OVERBERG MARKET REPORT

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Global Report

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Is it too late to invest in Artificial Intelligence?

The US equity benchmark, the S&P 500 index is up by 13% year-to-date and up over 20% since its low point in October last year. A 20% move qualifies as a "bull" market confounding the sceptics at the start of the year with their prophecies of recession and doom. However, the upward move has been driven by a remarkably limited number of shares. According to US investment bank Goldman Sachs, the current stock market rally has been the narrowest since the dot.com bubble of 2000.

The S&P 500 index is a capitalisation or value-weighted index, which means each company's weight in the index is proportional to the market value of its shares. The index comprises 500 companies. The companies with the largest market capitalisations, or the greatest values, will have the highest weights in the index. The rally in the S&P 500 index has been driven by the seven largest shares in the index, which combined make up an outsized 28% of its value. They are all technology driven shares, including Apple, Microsoft, Amazon, Alphabet, Tesla, Meta Platforms, and Nvidia, the latest technology company to break the $1 trillion market capitalisation barrier.

In 2003, the S&P 500 Equal Weighted Index (EWI) was created, an equal weighted version of the index. Although both indices comprise the same 500 shares, they have different weighting schemes. In the EWI, every share in the index has the same weight regardless of how large or how small the company. Therefore, Apple the largest constituent of the S&P 500, comprising 7.56% of the index would have the same weight as the smallest company. While the S&P 500 index is up 13% year-to-date, the equal weight index has barely budged. The S&P 500 index would be down if one excluded the seven technology giants. Globally, over half the constituents of the MSCI World Index are down YTD. Technology is leading the way, buoyed by surging interest in artificial intelligence (AI).

Is it too late to jump on the artificial intelligence bandwagon? Many analysts caution that valuations have run ahead of themselves, citing the dangers of previous equity market bubbles. Bubbles inevitably end badly, but they can persist for long periods, especially in a field as transformational as generative AI. This bubble could still be in its infancy, considering that media hype around generative AI only began in January when Microsoft announced its investment in ChatGPT. Goldman Sachs research concludes that AI could lead to a labour productivity boom similar to previous transformative technologies like the electric motor and personal computer. Productivity growth in the G7 economies has slowed since the turn of the century to an average annual rate of 0.8% compared with 1.8% in the 1980-2000 period. Goldman Sachs believes that generative AI could raise US productivity by a substantial 1.5% per annum.

Jen-Hsun Huang, the founder of Nvidia, which designs the advanced Graphics Processing Unit (GPU) chips that power artificial intelligence applications, said "we have reached the tipping point of a new computing era", in which "everyone is a programmer." Scottish Mortgage Investment Trust, a key holding in Overberg Asset Management's global private client portfolios, added Nvidia to its portfolio in July 2016, when the share traded below $10.00. It has since risen above $400 per share, up an astonishing 180% YTD and trading at an eye-popping price-earnings multiple of 123x. Yet Scottish Mortgage are holding on to the share, as it believes "Nvidia's opportunity in AI is still just beginning. Its capabilities underpin computational drug design, climate change simulation, speech recognition, automotive control systems, industrial automation, computer vision and much more… The markets it addresses are inestimably large, and Nvidia is developing a systemically crucial role."

It is not too late to add portfolio exposure to AI. Some of the doyens of the investment industry share this view. Pershing Square Holdings, the £5 billion investment company, only recently added its sizeable stake in Alphabet at a 9% portfolio weighting. Overberg Asset Management's global private client portfolios have exposure to AI via various holdings, most notably through Pershing Square Holdings Ltd, Scottish Mortgage Investment Trust plc, Rothschild Capital Partners plc and JPMorgan American Investment Trust plc. However, we believe that additional exposure is merited, via Allianz Technology Trust plc.

Allianz Technology Trust PLC (ATT) has a long and successful track record of investing in quoted technology companies on a worldwide basis. ATT has the competencies to sift through the winners and losers of the AI transformation. It has won several awards, including winner of the Association of Investment Companies (AIC) specialist category in 2021, and winner of the AIC shareholder communication award in 2022. It also has a 5-star Morningstar rating, the highest rating available. ATT is managed by Voya Investment Management, which is based in Silicon Valley where many of the world's key technology companies are headquartered. The share price fell sharply in 2022 by 40.4% as technology companies, which tend to be valued by discounting earnings many years into the future, were especially susceptible to rapidly rising interest rates but the peak in central bank interest rate hikes is now in sight. While the share price has already gained by 23.4% since the start of the year, it is still a long way from recouping last year's losses and still trades at a compelling 12% discount to net asset value.

AI is likely to be a transformative technology and likely to continue generating investor interest for a considerable period, certainly longer than it has done so far. Independent research company Capital Economics wrote on 16th June 2023, that "it will help to propel the stock market to a much higher level in 2024, aided by economic recovery and looser monetary policy... We wouldn't rule out a bubble surrounding AI to inflate well beyond the end of next year." While there are concerns over market valuations generally and the potential for a recession related global equity market sell-off, history shows that mega-cap outperformance, such as we have been experiencing, tends to continue even during an equity market sell-off. In addition, therefore, ATT should also bolster the defensiveness of client portfolios during these relatively uncertain times.

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WEEKLY REPORT

Local Report

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MTN and Vodacom

INTRODUCTION: MTN and Vodacom are the two biggest mobile phone companies in South Africa. MTN was established in 1994 and was one of the first cellular network operators in South Africa. The company initially launched its services after the deregulation of the South African telecommunications sector. In its early years, MTN faced various challenges, including limited coverage and competition from other network operators. Over the years, MTN continued to grow, both organically and through acquisitions. It expanded its presence to several countries outside Africa, including the Middle East and Southeast Asia. MTN offers a wide range of services, including mobile voice, data, and digital services.

Vodacom was established as a joint venture between Telkom and the British multinational Vodafone Group. Vodacom launched its services in 1994 and quickly gained a significant market share. It introduced various innovative services and products, such as the first prepaid mobile service in South Africa. When Vodafone became the majority shareholder in 2009, Vodacom expanded beyond South Africa and established operations in other African countries. Both MTN and Vodacom have played significant roles in transforming the telecommunications landscape in South Africa. They have been instrumental in connecting people, driving digital inclusion, and enabling various technological advancements in the country. Today Vodacom is the biggest mobile phone company in South Africa, while MTN is the biggest mobile phone company in Africa. Both companies are considered core portfolio holdings.

Vodacom is trading at R116.00. It has a market capitalisation of R240 billion, a price earnings (PE) ratio of 12.26x, a dividend yield of 5.77%, a return on equity (ROE) of 18.59%, a return on assets (ROA) of 12.23%, and a price to book (P:B) ratio of 2.48x. Over the last three years the share price has dropped by 4.30%. It is interesting that since 2015 not a single director has bought any shares in Vodacom. Trading in shares by directors draws attention because it can give a glimpse of their view on the company's prospects. When directors buy shares in their company, it is a vote of confidence. Directors, and directors of Vodacom's subsidiary companies, are regular sellers of Vodacom shares. It raises the question why ordinary investors should buy Vodacom shares if the company's directors are regular sellers. There may be very valid reasons for this. They may already have a big concentration of their wealth in Vodacom and prefer to diversify their wealth. Analysts' consensus is that Vodacom is a Hold.

MTN is trading at R136.00. It has a market capitalisation of R256 billion, a price earnings (PE) ratio of 11.78x, a dividend yield of 2.43%, a ROE of 19.83%, a ROA of 13.90%, and a P:B ratio of 2.11x. Over the last three years the price is up by 144.48%. MTN has only slightly better financial ratios than Vodacom, but its share price growth over the past three has far outperformed that of its peer. In contrast to Vodacom, MTN's directors were regular buyers as well as sellers of MTN shares over the last eight years. There was an equal split between buying and selling MTN shares.

MTN recently released its first quarter 2023 results. The balance sheet remains robust. In its outlook it said uncertainty remains as inflation is rampant across Africa. It downgraded its margins to factor in higher inflation and the outlook for loadshedding. MTN offers higher organic growth potential than Vodacom. Data and Fintech developments have been the main drivers. MTN's asset realisation (sale of noncore assets) programme has allowed it to deleverage and strengthen the balance sheet. A significant risk is MTN's material exposure to forex. Calculations show that 17% of the exposure comes from South Africa, and the rest comprises volatile currencies and inflation exposure in the rest of Africa. MTN Nigeria continues to be the key driver of revenue across voice, data, fintech (Momo) and digital services. Data continues to be a key growth driver for the business. Network availability in SA remains under pressure due to ongoing power outages across the country. There were approximately 90 days of load shedding in Q1 2023 compared to 14 days in Q1 2022. MTNs subscriber base is more skewed towards pre-paid than Vodacom. Prepaid subscribers are under pressure due to load shedding intensity and economic weakness. MTN has been looking at Telkom for many years for a possible merger or buyout. Last year MTN walked away from talks to buy Telkom – a deal that would have created South Africa's largest mobile phone operator. Telkom shares dropped 25% as a result. MTN could look at Telkom again.

BOTTOM LINE: MTN and Vodacom have a duopoly in the South African mobile-phone market. Any competitor attempting to enter the market will have to fight, not one, but two giants. There are regularly bits of news regarding smaller companies, like Telkom - a former state monopoly, Cell C, and Rain Holdings, trying to compete in the market. The Public Investment Corporation, (PIC) which manages more than R2.5 trillion in assets, is in talks to team up with investors for a potential offer for a stake in Telkom. Even with this kind of backing, success cannot be guaranteed. The barrier to entry is high – this business is highly capital intensive.

Please use this information as a reference, 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.