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OVERBERG MARKET REPORT

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Global Report

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Good things come in small packages

As the proverb goes, "All good things come in small packages". This is relevant to investing. Small-cap shares, although more volatile than the large caps, provide the best returns over time. This makes sense, given that they start from a lower base, but they are also relatively under-researched and so are more often under-valued. Attention today is predominantly focused on US mega-cap technology stocks, the so-called Magnificent-7, yet even they started life as small-cap shares.

US small-cap shares have seldom been cheaper relative to their larger peers. Independent research firm, MRB Partners claims that "In the past 35 years, there have only been three other times when the 1-year performance gap between small- and large-cap stocks was as wide or wider than at the recent relative lows (i.e. the early 1990s, the late-1990s, and the COVID-low). Each of these occasions proved to be a great buying opportunity for small-cap stocks."

The underperformance seems incongruous because the 2025 earnings growth estimates of small-caps is solid, in fact superior to large-caps, if the Mag-7 are excluded from the comparison. At the same time there is a massive valuation disparity. The S&P 500 index trades at a substantial premium on all key valuation measures versus the S&P 400 mid-cap index and at an even greater premium versus the S&P 600 small-cap index.

Valuation of S&P indices on 30 June 2024

Index	Forward P/E(x)	Price-to-book (x)	Price-to-sales (x)	Dividend yield (%)
S&P 500 (large cap)	21.1	4.8	2.8	1.4
S&P 400 (mid-cap)	15.2	2.5	1.4	1.6
S&P 600 (small cap)	14.5	1.8	1.0	1.9

Source: SPGlobal

The reason most cited for the valuation anomaly is the surge in interest rates which began in March 2022. Small caps are especially susceptible to rising interest rates. They carry more than double the debt-to-equity of large caps and pay three times more in interest costs as a share of earnings. This stems from having less access to alternative sources of capital funding.

When June's US CPI report indicated a faster decline in inflation than had been expected, the probability of a September Fed rate cut became all but certain and as a result small-cap shares surged. In July, small caps staged their strongest five-day outperformance of large caps in at least four decades. The stage appeared set for prolonged outperformance, with the imminent start of the Fed interest rate easing cycle.

A steeper than expected increase in US unemployment in the first week of August ignited US recessionary fears and financial markets slumped, bringing to an abrupt end the nascent trend in

small cap outperformance. While small caps typically outperform amid falling interest rates, there is an important proviso: There cannot be a recession, as small caps tend to be more leveraged to the economic cycle, explained in part by their greater use of debt but also their greater domestic focus.

Concerns over an imminent US recession are misplaced. The steeper than expected rise in unemployment is attributed to rapid growth in the labour pool stemming from the post-Covid normalisation in labour participation and a dramatic increase in the number of immigrants. A more balanced labour market bodes well for inflation returning to central bank targets, paving the way for interest rate cuts. Meanwhile, the global economy is slowly improving, led by rising trade volumes and strength in the service sector. Despite the excitement in the first week of August, The Federal Reserve Bank of Atlanta raised its estimate of third quarter US GDP growth. Its estimate lifted from 2.5% on 1st August to 2.9% on 8th August.

The current economic cycle is reminiscent of the late 1990s when the Fed was able to cut interest rates in the absence of heightened recessionary risks. In this so-called soft-landing scenario, when interest rates fall and the economic expansion is prolonged, small cap shares may well outperform as they benefit from an easing of financial conditions, an improving earnings outlook, and an unlocking of a substantial valuation discount.

We believe small cap shares play a key role in global diversified investment portfolios. Not only do they offer a strong probability of outperforming benchmark indices, but also offer useful diversification to investors' portfolios, after a period when returns have been dominated by a handful of mega-cap US tech shares. In the US, the top 1000 shares by market capitalisation make up 95% of the total value. The next 2000 shares are worth less than the largest company, currently Apple. Even a moderate market realignment into small cap shares would have a significant impact on small cap share price performance.

Overberg Asset Management has added Edinburgh Worldwide Investment Trust plc (EWI.L) across our clients' global private share portfolios. EWI is an investment company listed on the London Stock Exchange managed by Baillie Gifford with a mandate to invest in a global portfolio of smaller companies with significant long-term growth potential. Positions tend to be initiated at the start of a company's commercialisation phase when the technology is proven but the market has not yet priced in its potential. EWI has gone through a difficult period of net asset value (NAV) performance and as a result the share trades at a compelling 8% discount to NAV. Given our belief in Baillie Gifford's long-term track record in discovering successful future companies and the ability to generate exceptional returns from a small number of winners, we believe the best time to invest is after a period of unusually weak performance. By region, EWI's largest exposures are to the US (76%) and the UK (12%).

Investment companies form the basis of Overberg's global private share portfolios. Each portfolio typically comprises around 20 investment companies, providing effective global diversification across regions, currencies, and asset classes.

Local Report

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Investment case for South African assets

Introduction

After a decade of turmoil under the Zuma administration, followed by the false dawn of Ramaphosa, the COVID-19 pandemic, record-high inflation and interest rates in 2022/2023, the collapse of Transnet, and record levels of load-shedding, it seems there is finally light at the end of the tunnel for the South African economy and its assets. The recent peaceful formation of the Government of National Unity (GNU) after the May 29 general election has led to a fundamental shift in investor sentiment towards South Africa. This optimism is further bolstered by the absence of load-shedding since 26 March 2024 (146 days), improvements in rail and port efficiencies, declining inflation, and a strengthening rand. Although risks remain, the confluence of these positive factors has significantly improved the outlook for South African assets, particularly given current valuation levels. South African asset valuations screen cheap compared to other emerging and developed markets. One swallow doesn't make a summer, but in South Africa's case, more swallows seem to be flying together.

Structural changes and Improvements

a. Formation of a Government of National Unity (GNU)

The election outcome was likely the best that South Africans could have hoped for. The ANC peacefully relinquished power after losing its majority, leading to the formation of a GNU that includes the Democratic Alliance (DA), a party generally seen as business friendly. This outcome is especially significant when considering that one of the probable outcomes could have been a coalition between the ANC and the EFF and/or the MK Party—both of which support policies like land expropriation without compensation, the nationalization of mines and the SARB, and have made various attacks on the constitution. Such a coalition would have been a massive blow to South Africa's recovery prospects and its overall investment profile. Fortunately, the new GNU has prioritized economic growth and is driving greater private sector involvement. While these developments are promising, investors will now look for concrete policy steps from the new administration to improve trend growth before increasing their portfolio exposure to South Africa assets.

b. Eskom

Load-shedding has been absent for nearly four and a half months. Based on previous SARB estimates of how much load-shedding has negatively impacted South Africa's GDP growth, the economy has the potential to grow by an additional 1.5% simply from the absence of load-shedding. Is it realistic to expect that load-shedding is a thing of the past? This cannot be answered with complete certainty, but recent data is encouraging. Several Eskom generation units have returned to commercial operation, and this will continue to help alleviate load-shedding pressure this year. Eskom's Energy Availability Factor (EAF) was 52.6% in the first quarter of 2024, improving to an average of 61.29% in the second quarter. The third quarter saw a more significant increase in the EAF to over 70% (the first time since mid-2020), supporting an ongoing recovery in economic activity. The EAF in 2024 thus far averages 58.3%, above the 2023 average of 54.7%. This improvement is largely due to a combination of factors, including increased private-sector electricity self-generation capacity and lower levels of unplanned outages.

c. Transnet

Kumba Iron Ore and Sasol have reported recent improvements in Transnet's rail operations, attributing these to the company's new management team and recent leadership changes. These

improvements, though slightly below target, are also linked to legislative reforms that have allowed for greater private-sector involvement. A new board, appointed in July 2023, introduced a phased Transnet Recovery Plan aimed at stabilising operations and financial performance by March 2025. This plan focuses on structural reforms in rail and port operations through private sector participation, and there has been a notable increase in output levels.

Rail volumes have increased from 150 million tons in FY2022/23 to 151.7 million tons in FY2023/24. The significance of this increase lies not in the percentage but in the fact that this is the first year-on-year increase since 2018. Productivity at the Port of Cape Town has increased by 30% in the past six months, contributing to renewed optimism in the logistics capacity of the Western Cape. Transnet has also recently undertaken significant efforts to improve operations at the Port of Durban and expand container capacity.

Financial tailwinds

Inflation and Interest Rates

Inflation has been trending downward from its peak in 2022, in line with other global economies. The South African Reserve Bank (SARB) is forecasting inflation to reach the 4.5% midpoint target in the fourth quarter of this year, setting the stage for potential rate cuts starting in September. Declining interest rates will support asset valuations, improve consumer and business confidence, and over time increase disposable income for consumers and expand corporate profit margins.

Risks

Several risks, both local and global, could undermine South Africa's recovery. These include potential instability within the GNU, water-shedding, high levels of crime and corruption, a slowdown in global economic growth, continued economic weakness in China, and geopolitical conflicts. While global risks will always exist, it appears as if South Africa has turned the corner on scoring own goals and is starting to address the political, economic, and structural challenges within its control.

Conclusion

Despite various risks, the confluence of factors such as the formation of the GNU, improved electricity generation, higher business and consumer confidence, declining inflation, expected future interest rate cuts, and a strengthening Rand have significantly improved the investment case for South African assets. Valuations remain relatively low, making the overall investment case attractive. The economic recovery may take time as initiatives are implemented and changes take hold, but financial markets, as we know, are discounting machines and will start pricing in improvements in advance.

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