OVERBERG MARKET REPORT

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Global Report

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A fading rockstar or prepping for a follow-up act?

Scottish Mortgage Investment Trust (SMT) has built a formidable reputation, with a unique investment philosophy and an enviable performance track record. The investment company, managed by Baillie Gifford & Co. made early investments in Amazon and Tesla, which propelled massive gains. In financial year 2021, the net asset value (NAV) increased by 111%. The rockstar mantle rested comfortably on the shoulders of SMT. In FY 2022, however, the NAV fell 13.1% and by another 18% in FY 2023. The share price fell even harder, dropping in FY 2023 by 33.5%.

Sharply rising interest rates have been particularly testing for SMT's global portfolio of high growth stocks. Companies promising returns many years in advance are especially susceptible to rising interest rates that are used to discount long duration income flows. Financial markets have been especially hard on unquoted private equity investments, which comprise 30% of SMT's NAV. There is a good deal of scepticism over the valuations ascribed to unquoted investments.

SMT has one of the most rigorous valuation processes for its unquoted investments in the industry. Valuations are reviewed on a rolling three-month basis. A third of the assets are reviewed each month by the Baillie Gifford valuation group and the independent third-party valuer, S&P Global. Beyond the regular cycle for the valuations, an ad hoc valuation is conducted if there is a trigger event such as a change in company fundamentals or changes to valuations in publicly listed comparator companies. During FY 2023, there were 532 revaluations performed on the 87 unquoted line items, resulting in an aggregate write down of 28% across the unquoted portfolio. Seven unquoted companies were revalued upwards during the year.

The unquoted holdings are not venture capital or start-up companies. They are late stage with a global footprint at an average value of $10 billion. Some of the unquoted holdings have already grown into household names. SpaceX is launching more satellites into space with its reusable rockets than the rest of the world combined. Northvolt has already made history by making the first ever lithium-ion battery cell using 100% recycled nickel, cobalt, and manganese. It has $55 billion in contracts to supply major auto manufacturers. Bytedance, which owns TikTok amongst other apps, uses artificial intelligence to target content and advertising distribution to users. These three unquoted investments have enjoyed steady upward valuations and together comprise 9.4% of SMT's NAV.

SMT's investment philosophy has always been based on the belief that technological improvements will drive innovation and that even picking a small number of these successful future companies and holding on to them long enough to let the magic of compounding work, will lead to exceptional returns for clients. There have been some mistakes along the way, such as the exposure to Chinese tech stocks but the approach has never been about trying to get everything right, nor timing short-term market moves, but rather seeking to benefit from a few outsized winners over the long-term.

According to management, the "greatest investment mistakes come not from those investments which fail, but from the opportunities missed."

Management has a bottom-up approach in its search for the best growth companies, but this is framed by four key long-term structural growth trends. (1) Digitalisation, which has revolutionised retail, media and advertising and is now broadening into food, finance, and enterprise. (2) Healthcare innovations, which are expected to take a great leap forward with the growing adoption of technology. (3) Decarbonisation. (4) "And beyond," which includes space exploration and timeless luxury goods. SMT's largest holding is ASML with a weighting of 7.8%. It is the dominant world manufacturer of the lithography equipment used to make microchips. Chief technology officer, Martin van den Brink is a visionary who has been described as the "main driver of our generation's Moore's Law," the idea that computing power doubles every two years. ASML is not just at the forefront of the next big thing, rather the next several big things. Another microchip manufacturer in SMT's portfolio is Nvidia, which through its Graphics Processing Units plays a systemically crucial role in artificial intelligence. Moderna is the second largest portfolio holding, a biotech company developing medicine based on messenger RNA (mRNA) technology, which has transformational potential in pioneering a new class of medicines. Talking about Moderna as simply a Covid-19 vaccine provider is akin to pigeonholing Amazon as just a bookshop in the early 2000s.

The time to buy the share is probably now. The share price has dropped nearly 50% from its late 2021 peak, the largest decline since the 2008/09 Global Financial Crisis, when the shares fell over 60%. Despite this, the shares are still up a remarkable 325% over the past 10 years, well above the 179% return in the FTSE All-World Index. Right now, management believes novel technologies can be acquired "on the cheap" and highlights that "the biggest winners are built in bear markets." Given its exceptional long-term track record, the share regularly trades at a slight premium to NAV, but the performance over the past 18 months has led to an unravelling of that premium and the share is now trading at a discount to NAV. A recent board room spat, which was aired publicly, caused the NAV discount to widen to 22%, creating an exceptional opportunity to buy the shares on the cheap.

Overberg Asset Management purchased the share for its global private client portfolios in late March 2020, when the Covid pandemic selloff created a good buying opportunity. A narrowing in the discount to NAV and simultaneous recovery in underlying investments led to a sharp rally in the share price, which doubled in less than a year from the 533p purchase price. When the share price hit 1393p in February 2021 we banked profits by rebalancing the share back to model portfolio weightings. The share continued to rise, reaching a peak of 1528p in November 2021 but has since slumped, plumbing a recent low of 612p earlier this month. The share is now at almost half our model weightings. A further rebalancing exercise makes a lot of sense, this time involving a reweighting rather than a trimming of profits. The share has a market capitalisation of just under £10 billion and is a constituent of the FTSE 100 index. If one values the quoted investments at NAV, which is reasonable given their liquidity, the 20% discount to NAV of the share price means investors get the unquoted portfolio at a 66% discount to NAV. If one also values the unquoted rising stars, SpaceX, Northvolt and Bytedance at NAV, which is reasonable given their listing prospects, investors are getting the remainder of the unquoted portfolio for free. This is too good an opportunity to ignore.

Local Report

Gielie Fourie

Does SA Inc. still offer value?

INTRODUCTION: Does SA Inc still offer value? For many investors globally, 2022 was a year to forget. It started with the Russian President Vladimir Putin's invasion of Ukraine in February. This event and China's brutal 'zero Covid' policy described by the press as a 'mass imprisonment' campaign, led to higher global inflation, followed by continual interest rate hikes. This scenario led to negative growth and markets became a minefield for investors. In 2022 the Nasdaq dropped 32.87%, and the S&P500 dropped 19.34%. The JSE performed better and was down only 0.90%. After 2022's dismal performance, investment analysts were mostly wary of market prospects for 2023. Inflation was still out of control and the Ukrainian war was still raging on.

Coined in 1810, and attributed to London financier Nathan Rothschild, the phrase "buy on the sound of cannons, sell on the sound of trumpets" suggests that the start of a war is a good time to invest in the stock market. Conversely, the end of a war is a good time to sell. Rothschild added: "The best time to buy is when there is blood in the streets." It simply means, when everyone else is selling, it is a great time to invest.

On 27 September 2022 we wrote here on Prosus and Naspers. At that time Tencent, Prosus and Naspers were struggling. Year-To-Date (YTD) Tencent was down 33%, Naspers was down 6%, and Prosus was down 23%. Investors who panicked and sold, made a mistake. Contrarian investors who bought, made big profits of around 100% within a year. The drop was caused mainly by the war, especially for Prosus which had operations in Russia. It was also driven by the Chinese crackdown on technology companies. In 2021 Chinese regulators froze all licensing activities for new computer games. Prices were low and it was an excellent time to start buying shares. Today, a year later, Prosus is up Year-on-Year (YoY) by 79.27% and Naspers is up 98.57%. We have both Prosus and Naspers in our clients' portfolios.

Currently foreign investors tend to avoid SA Inc. shares. Analysts' advice is generally to move most, if not all your wealth, offshore. This advice is neither bad, nor good, because it is not a one-size-fits-all solution. That South Africa has troubles politically and economically is obvious; yet the price at which most SA Inc shares now trade makes them a compelling option on a future that might not be that bad.

JOHN BICCARD, manager of the Ninety-One Value Fund recently wrote: "Making money in the equity market is not as easy as reading the newspaper and looking at what is going on around you. The key to investing is to try to work out how much of what is in the newspapers and what is happening in the streets is in the price. Making money out of investing on information that is fully known by the market is not possible — that is why insider trading is so lucrative (and illegal). On this basis, an investment in South African equities should at least be considered." Holding SA Inc stocks could be considered risky, but not holding them carries risks as well.

HENDRIK DU TOIT, CEO of Ninety-One, supports the views of John Biccard. Du Toit says: "South Africa may be down, but not out. Ninety-One is not abandoning its home market, despite South Africa's existential challenges. Even as the rand gets punished by foreign investors, Ninety-One remains positive about the country's opportunities for investment. And compared with the pain experienced by the developed world's bond investors, South Africans might even count themselves lucky."

DISCOUNTED PRICES: South African equity valuations already discount our current reality of prolonged loadshedding, dysfunctional State-Owned Enterprises (SOEs), like Transnet, Airports, Harbours, lack of service delivery, low economic growth, and the collapsing of the value of the rand. The markets function as if these conditions will last ad infinitum.

DISTORTED PRICES: South African equity valuations are likewise distorted upwards by dual listed shares with extremely high valuations, like Naspers and Prosus. The market is also distorted downwards by the generally low valuations of the mining stocks trading on the JSE.

BOTTOM LINE: 2022 was indeed a year to forget, but 2023 could be better. Markets never move in a straight line. Good times will be followed by tough times. Nobody can predict the bottom of the market. We cannot be too far away from the bottom. Last year net selling of shares by foreigners amounted to around R100 billion. It has happened every year over the last five years. Almost R600 billion has left our shores during the last five years. A major portion of these funds could return to our shores once we get our house in order. You can buy shares locally at discounted prices, or you can take your money offshore and buy shares at inflated prices. Please use this information as a reference only, rather than as a basis for making investment decisions. To take the emotion out of equity analysis, you are welcome to contact one of our friendly consultants for a free consultation.