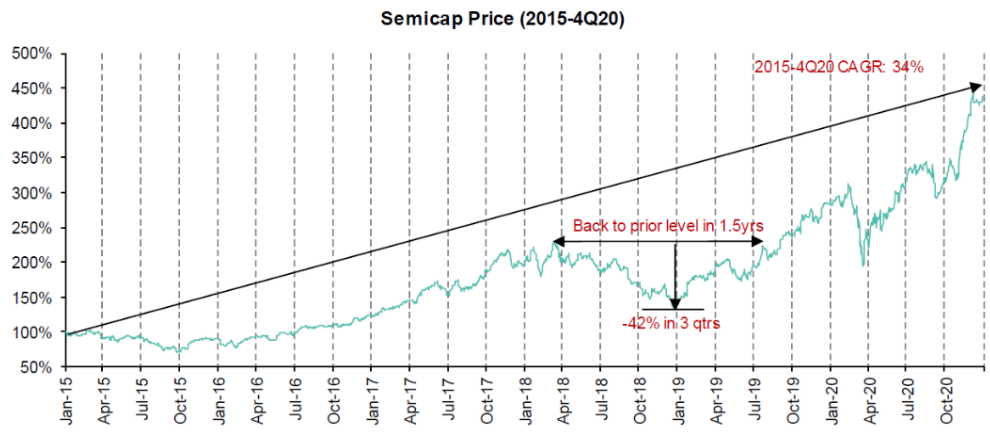
The semiconductor industry is at an inflection point.

The semiconductor industry is at an inflection point. A number of secular drivers such as the advent of the big data era, Artificial Intelligence, autonomous driving, 5G, and Internet of Things will all require more, smarter, faster semiconductors. The industry, therefore, has to keep evolving and creating more and more complex structures – which, in turn, means the equipment manufacturers will be called upon.

Another important factor to consider is the influence of geopolitics on the industry as a result of recent semiconductor shortages which have hampered economic output worldwide. Every economic block is seeking self-sufficiency, which will lead to diseconomies of scale, with demand for capital equipment manufacturers outpacing the growth of the larger semiconductor industry.

Given the above, we are of the opinion that the semicap space will outperform the broader semiconductor space in the next decade – hence our decision to sell TSMC and buy Applied Materials. Even though the industry is known for some cyclical volatility, we view this as a function of the market's short-term bias.

Semicap short term volatility and longer-term returns (Source: Bernstein)



Source: Bloomberg, Bernstein analysis

We believe the secular drivers, increased complexity, diversified revenue streams, and a high-quality management team (which will be expanded on in the Investment Case that follows) make Applied Materials a solid long-term investment.

*Disclaimer: Wall Street does not *really* have an old saying about semiconductors and how they make the world go round, but perhaps they should have...*

Investment Case: Applied Materials

JD Hayward

Summary

Applied Materials (Amat) is the biggest player in the semiconductor capital equipment (SCE) market. There are currently a number of secular drivers providing strong tailwinds for continued growth. These include:

1) Increasing need for, and adoption of, semiconductors.
2) De-globalization of supply chains, leading to an increased demand for SCE, outstripping the increase in demand for semiconductors themselves.
3) Increasing complexity of structures on microchips including;
    - Continued shrinking of transistor size
    - Shift from 2D to 3D structures on microchips which benefits Amat disproportionately, because it is the largest player in this sector of the SCE market.

The above, combined with Amat's record of taking market share, strong earnings growth, impressive management team, and relatively cheap price, make them an excellent investment opportunity when looking through a long-dated lense.

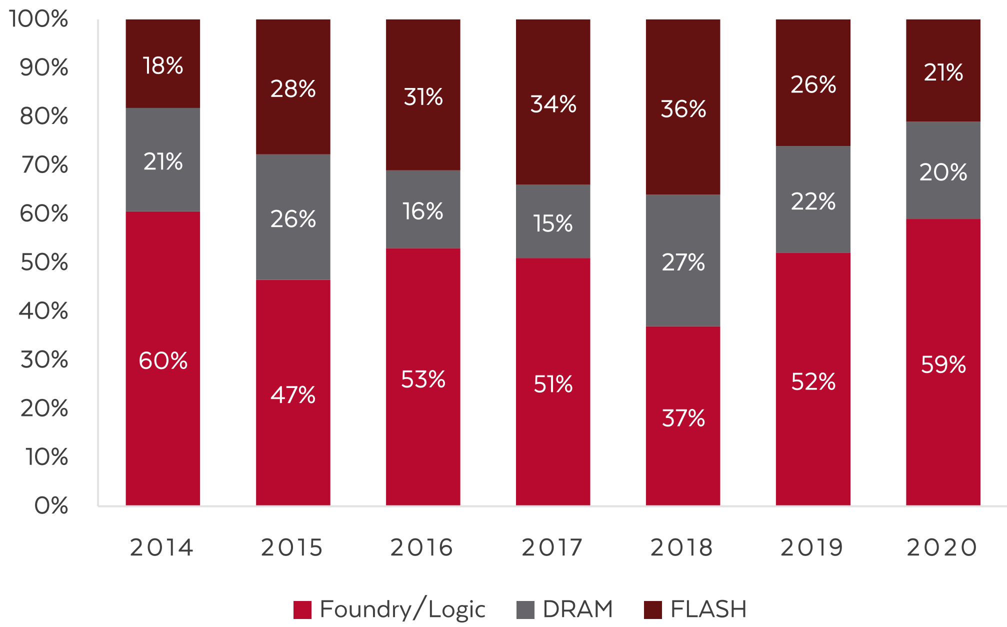
This year – a factory of semiconductors. Next year – a factory of whole conductors!

- *Todor Zhivkov, former leader of the People's Republic of Bulgaria.*

Amat is an SCE company that has been around since the 1960's. They have more than 14 000 registered patents and apply, on average, for 4 new patents every single day. This continued pursuit of technological advancement has enabled them to capture about 20% of the total semicap market, a number which they have been steadily increasing for a number of years. Recall from the primer that Semiconductors can broadly be divided into 2 segments – logic and memory: Logic is the ability to process information and make "decisions". Memory is the ability to store data, either over the long-term (NAND memory), or over the short-term (DRAM memory).

Traditionally, Amat generates between 55% and 60% of revenues from logic/foundry clients, however memory's share can increase during so-called memory "booms" . The fact that Amat has slightly more exposure to logic/foundry than to memory is a positive consideration, seeing that it is traditionally less cyclical than the memory industry.

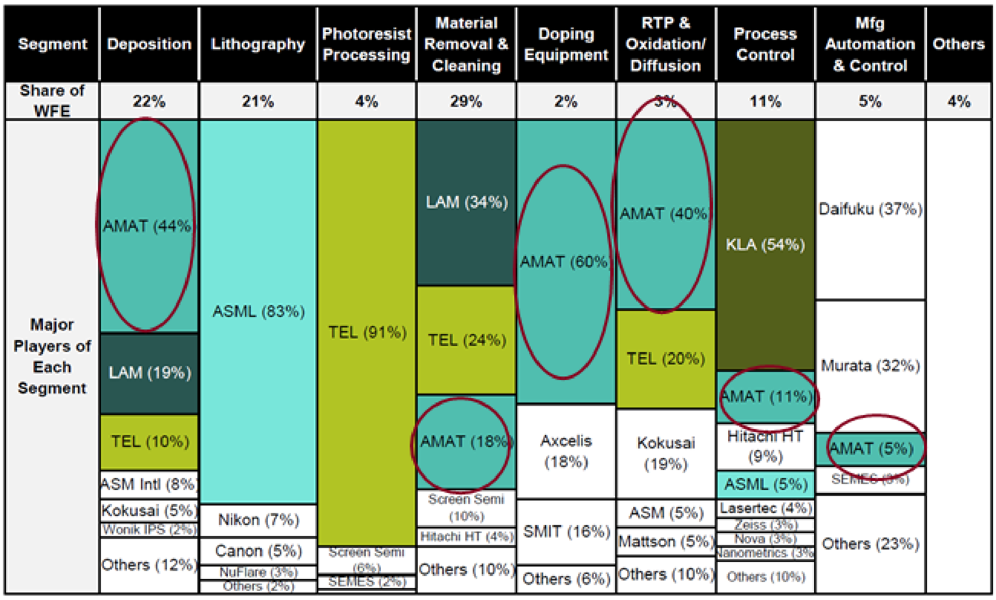
AMAT Revenue share 2014 - 2020



Amat has the broadest offering in the semicap market, with a presence in most sectors.

Amat has the broadest offering in the semicap market, with a presence in most sectors.

- 1st in the deposition market (2nd largest subsector);
- 3rd in the material removal/etch (biggest subsector with Amat taking share);
- 2nd in process control (slowly taking share)
- Leading presence in a number of other, smaller subsectors;



Source: Gartner, Bernstein analysis

Demand for AMAT's products continue to grow

Firstly, humanity has moved into an era of true big-data, where more devices, vehicles and products are connected, constantly sending and receiving information. All of this information is useless if not analysed, processed and stored effectively – potentially driving semiconductor demand for years to come. The general consensus is that the semiconductor market will grow at a CAGR of 8.56% over the next 9 years and reach $1 trillion by 2030.

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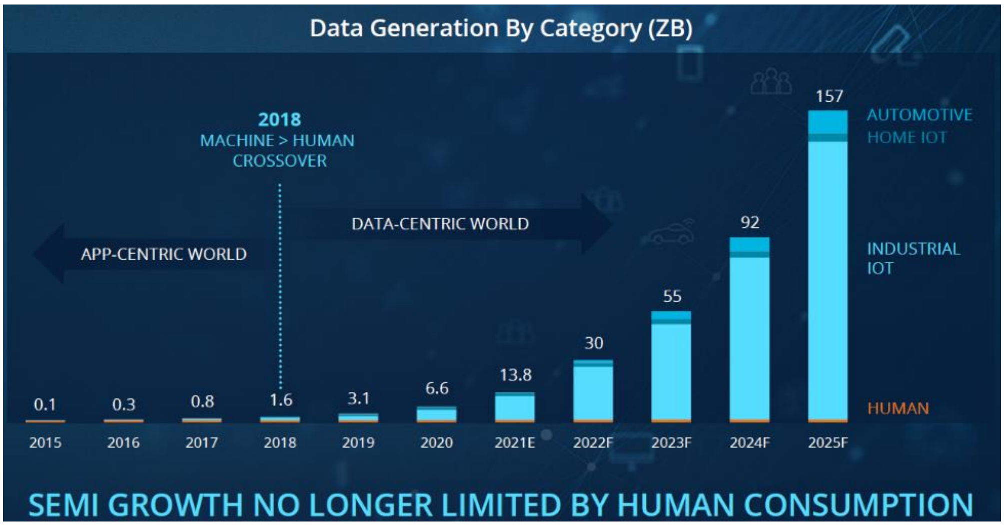


Secondly, there are mounting concerns globally about the concentration of semiconductor manufacturers. TSMC (a previous holding in the portfolio) is by far the dominant player when it comes to leading edge manufacturing. However, TSMC's proximity to China, and China's increasingly aggressive rhetoric when it comes to "re-uniting the breakaway province of Taiwan with the Motherland" has raised alarm in other regions of the world, with both the US and Europe urgently looking to address their lack of manufacturing capability.

This could lead to increases in semiconductor manufacturing capacity in other parts of the world, as well as increased foundry competition in the shape of Samsung and Intel, leading to more revenue opportunities for semicap players.

We therefore expect demand growth for the semiconductor equipment to outstrip demand growth for semiconductors due to inefficiencies arising from de-globalization and underutilization for foundries such as TSMC.

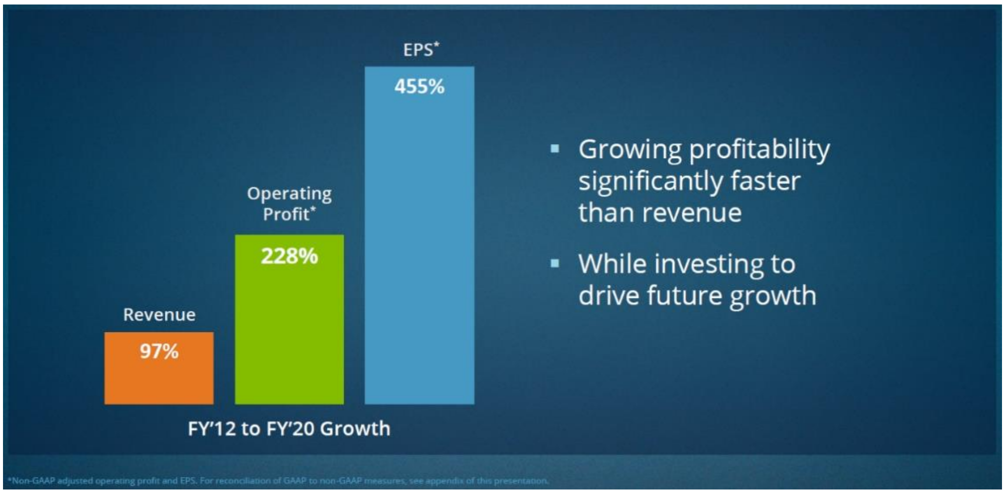
Finally, in order to keep up with the technological advancements, semiconductor structures need to either continue scaling horizontally, or transistors need to be constructed in multiple layers upon each other. Both of these advances will place extra emphasis on the deposition and material removal subsectors - Amat's 2 biggest revenue drivers - which deepen its relative advantage to other semiconductor equipment manufacturers.

We thus believe that Amat is best positioned to capitalize on all secular tailwinds in the industry.

Amat is a good business with a deep moat

Despite its pre-existing strength, Amat's business continues to get even stronger.

Amat has grown dividends at a 16% CAGR since 2005, while repurchasing 30% of shares outstanding since 2015. They have illustrated their ability to return almost 100% of FCF to shareholders, while managing to grow EPS at a much higher rate than revenue and increasing their market share while doing this.



CEO, Gary Dickerson, was named as one of the "World's best CEO's" by Barron's for each of the past 3 years. He was recognized for the solid performance and compelling growth strategy exhibited during his tenure at the helm. He has also been named on similar lists by Harvard Business Reviews and Forbes.

Despite its pre-existing strength, Amat's business continues to get even stronger because they are generating more of their revenue from sticky, longer-term servicing contracts, thereby decreasing the cyclical effects of the industry, and are well positioned to continue taking share from competitors. Their services division (which they refer to as their "Applied Global Services" or AGS division) currently represents about 25% of total revenues and operating income.

Finally, we believe that Amat's margins, which already sit at an enviable 26%, can expand further to 32% by 2024 as the operating leverage from its increasing revenue base is felt.

AMAT's valuation works in our favour

Amat is one of the cheaper stocks in the semicap space, trading at a FY22 earnings multiple of 18.7x, which we believe presents a buying opportunity with compelling upside when taking a long term view.

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.

Warm Regards,

The Flagship Global Team

FLAGSHIP
ASSET MANAGEMENT

Navigate Safely Forward

T +27 21 794 3140

E info@flagshipsa.com

www.flagshipsa.com

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