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INVESTMENT PROCESS IN ACTION

AFRICA FUND

THE SOUTH AFRICA DIARIES

A critical element of our fundamental investment process is first-hand analysis of the economies and companies we invest in.

Recently our African investment team visited South Africa as part of their continuing management of existing investments and pursuit of new opportunities. The trip provides a clear snapshot of our investment process in action.

OUR UNCONSTRAINED UNIVERSE

In January 2016 our fund exposure to stocks in South Africa was 33%, today it's 60%. We had spotted a deeply undervalued currency and a country concerned about the unpredictable behaviour of President Zuma. We believed the currency more than factored in the country risk and were comfortable with the strength of independent finance leadership from the respected Central Bank.

Flash forward to today and we find its enduring institutional strength has helped to maintain its investment grade rating, the currency has appreciated over 20% and the external positioning continues to improve with the recovery of commodity prices.

Our non-benchmarked approach has enabled us to build our positions in companies with the potential to deliver great returns over the next 3-5 year cycle, not just from a short-term bounce in sentiment.

PROSPECTS FOR IMPROVING COUNTRY RISK

We assess country risk in terms of economic health and institutional and government quality. It is clear that Zuma has been a disastrous leader for South Africa. He has misused public funds and allowed himself to be manipulated by the "infamous" Gupta brothers. Zuma has survived three parliamentary votes of no confidence, but only because of the ANC's significant parliamentary dominance and their desire not to lose face.

However, 2017 holds the prospect of change, with the ANC electing a new chairman. The leading contenders are the vice chairman, Cyril Ramaphosa, and Nkosazana Dlamini-Zuma, Zuma's ex-wife dating back 18 years.

The business community's favourite is Ramaphosa, due to his background as a businessman. However, an informed political analyst we met with suggests that Diamini-Zuma would not allow interference from anyone (including

KEY TAKEAWAYS

1. There is real prospect of a positive leadership change, alongside a strong central bank that could mark the beginning of a reform driven agenda, triggering a return to faster economic growth
2. South Africa is home to companies with strong management teams and sustainable competitive advantages
3. We are now witnessing headwinds being replaced by cyclical tailwinds; inflation is falling, exports are rising, and business confidence is improving

her ex-husband) regarding the selection of her cabinet members. So a real prospect of a positive leadership change, alongside a strong central bank could mark the beginning of a reform driven agenda, triggering a return to faster economic growth.

THE "TAIL"WINDS OF CHANGE

During 2016 significant headwinds remained and South Africa's GDP expanded by just 1%. This was clearly below its growth potential and is explained by cyclical factors such as falling investment, weak commodities environment and higher food inflation, caused by the drought following the impact of the El Nino weather pattern.

Despite these cyclical headwinds, we were able to find many exceptionally well-managed firms with coherent business plans, a track record of prudent capital allocation and a sustainable competitive advantage. As we anticipated, we are now witnessing headwinds being replaced by cyclical tailwinds; inflation is falling, exports are rising, and business confidence is improving.

At Alquity, we focus on the cycle of profitability, with the primary aim of investing in companies towards, or close to, the bottom of their cycle and where our expectations are significantly greater than the market.

PRICE TO BOOK & RETURN ON EQUITY OF MSCI SOUTH AFRICA, 2005-2017

Source: Bloomberg

One such company is KAP Industrial Holdings, a leading supply chain logistics and manufacturing business. As the South African economy faced headwinds the business maintained its profitability but the market punished its share price, implying a structural change in outlook. As the economy improves, KAP is therefore well positioned to capture growth and increase profitability ahead of market expectations.

On the other hand, we avoid companies that are at or near their peak valuation levels. One such company is Clicks - a well-managed chain of drug stores, which is delivering record profit margins. However, the market has extrapolated that this will remain intact 'forever'. We will therefore only keep them on our watch-list for future investment if valuations or cyclical factors change.

The graph above illustrates the cyclical low positioning of South African equities' profitability, represented by Return on Equity, as well as valuations below their historical median levels (represented by Price/Book) .

Based on our research and after meeting with 16 South African companies (ranging from financials, to industrials, to consumer companies) we believe that the market is under appreciating the tailwinds that South African companies will begin to experience this year. The Alquity Africa Fund portfolio now reflects our thesis on the prospects for South Africa.

> ***South African equities have delivered the highest average return in US Dollars for any equity market in the world over the past 117 years***

HIDDEN GEMS WITH SUSTAINABLE COMPETITIVE ADVANTAGE

South Africa is a challenging place to do business. Though it ranks 74/190 in the ease of doing business rankings, it is poor with regards

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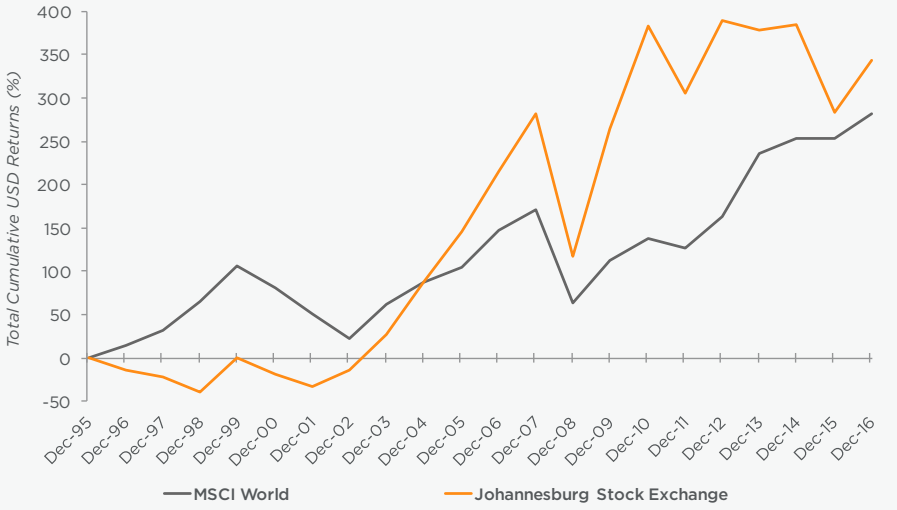
The view from the hills surrounding Cape Town

to ease of starting a business, ranking 133/190. This makes it a less-appealing destination for direct investments, but does allow savvy domestic operators to build world-class operations with sustainable competitive advantages; once they build up their high market share, it becomes difficult to lose.

There are examples such as the branded consumer goods company AVI, with leading branded bakery products; the clothing & food retail operator Woolworths, that developed its own supply chain and branded food company; and Discovery, the insurance company that is exporting its innovative marketing and risk management to develop a community of health orientated customers. An example of how Woolworths cares about the environment is its recent removal of all plastic microbeads from its private label beauty and personal care products, making it easier for consumers to avoid being part of an environmental problem that is causing worldwide concern. They replaced microbeads with natural and biodegradable alternatives such as Jojoba Oil Beads, apricot kernels and synthetic wax beads. This reflects their strong supply chain management and responsiveness to consumer trends.

Many of these companies embrace a shared values mindset: supporting their human resources with training, establishing meaningful goals to decrease their environmental impact, providing transparency, respecting minority shareholders and delivering value to their customers.

TOTAL CUMULATIVE RETURN IN USD OF THE JOHANNESBURG STOCK EXCHANGE & MSCI WORLD



Source: Bloomberg

BEST PERFORMING GLOBAL MARKET OVER 100 YEARS

It is not surprising to us that a recent article revealed a study by London Business School and Credit Suisse showing that South African equities have delivered the highest average return in US Dollars, for any equity market in the world, over the past 117 years.

This level has been maintained, with the total return of MSCI South Africa between December 2005 and December 2016 was 344% vs MSCI World's 281%.

South Africa is an economy with strong institutions, great companies and blessed with natural resource, which means that it is potentially well-placed for this out-performance to continue.

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All data correct as of March 2017.
Sources: Alquity, Bloomberg, Credit Suisse, Company Data, London Business School

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