FLAGSHIP ASSET MANAGEMENT

Navigate Safely Forward

# Quarterly Telescope Q4 / 2020

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## Flagship Asset Management

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.

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## 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 returns of between 11.5% - 14% per annum since inception.

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## We believe in long-term valuation-based investment

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.

# Contents

# Introduction

Welcome to our latest **QUARTERLY TELESCOPE**. We hope these quarterlies provide you with greater insight into our thoughts on global assets as well as how your global assets are being managed.

In this quarter's Telescope, **Pieter Hundersmarck** discusses how our portfolios navigated the fourth quarter, as well as how the funds are currently positioned. He then examines Modern Monetary Theory, the impact of generational investing and the role of China in our global strategies. Finally, **Kyle Wales** takes us through the investment case for **Take-Two Interactive**, a high-quality gaming studio that we have recently taken a position in.

**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**

Kyle has been investing internationally for over 12 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.

# Performance

All performance is net of fees. Periods longer than one year are annualized.

| to 31 December 2020 | AUM | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | S.I. |
|---|---|---|---|---|---|---|---|
| **Flagship IP Worldwide Flexible Fund (ZAR)** | **R464m** | **26.4%** | **26.4%** | **12.2%** | **3.5%** | **11.2%** | **11.8%** |
| Composite Benchmark | | 11.7% | 11.7% | 8.5% | 6.4% | 10.8% | 9.3% |
| Outperformance vs. Benchmark | | 14.7% | 14.7% | 3.7% | -2.9% | 0.4% | 2.5% |
| Sector average | | 10.9% | 10.9% | 7.7% | 4.7% | 11.2% | na |
| **Flagship IP Worldwide Flexible FoF (ZAR)** | **R292m** | **21.1%** | **21.1%** | **11.9%** | **4.5%** | **13.7%** | **13.9%** |
| Benchmark (SA CPI + 5%) | | 8.4% | 8.4% | 9.3% | 10.0% | 10.4% | 10.4% |
| Outperformance vs. Benchmark | | 12.7% | 12.7% | 2.6% | -5.5% | 3.1% | 3.5% |
| Sector average | | 10.9% | 10.9% | 7.7% | 4.7% | 11.2% | na |
| **Flagship International Flexible Fund (USD)** | **$33.4m** | **27.1%** | **27.1%** | **9.3%** | **6.8%** | **9.2%** | **3.0%** |
| Composite Benchmark | | 10.3% | 10.3% | 6.3% | 6.9% | 10.1% | 3.7% |
| Outperformance vs. Benchmark | | 16.8% | 16.8% | 3.0% | -0.1% | -0.9% | -0.7% |

Note: 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.

# 2020: A year to remember

*The thing that most affects the stock market is everything.*

- James Wood

*The history of all hitherto existing society is the history of class struggles. Freeman and slave, patrician and plebeian, lord and serf, guild-master and journeyman, in a word, oppressor and oppressed, stood in constant opposition to one another, carried on uninterrupted, now hidden, now open fight, a fight that each time ended, either in a revolutionary reconstitution of society at large, or in the common ruin of the contending classes.*

- Karl Marx

2020 was an unprecedented, record-breaking and for some, a heart-breaking year. We hope that the new year charts a gentler path than the previous one, especially for those of you who experienced personal or professional loss due to the COVID pandemic.

We begin the year on positive notes. Despite the rancorous events on Capitol Hill in January, 2021 welcomes the peaceful handover of power and a renewal of political stability in the United States, as well as the first 'madame vice-president' in the 245-year history of that nation. Economically, in 2021 we expect most nations to exit recession and foresee a renewal of economic activity in the developed world and a stabilization in hard-hit developing countries across Asia and Africa. Many of the global policies implemented during the pandemic will be rolled back in the course of the year, particularly 'hard lockdowns' which proved of limited use in restraining the virus and often shifted the impact of the pandemic to the economic sphere, and on much broader segments of the population. Inoculations, already well under way in Israel, UK and the US, will provide much needed immunity for the vulnerable.

*Money printing continues to be good business for the global stock exchanges.*

There were other positive impacts in 2020. The trend of employers giving their staff flexibility to work from home, which was already taking shape prior to the pandemic, was accelerated. For many non-collaborative and solo production-focused employees this has meant more time with family, and less time on the road. Heightened health awareness emerged in 2020, and is hopefully here to stay, as well as an increased sense of social responsibility.

Turning to the negative side, government's finances are a mess. While Western nations could afford to hand out enormous sums of money to support industry and consumers, developing nations were not as fortunate. There were other variances here too: China sailed through with less stimulus than what was seen in the US, for example, but no government balance sheet was left unscathed.

Money printing continues to be good business for the global stock exchanges. Society has edged over the cliff of allowing fiat currency to be debased as a store of value (but still a unit of account), and this opens the door to any other more stable unit of account to take its place (i.e., Bitcoin), which we are closely monitoring.

There is no such thing as a free lunch, and the consequences of huge debt issuance will ultimately be detrimental to the foundations for growth, long-term wealth creation and prosperity of future generations. In the long run, the most likely outcome is that the current manner of money printing can only lead to lower standards of living for everybody.

Political tensions continue to simmer between China and the US. Despite enormous effort by the sitting president at the time to 'punish' China, seen as the prime antagonist to US interests, the US looks the worse for wear. A Biden presidency offers hope for a more productive engagement with China.

Balancing the good with the bad, we take a cautious stance as we enter the year. Central banks have created an extremely favorable backdrop for risk-taking and resultant asset price-inflation. Investors are being rewarded for taking on risk and this has manifested in a further sharp widening of an already remarkable gap between financial markets and the economy. Central banks' deepening distortion of markets will be harder to defend in a recovering economy amid rising inflationary expectations.

*We believe at this point in the cycle the best approach is through active portfolio risk management and a focus on company specific stock selection rather than simply sector/index exposure.*

Without arguing for or against the wisdom of this belief, we instead simply view it as a feature of this current market. The world is cyclical, and even though stock prices may be elevated and higher multiples are here to stay (given there are few alternatives to equities) we believe cyclicality will still feature. Markets being markets, investors have accepted the higher multiples and extended their hunt for further upside by piling into related opportunities (IPOs, emerging markets, SPACs). This is an extremely powerful dynamic, and one that inevitably overshoots.

As we enter 2021, companies in the worst-affected sectors will go on burning cash for months. Consumers globally are rebuilding balance sheets, and the majority of global companies enter the year with higher debt loads than they started. This means that for them to generate the same level of earnings they did in 2019 requires higher revenue or profitability to service both equity and debt holders.

This does not mean that sitting on cash to wait for the next correction is the best decision. While there is risk that the market may decline in the future, using history as a guideline, it is difficult for investors to time the market hoping to get back in again at the opportune time.

As such, we believe at this point in the cycle the best approach is through active portfolio risk management and a focus on company specific stock selection rather than simply sector/index exposure.

# Performance

The 'pandemic trade' defined the manner in which investment decisions were made from March to December 2020. Flagship's Global Strategies all benefitted from investments in increased online activity, such as e-commerce (Alibaba +26% during 2020, Tencent +54%, Zalando +125%), software (Microsoft +38%, Adobe +51%, Xero +67%), internet payments (Global Payments +17%, Pag Seguro +69%), online gaming (Square Enix +16%, Netease +52%, Ubisoft +26%, Take-Two +70%), hardware (TSMC +120%) and social media (Facebook +37%).

*Despite their sharp upward moves over the past 10 months, we continue to see them as core holdings for the next 10 years.*

As a reminder, our equity selection consists of a maximum of 25 stocks at all times. Our Global Icon Fund holds these 25 positions, and the equity component in the flexible strategy mirrors that selection. All the stocks in our flexible and equity strategies have powerful business models with long runways for growth. Despite their sharp upward moves over the past 10 months, we continue to see them as core holdings for the next 10 years.

**The Flagship IP Worldwide Flexible Fund [ZAR]** returned 2.3% for the quarter, bringing its total 2020 return to 26.4%, versus its benchmark of 11.7%. The Fund came in the top 3 out of 83 funds in the ASISA Worldwide Flexible category for the year 2020.

**The Flagship International Flexible Fund [USD]** returned 19.2% for the quarter, bringing its total 2020 return to 27.1%, versus its benchmark of 10.3%. The Fund ranks in the 90$^{th}$ percentile over meaningful time periods in its class (offshore, multi asset) according to Bloomberg.

The largest contributor to performance for our Flexible Strategy in 2020 was **Zalando**, followed by **Netease**, **Trupanion**, **Microsoft**, **CAE** and **Xero**.

**Zalando**, the largest online fashion retailer in Europe, benefitted from the lockdowns experienced in Q1 and Q2. Active users jumped from 31.9 million to 34 million in the space of two months, and by Q3 stood at 35.6 million. Average number of orders as well as basket size rose materially, leading to sales increasing far in excess of expectations. The Company lifted its sales guidance for the year no less than three times.

**Netease** saw large increases in its monthly active users in Q1 and Q2 of 2020, delivering higher sales than expected which fed through to higher expectations for the year. Its local user base has since pulled back marginally, but is still higher than before the pandemic. The Company capitalized on the pandemic by entering Japan, a new market for them, which we estimate now accounts for 17% of their sales. Its franchise *Knives Out* has seen huge success, proving their products generate cross cultural appeal.

**Trupanion** was discussed in our Q3 2020 Telescope (found here).

The largest detractors were property holdings **Hammerson** and **Unibail**. Unsurprisingly, retail landlords in Europe have been under enormous pressure due to the effect of lockdowns on their business. The economics of lower footfall, falling rentals and financial leverage meant they failed to generate sufficient returns to service debt and equity holders, and both these businesses have had to make large changes to their operations. We remain confident in the prospects of Unibail, at an appropriately sized position.

Note: The Worldwide Flexible Fund and the International Fund follow the same portfolio construction and equity selection ("the Flexible Strategy"). The only difference is their domicile and the pricing

**The Flagship Global Icon Fund [USD]** returned 21.2% for the quarter, bringing its return since inception on July 30, 2020 to 26.4% versus the MSCI ACWI return of 17.8%. The largest contributors were Capri +161%, Zalando +48%, Xero +74%, Pag Seguro +46% and Cartrack +129%. The largest detractor was the fund's holdings in Alibaba -7%.

We first wrote about **Capri**, the owner of the Michael Kors, Versace and Jimmy Choo brands, in January 2020 (found here). At the time the share was trading at $35 and change. The business, and the share price, was hard hit by the pandemic, falling to a low of $8.53 in April. We used the opportunity to buy more, believing that the pessimism in its operations, as well as the concrete steps that management took to slash costs and raise liquidity, was misplaced. The share ended the year at $43, up over 5 times from the lows.

**Cartrack** is a South African founded vehicle tracking business with over 1.2 million customers across South Africa, Europe and Asia. The company managed to grow subscribers, revenue and profits despite the pandemic's impact on its business. We are pleased with the steps taken by management to unlock value in the business and foresee further gains in its operations, and share price, in the years to come.

**The Flagship IP Worldwide Flexible Fund of Funds [ZAR]** returned -3.9% for the quarter, bringing its total 2020 return to 21.1%, versus its benchmark of 8.4%. The stand-out performer was Sands Capital with 56.4% return for the year, while its worst performer, Mondrian Global Equity, delivered less exciting returns. While holding value managers like Mondrian detracted from performance in 2020, we remain committed to maintaining a diversified portfolio of manager styles because we believed this will lead to higher returns and lower volatility over time. We have made no changes to the managers or the equity weighting (c.80%) in the fund.

## Equity selection

As a reminder, Flagship Equity portfolios look very little like the index, and very little like our competitors. We favour concentration, and only hold a maximum of 25 positions that we know well.

A consequence of running concentrated portfolios of only 20-25 stocks is that when a new share is added to the portfolio, we have to sell another. During the quarter we added four shares to the portfolio (**Take-Two Interactive**, **Ubisoft**, **IFF** and **Antofagasta**) and sold out of four shares (**CAE, Trupanion, BAT** and **Heineken Holdings).**

| IN |
|---|
| Take-Two Interactive |
| Ubisoft |
| IFF |
| Antofagasta |

| OUT |
|---|
| CAE |
| Trupanion |
| BAT |
| Heineken Holdings |

Two of the four companies we added (Take-two and Ubisoft) are game developers and publishers. Regular readers of our reports will be familiar with our discussion on game developer Square Enix in the Q4 2019 Telescope (found here). We remain positive on the developing dynamics of the gaming industry, and Take-Two and Ubisoft's positioning therein.

International Flavours and Fragrances (IFF) is a leading manufacturer of flavours and fragrances to the consumer and food production industry. It has recently merged with the Nutrition and Beverages business of DuPont, and we believe this will lead to faster revenue growth and expanding margins. Antofagasta is a leading copper producer. We are positive on the assets of Anto, as well as the supply and demand dynamics in the copper market.

All the positions we exited were due to their share prices reaching our estimate of their fair value.

# Launch of the Flagship Global Icon Fund

The largest development at Flagship in the fourth quarter was SA regulatory approval to start marketing our new fund, the **Flagship Global Icon Fund [USD]**, the master fund of our **Flagship IP Global Icon Feeder Fund [ZAR]** in South Africa. The Global Icon Fund was seeded with over R100m from Flagship clients and employees. As at 31 Dec '20 this has grown to over R140m.

We are tremendously excited to be able to offer this solution to our clients. We strongly believe the appropriate investment approach for South Africans in these times of increased market and economic uncertainty is one that invests *in a concentrated selection of businesses that have the hallmarks to thrive in even turbulent global growth scenarios*, and is 100% offshore in order to protect against ZAR weakness and local inflation (which we believe are set to continue and even accelerate).

Our newly launched Flagship Global Icon Fund addresses this:

- The fund is managed on a clean-slate, benchmark agnostic basis
- 100% offshore
- Access to our top 25 best ideas, diversified across geography and sectors
- Accessible via two entry points, onshore (ZAR) and offshore (USD)

The fund will only own shares in businesses that have 'Iconic' attributes, being:

- A large addressable market
- A hard-to-replicate competitive advantage
- Recurring revenue streams
- Lower sensitivity to the economic cycle
- Cash generative and a capital light balance sheet

The fund's top holdings, as well as their various attractive attributes, are shown below:

**Table 1** Top 10 holdings of Flagship Global Icon Fund (31 December 2020)

| Name | % | ROE% | 5 Yr ROE% | FCF conversion | Net debt/EBITDA |
|---|---|---|---|---|---|
| Zalando | 6.8% | n/a | n/a | 77.5% | net cash |
| Netease | 5.3% | 39.8% | 27.8% | >100% | net cash |
| Microsoft | 4.7% | 44.2% | 26.2% | 99.3% | net cash |
| Alibaba | 4.5% | 28.5% | 25.0% | >100% | net cash |
| TSMC | 4.4% | 27.8% | 24.0% | 82.0% | net cash |
| Pag Seguro | 4.4% | 17.5% | 22.0% | >100% | net cash |
| Global Payments | 3.9% | 5.0% | 7.2% | >100% | 3.2x |
| HDFC Bank | 3.6% | 16.5% | 17.8% | n/a | n/a |
| TCS Group | 3.6% | 43.0% | 44.2% | n/a | n/a |
| Capri Holdings | 3.5% | -17.3% | 23.6% | 80% | n/a |
| **Total top 10 as % of fund** | **45.0%** | | | | |

Stock selection has been a major driver of Flagship returns over time. Our Global Equity and Global Flexible Strategies seek to provide our investors with growth, and we know of no better asset to provide this than equities. The fact that stock returns in the long-run have surpassed other financial assets through market peaks and troughs attests to the resiliency of stocks in all economic climates.

The table below shows how the stock selection (equity only) portion of our flexible funds have performed over recent turbulent periods.

**Table 2** Performance of the equity selection within the International Flexible Fund since August 2019

| to 31 December 2020 | Dec | 3m | 6m | 1 Yr | Since Aug '19 |
|---|---|---|---|---|---|
| **Flagship International Flexible Fund (Equity Only)** | **7.9** | **22.2** | **39.6** | **41.4** | **60.9** |
| MSCI All Country World Index | 4.6 | 14.7 | 24.0 | 16.3 | 22.6 |
| Outperformance vs. Benchmark | 3.2 | 7.5 | 15.6 | 25.1 | 38.2 |

As with our flexible funds, the Flagship Global Icon Fund will invest with the same Flagship DNA:

- **Specialization.** We are focused on a very small number of strategies where we have the skill and experience to add value to our clients' lives
- **Concentration.** We concentrate our equity exposure to our best ideas, ensuring that capital is most efficiently applied to generate the highest possible return
- **Global experience.** Our portfolio management team is highly experienced across global asset classes
- **Independence.** We are owner-managed, and we pride ourselves on being able to apply an independent, global perspective to our portfolios

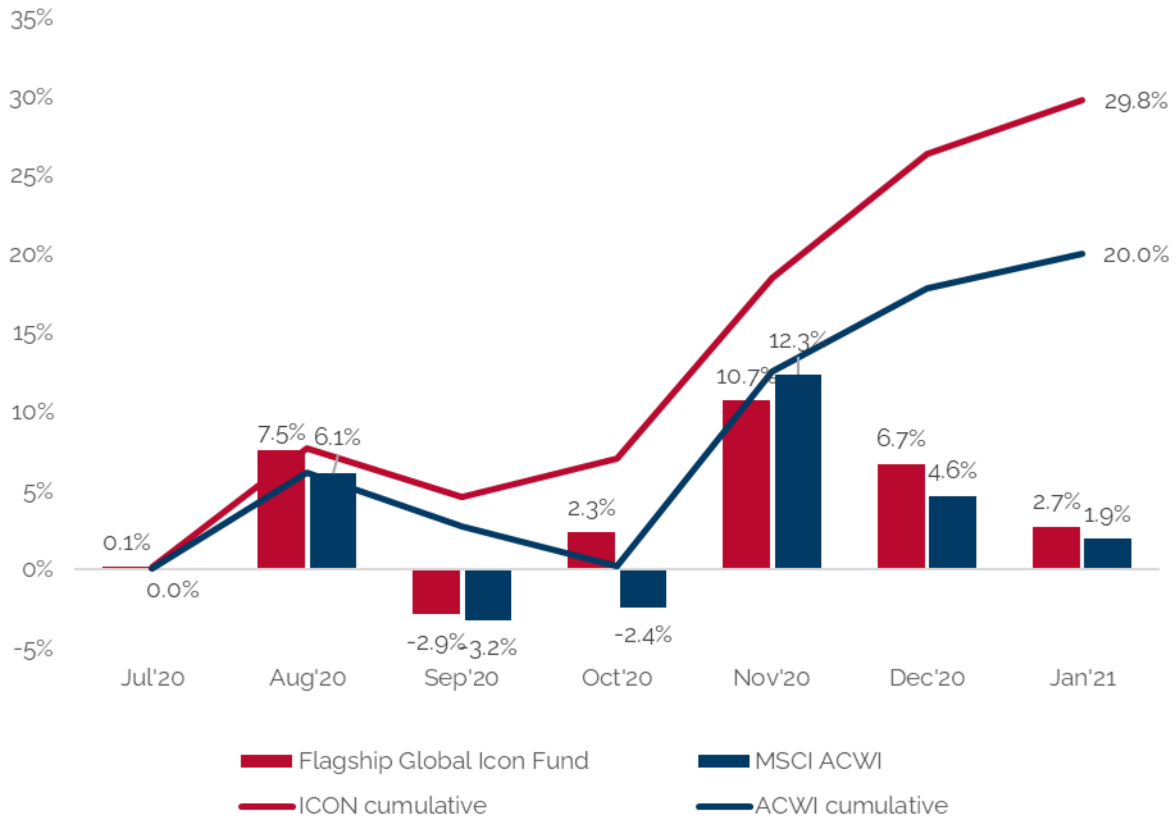
## Can you invest in the Icon Fund as well as our flexible strategies?

**Yes**. Flagship is best known for its award winning Global Flexible Strategies, where we conduct both asset allocation and stock selection on behalf of our clients. *Asset allocation* is deciding which asset classes to own (for example bonds, equity or cash), while *equity selection* is deciding on which individual equities to own, within the available universe of equities.

Consequently, there has been an unmet need for clients who are happy to do their own asset allocation but want us to select stocks on their behalf. This need has finally been met with the launch of our Global Icon Fund, our first pure global equity fund.

# Global Icon performance

**Chart 1** Flagship Global Icon Fund performance, in USD, since inception (30 July 2020) to Jan 11,2021



# Asset allocation

## Despite high expectations, equities still preferred

*Multiples are elevated due to the lack of viable alternatives to equity. Regardless of their level (high or low), we will still see cyclicality around equities, as we always have.*

We enter 2021 with the MSCI All Country World Index (MSCI ACWI), a broad measure of global stock markets, up 16.7% in USD from the start of 2020. For context, if one had perfect foresight and knew this time last year that there would be a pandemic, that governments would print trillions of dollars, that the US and China would be at each other's throats and that the US election would be so hotly contested, we doubt the consensus would wager that the MSCI ACWI would be 16.7% higher. Compounding this surprise was the fact that markets weren't particularly cheap at the start of 2020 either.

Expectations remain high when referencing the PE ratio on global index levels (i.e., the MSCI ACWI) or the S&P 500, which is heavily weighted to the US, Europe and Japan. However, this isn't the whole picture. The level of the PE is not useful on its own, and requires an understanding of earnings expectations embedded in the multiple, as well as the alternatives to equity as an asset class if one believes that equities are expensive.

When valuations aren't cheap, it is imperative that earnings expectations are met, or exceeded. If not, the optimism behind the multiple wavers and multiples compress. Earnings expectations were cut dramatically at the start of 2020 due to the pandemic, often too deeply.

Expectations have been rising since H2 2020 on the back of better than anticipated results from listed entities, vaccine optimism, and the lack of investment alternatives. Because of the unprecedented rise in debt, a "bridge" to avoid the collapse in consumption and investment, corporate bankruptcies and economic hardship for households have been significantly lessened. Government support of consumption will ultimately be removed. Businesses have cut staff and many have realized they can still operate with smaller workforces. Taxes will have to rise to reduce deficits. As such, index levels are fragile to a decline in earnings expectations.

At the same time PE multiples are elevated due to the lack of viable alternatives to equities. Regardless of their level (high or low), equity valuations will continue to be cyclical.

## Bonds remain uninvestable

*While a glut of savings may perhaps have driven interest rates so low, a falling appetite for risk is keeping them there.*

Our view on bonds remains unchanged. The monetary system is in a downward spiral. Money printing, and resultant bond price inflation, has been coupled with consistently dovish central bank policy in an environment of technological advancements and efficiencies, keeping consumer price inflation (the target of central banks) at multi-decade lows. This, in turn, feeds into expectations that interest rates will remain low, feeding asset price inflation.

Population ageing augments this. As those born after 1945 near retirement, they began to convert holdings of risk assets (like equities) into safer assets (like bonds). This is done at personal and institutional level as actuarial models and asset allocators seek to provide income to retirees. This cumulatively pushes bond yields down and keeps equity yields high. While a glut of savings may have driven interest rates to very low levels, a falling appetite for risk amongst a large ageing population is keeping them there.

# Changing of the guard: understanding and valuing the generational shifts in society

When were you born?

- Silent Generation (born 1928-1945, current age 92-75)
- Baby Boomers (born 1946-1964, current age 74-56)
- Generation X (born 1965-80, current age 55-40)
- Generation Y or Millennials (born 1981-1995, current age 39-25)
- Generation Z or Centennials (born 1996-2016, current age 4-24)
- Generation Alpha (born 2017-present, current age 3)

A generation is defined as "the average period, generally considered to be about 20-30 years, during which children are born and grow up, become adults, and begin to have children". Generation is also often used synonymously with cohort in social science; meaning "people within a delineated population who experience the same significant events within a given period of time".

## By this definition there are currently 6 generations on planet earth.

*"The average millennial attention span is now 10 seconds, which means they might not catch the end of th…"*

Generations are defined by, amongst other things, the available means, technology and popular culture of their day. For example, the silent generation (of which there are only 25 million left in the United States) are defined by their work ethic. Raised by turn-of-the-century farmers and tradesmen, this generation value loyalty, respect and temperance. While technological advancement was slower for this generation than subsequent ones, their wealth accumulation was staggering, bested only recently by their children, the baby boomers. In contrast, the rise of the internet, social media, and a renewed focus on the individual as opposed to the collective has defined the millennial generation. Millennials are also far less wealthy than the boomers were at the same age, seeing 28% declines in median wealth for the <35-year-olds compared with those in the same age bracket in 1989 according to the Federal Reserve.

While current spending power sits with the baby boomers and Generation X, next in line are Generation Y (millennials) and Z, which includes those born between 1981 - 2016.

## Generation Y and Z exhibit different views towards society and consumer goods and services than their parents.

The lives of both these generations are conducted online and they are financially conservative (perhaps because they have to be……?). Importantly, 90% of them live in emerging markets. Why is it important to understand this, and what conclusions can we draw from it?

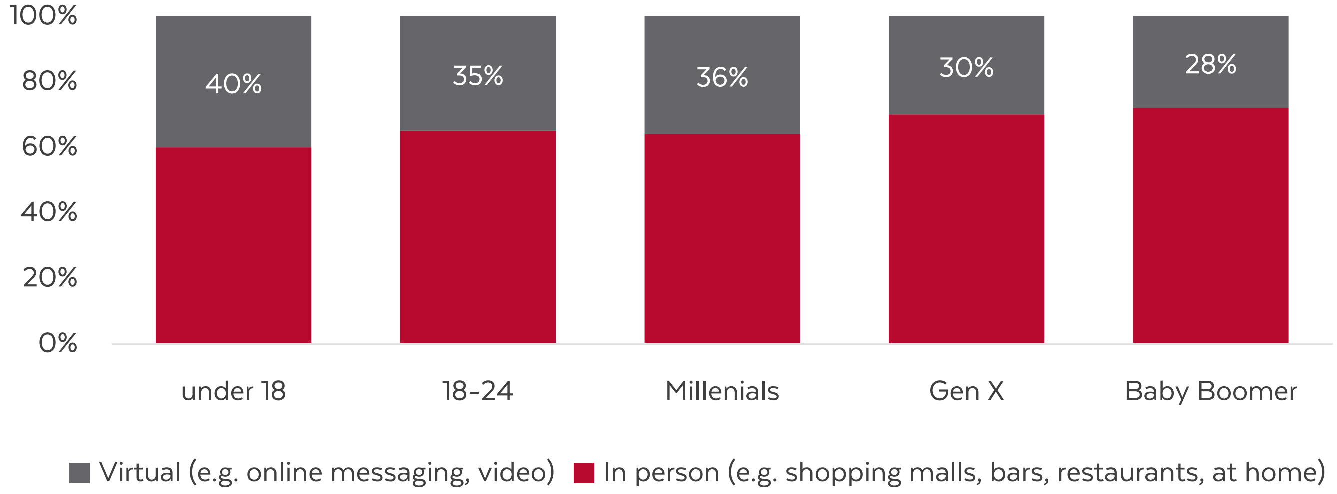
On the one hand, generation Y and Z have youth on their side. One might say "who cares" what the current crop of young kids wants? We all had desires, limited means (and not much wisdom) when we were young. This is the defining theme of generation Y and Z: they are young. As we grow older, our understanding of the world, and how we participate in it, changes, and with it so will our needs and wants.

## Durable investment conclusions cannot be drawn on the fact that young people today don't use credit cards, like to play video games or don't currently drive a car.

Some of these phenomena can be explained by their current stage of life, and their means. Financial success (and differing payment methods like credit cards), as well as responsibility (you can't play video games all day when you have children) and driving habits (at the right price or if you live outside a city you will own a car) change as you age.

Which brings us to an important point. Interpreting generational change is intertwined with technological change. To a certain extent we could say some generational changes are shaped by technology, which in turn shapes the way people consume, save and invest. For example, many of the pastimes we currently enjoy were unavailable to previous generations due to technology:  the smart phone is easy to point out. Going a step further, a third of generation Z would trust a robot to make their financial decisions, and they watch eSports more often than traditional sports. As a result of the internet, interactions are increasingly conducted online: Chart 2 shows that a staggering 40% of 16-18-year-olds prefer to interact virtually.

**Chart 2** How do you prefer to spend the majority of your interactions with friends?




Source: BofA Thematic Proprietary Survey n=14,592, conducted Aug 2020 "How do you prefer to spend the majority of your interactions with

Core, cultural needs will likely remain the same. Mothers and fathers of thirty years ago will desire the same things as mothers and fathers in the next thirty: a good education for their children, a safe environment, a stable income and food on the table. Disposable income then, and in future will be spent on apparel, the outdoors, and travel for as far as we can anticipate. Money earned will need to be spent: unless generation Y and Z become massive savers, which at the current rate seems unlikely. On that note, a savings industry, as far as the continuation of a capitalist, free market economy exists, will be vital.

Some of the mainstays of previous generations (independent of technology) are changing. For example, surverys reveal that only half of US teens can drive, less than half of Gen Z over 18 drink alcohol (versus a third of millennials), and more than half have some kind of meat eating restriction. For both generations, mobile phone usage, social media, cultural participation, awareness of the environment and social awareness are essential themes.

There is no doubt that generation Y and Z are delaying marriage, children, and home ownership, as well as postponing other traditional consumer purchases. Commercial intentions are also affected - 80% of Generation Y and Z factor ESG investing into their financial decisions, and they are also quick to drive sustainability campaigns, such as green energy (much of this campaigning is conducted from relative safe perches behind their mobile phones or tablets).

Much as all children born in South Africa since 2007 have known load shedding, in the technological era, Baby Boomers, Gen X and Millennials have known digital for most of their lives.

They see technology as inseparable from human life, an extension of themselves, and they master digital skills with ease.

There is money to be made in understanding the nuances of changing consumption habits, but also in understanding that some things don't change. Investors need to concern themselves with the changes that will endure, and understand those drivers that will not change.

## What conclusions can we draw from this?

Extracting the first order conclusions is, in part, simple. Cable television, like compact discs and records before them, will go the way of the horse and buggy. Disposable plastics and petrol engines will follow in the not-too-distant future. Meat and alcohol consumption may change, or be supplanted by other proteins and recreational drugs. Second order changes, based on changing demographics, become more subtle. How will companies get their message across to consumers when everyone is an influencer on their own platform? How does delaying marriage and changing social models affect financial goals and retirement? What is the future of nation-states - and even nationality - when successive generations view themselves more as global citizens? The answers to these questions aren't readily apparent.

For investment conclusions, by far the most important factor that can be gleaned from a study of upcoming generations in relation to the past is the enormous, far reaching impact that the internet is going to have on human society. Many before us have said it, modelled it and bought into it, but the truth is we don't believe we are even scratching the surface of the social, consumption and investment changes that will occur as we grow ever more interconnected and online. Our global funds participate in many of the themes we have identified in the newer generations, and we continue to look for more ways to invest behind them.

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- 9 out of 10 of Gen Z thinks it's appropriate to use their phone in the bathroom, and 36% think it's appropriate to use it in a place of worship
- Gen Z & Millennials have a much weaker handshake than other generations
- Gen Z will spend nearly 6 years of their life on social media... that's more time spent than eating, studying & socializing combined
- Young surgeons are losing the dexterity to stitch up patients because they're spending too much time swiping smartphone screens
- Gen Z have a shorter attention span than goldfish, at 8 seconds
- 70% of Millennials would consider buying a lab-grown diamond, when getting married, which costs around a third less than a mined one

A second, just as important, conclusion that goes beyond the understanding of what is happening between generations, is stepping back and understanding what is happening to society as a whole.

## In our lifetime, the elderly will outnumber the children.

Declining birth rates alongside longer lifespans mean the demands on a smaller working population to support ageing populations are increasing year by year. In particular, according to Euromonitor, Europe is expected to see the ratio of 3.6 workers to each over 65-year-old in 2020 decrease to 2.5 workers/over 65-year-old by 2040. By 2031, the over-60s will outnumber the under-10s.

The impacts of ageing are multi-disciplinary. They affect all asset markets, economies and currencies. Even succinct conclusions are far too numerous to lay down here. *This makes our job of delivering growth on your investments increasingly important.*

**Table 3** Current generations and their various cultural habits

| Generation | Greatest / Silent | Baby Boomers | Gen X | Millennials | Gen Z |
|---|---|---|---|---|---|
| Years Born | 1928 - 1945 | 1946-1964 | 1965-1980 | 1981-1995 | 1996-2016 |
| Age Range in 2020 | 75-100Y+ | 56-74Y | 40-55Y | 25-39Y | 4-24Y |
| Population (Global) | 0.2bn | 1.1bn | 1.4bn | 1.7bn | 2.5bn |
| % of Global Population | 3% | 15% | 18% | 22% | 32% |
| Life-Defining Events | World War I and II<br>Great Depression<br>Electric Appliances | Cold War<br>Moon Landing<br>Transistor Invented | End of Cold War<br>Live Aid<br>First Personal Computer | 9/11 Terrorist Attacks<br>Global Financial Crisis<br>Social Media | COVID19<br>Post-Great Recession<br>MeToo / LGBT movement<br>Electric / Driverless Cars |
| Communication Style | Letter | Telephone | Email / SMS | Instant Message | Emojis |
| Key Technology | Car | TV | PC | Smartphone | AR/VR |
| Hobby | Reading | Watching TV | Surfing the Internet | Music Streaming | eSports |
| Digital Proficiency | Pre-Digital | Digital Immigrants | Early Digital Adopters | Digital Natives | Digital Innates |
| Iconic Figure | Franklin D. Roosevelt | John F. Kennedy | Kurt Cobain | Mark Zuckerberg | Greta Thunberg |
| Music | Jazz<br>Swing | Elvis<br>The Beatles | Queen<br>Madonna | Beyonce<br>Coldplay | Billie Eilish<br>Justin Bieber |
| How They Get Around | '55 Ford Thunderbird | SUV | Bicycle / Car | Uber / Lyft | Mom's Prius |
| Current Living Situation | Retirement Home | Semi Detached House | Own Small Apartment | Sharing an Apartment | Parents' House |
| Social network other than Facebook | The Rotary Club | Match.com | LinkedIn | Instagram | TikTok |
| Deepest Fear | The world in 2019 | No longer center of attention | What about my generation | Paying off student debt | Low batteries |
| Key Life Question | How did the country go so wrong? | What will I do when I retire? | What's the point? | What's a career? | What's a landline? |
| Defining Condition | PTSD | Dementia | Stress | Gluten-Intolerant | Peanut Allergy |
| What They Spend On | Oklahoma Community Dinner Theater | VIP tickets to The Rolling Stones | Radiohead concert | Coachella | Fortnite |

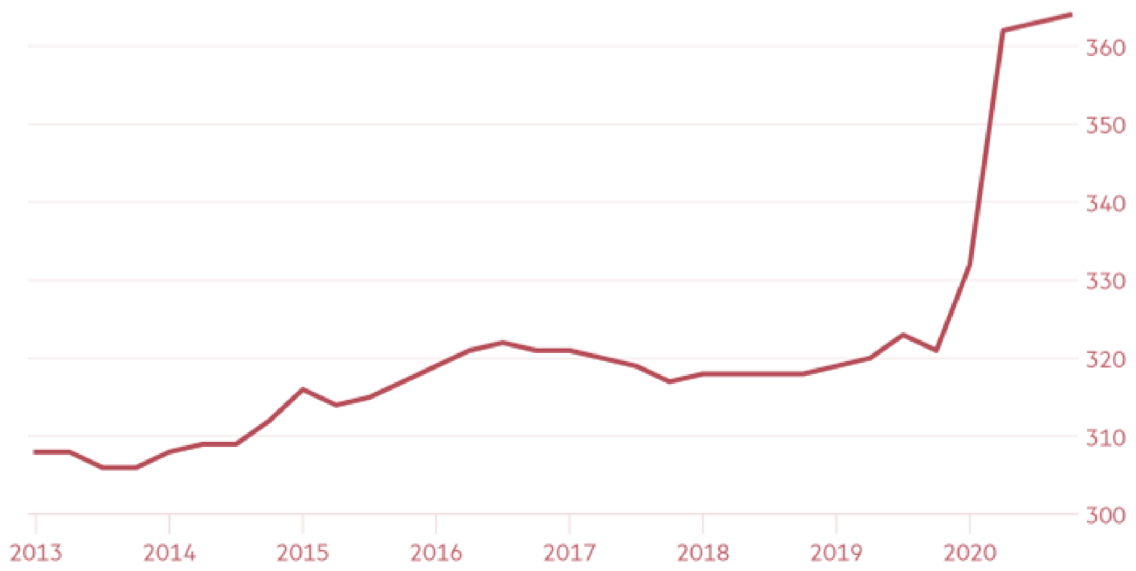
Source: BofA Thematic Demographics Survey, conducted by SurveyMonkey, polled over 14,500 consumers aged 16 and over across the US, UK, France, Germany, Japan, South Korea, China, India, Mexico, and Brazil. The survey was undertaken in late August 2020 and was an internet-based survey.

# Modern Monetary Theory: An exercise in wishful thinking?

Debt levels across all major economies are the highest they have ever been outside of wartime. Government debt only decreases by growing the economy, or by inflating it away, or taxing the economy more, or by embarking on austerity.

**Chart 3** Government debt is most usefully expressed as a share of GDP

Total debt as share of GDP (%)




Source: Institute of International Finance
*© FT*

There are two ways that the ratio of Debt to GDP can fall. Firstly, the denominator can increase. This happens through strong acceleration of economic growth, such as in the 1950s following World War 2. The second way is to reduce the numerator (debt). This means higher taxes, increased austerity, inflation or default, all of which are unpalatable.

*There are only two ways that the ratio of Debt to GDP can fall.*

In 2020 the chorus for a third approach become louder. It's called Modern Monetary Theory, or MMT. MMT is a mammoth departure from conventional economic theory. It proposes governments that control their own currency can spend freely, as they can always create more money to pay off debts in their own currency. It proposes that there are no limits to spending, and debt (or taxes) don't matter. Money required for spending purposes can simply be printed (which is exactly what happens in some countries in the event of war or pandemic). Defaults are unheard of, because money can simply be printed to pay the interest as and when its due.

Theoretically, the only limit on money creation is when inflation arrives, which *theoretically* will only happen once the real resources (labour, capital and natural resources) of the economy are utilized at full employment. The theory suggests government spending can grow the economy to its full capacity, enrich the private sector, eliminate unemployment, and finance major programs such as universal healthcare, free college tuition, etc.

If the spending generates a government deficit, this isn't a problem either. The government's deficit is by definition the private sector's surplus.

Increased government spending will not generate inflation as long as there is unused economic capacity or unemployed labour, MMT proposes. It is only when an economy hits physical or natural constraints on its productivity, such as full employment, that inflation happens because that is when supply fails to meet demand, ratcheting up prices.

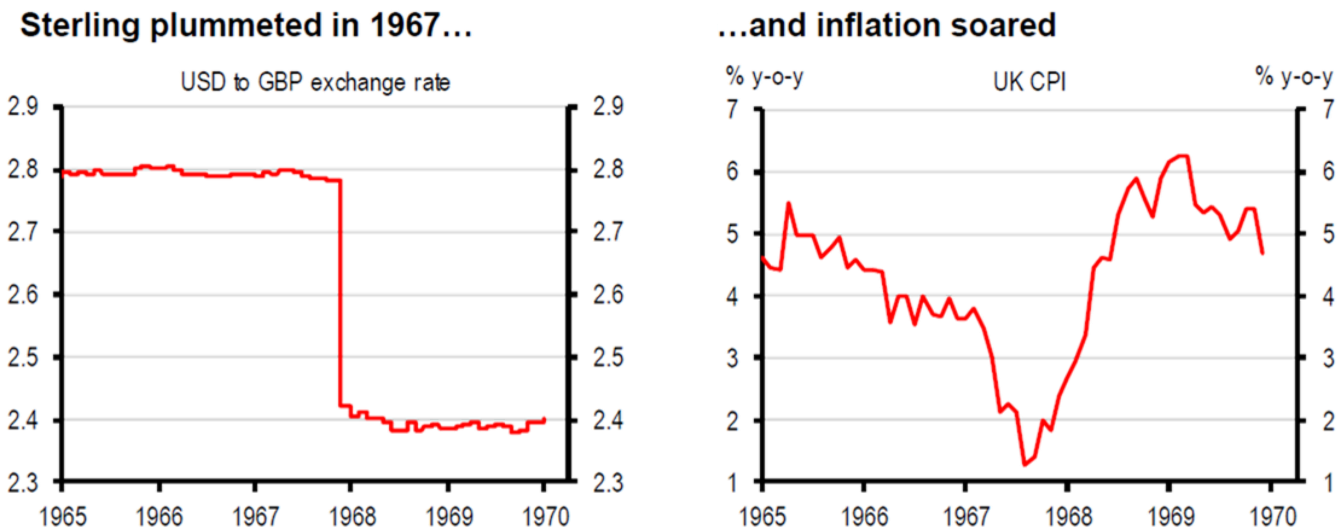
The only macroeconomic constraint is inflation. MMT proponents argue that this can be contained. In boom times, which are inflationary, the government should withdraw money from the economy through taxes, and public spending should be lowered. During recessions, public spending should be raised and taxes lowered.

*It is no surprise that MMT's popularity has grown in attractiveness in the low inflation environment within which we find ourselves.*

One can see the attraction for MMT to those seeking to increase spending without consequence, and it is no surprise that MMT's popularity has grown in attractiveness in the low inflation environment within which we find ourselves. There are, however, reasons to be cautious on its promises.

The first problem is the faith in publicly elected officials to control inflation. Years of successful independent central bank policies in the developed world led to the containment of inflation in the early 1980s. Much of that success is due to the world's central banks conducting unpopular policy (such as Paul Volker's interest rate decisions from 1981 – 1985), something politicians struggle to enact.

**Chart 4** UK pound response to devaluation in 1967 (source: HSBC, Reuters and OECD)




The second concern around MMT is the belief that currency-producing governments cannot go bankrupt, provided they are not dependent on external capital. While this is in theory true, it doesn't matter: inflation still arrives, and its effects are similar to a default. The real value of cash (and savings in the form of government bonds) will fall in value.

The third concern is that MMT theory dictates that taxes are unnecessary other than as tools to control spending, and hence inflation. Since money can be printed at will, there is no need to raise taxes to match them with expenditure. This is an extension of the second concern, and raises the same questions around how to limit the excesses of politicians.

In sum, the execution of MMT in its fullest form runs the risk that the value that people ascribe to currency will be questioned, and once this happens the consequences will be very difficult to bear.

# Four common misconceptions about offshore investing

*Over the years we have fielded a number of queries regarding our views on global investing, and specifically our views on South Africa (shared in our Q2 2020 Telescope found **here**). We felt it necessary to address a selection of these queries by demonstrating that offshore investing is simply a question of diversification and risk management, rather than a decision to 'un-invest' from South Africa. In a nutshell, your South African portfolio needs to be appropriately sized.*

## 01

**"I already get substantial offshore exposure on the JSE via the large dual-listed stocks which comprise a substantial portion of the opportunity set."**

The JSE continues to become smaller, more concentrated and less investable. Offshore exposure on the JSE is concentrated in 6 areas: Naspers (essentially Chinese tech), tobacco, mining, beer, property and luxury goods. There is no need for local investors to limit themselves to these sectors. Opportunity exists in growing global sectors (software, technology, payments, media, apparel, gaming and e-commerce) that are available to local investors via unit trusts or using their offshore allowance. Flagship is one such provider with dual entry points for offshore investors.

## 02

**"But South Africa Inc. is cheap!"**

Yes, it is, and it also comes with risk. The question that arises is – how much money would you put behind a cheap and risky asset? For example: We often find 'cheap' assets to buy in Russia and Brazil; but neither on a personal nor professional level would we place more than 20-30% of our or your wealth into either high-risk region. Why do South African's insist on doing this?

Many South Africans have well over half their wealth sitting in South Africa (see our articles **here** and **here**), which is far too high for a country that has the risk/reward profile that South Africa does. We argue the discussion is about asset allocation: South Africa should occupy an appropriate part of your portfolio for a small, troubled emerging market on the tip of Africa. Over 50% allocated to this market is, in our opinion, highly inappropriate.

## 03

**"Things are improving locally, so local shares will pop and my portfolio will be fine."**

This can indeed occur. However, the discussion is about asset allocation and risk, not timing your buying and selling decision. Once the improvement is priced in, we will once again be in the position to judge whether or not we should now allocate more offshore. This is a timing decision, and not a long-term allocation decision. We argue that a substantial portion of your investments towards one country or region is highly risky, and that a balanced global asset allocation is far more suitable for the long-term investor.

## 04

**"Offshore returns are far lower than the 8-12% I'm used to from the JSE."**

Much of the aforementioned high returns that South Africans have gained from the local market have simply been negated by currency weakness and inflation. A small number of excellent local asset managers have managed to provide both rand protection as well as USD returns to their investors over long periods of time.

# Flagship Primers: China

"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**

*The next twenty years will see the dominance by China of the social, political and economic fields in South East Asia, much as the United States was to the Western world during the early 1900s.*


A young man, Beijing © Patrick Dransfield from the Financial Times

Summary

- Persistent anti-China bias has mischaracterized and misjudged China's enormous economic and social advances compared to modern western democracies
- Claims that China's rise is unsustainable, while simultaneously claiming the western worlds' advancement is somehow more sustainable, require careful research. Risks in China have been over-emphasized while progress has been under-emphasized
- The next twenty years will see China dominate the social, political and economic fields in South East Asia, much as the United States did in the Western world during the early 1900s.
- Global asset allocators have traditionally focused on the 'natural hunting grounds' of US, Europe and Japan, and this trio will soon include China.
- The Flagship Global Investment team have spent over 14 years investing in emerging markets such as China and use this experience to price assets in this geography with appropriate circumspection in a globally diverse portfolio.

A wariness of China was instilled in me since my first year investing in emerging markets in 2007. At the time, China was an up and coming 'new kid' to the global community, gaining in prominence since the late 1990s primarily due to its rapid growth and the enormous volume of commodities it was consuming relative to other nations.

Steel analysts in particular were in high demand as investors struggled to make sense of the expanding Chinese economy, and resource analysts (as I was at the time) had the hapless task of trying to figure out when this behemoth was going to slow, and what that meant for commodities. The Global Financial Crisis (GFC) arrived before China's resource consumption slowed, though even that destructive event was only a temporary hiccup in the continued rise of the Chinese economy.

And rise it has. Since China began to open up and reform its economy in the late 1970s, GDP growth has averaged almost 10 percent per annum (source: World Bank). Today, China is an upper-middle-income country and the world's second largest economy behind the US in constant US$, and the largest when measured by purchasing power parity (PPP).

*The pace of Chinese advancement means the extent of their deficiencies versus Western nations will be negligible in 10 years' time.*

For much of its history, China has been classified as an emerging economy characterized by high GDP growth rates and a growing middle class, but lacking the robust institutions, governance and economic dynamism of the more established "developed" nations. While much of this remains true today, the pace of advancement means the extent of these deficiencies will be negligible in 10 years' time.

## China's advances cannot be under emphasized.

Besides the much-lauded lifting of over 800 million people out of poverty since 1980, as well as enormous engineering and industrial feats, China has demonstrated that it is willing to invest in the necessary infrastructure and institutions to grow its economic might. Because of this, China is becoming wealthier and more experienced with its new found capitalistic credentials. It is an important – and growing – trade partner in many of the world's most important supply chains, and a critical end-market for consumer products.

As the rest of the world struggles to contain the various coronavirus outbreaks and restart their economies, China appears to be gaining potency. Chinese GDP expanded 4.9% in the third quarter, an astonishing rebound which speaks highly of their societal resilience and deft handling of COVID bureaucracy.

Politically, China has become more assertive. It has expanded its influence of its maritime borders with Vietnam and Taiwan, raised hackles on its land border with India, built closer ties to the World Health Organization and crushed the pro-democracy movement in Hong Kong, all while under heavy US pressure.

On the research and developmental edge, China has also shown that it can be a leading innovator both globally and domestically. China has made noticeable gains in four broad categories of innovation, being: 1) manufacturing; 2) digital platforms; 3) the utilization of apps and "super apps" and 4) R&D in fields such as computing and biotechnology.

Despite its strong economic growth, large consumer markets, adept handling of the GFC and the COVID pandemic, China's forays have been hampered by a variety of beliefs:

- **Style of government**. China's communist and authoritarian system of government is considered incompatible with longer-term capitalist institutions, and vulnerable to unrest as citizens ultimately seek to define the manner in which they are governed.
- **Debt**. Chinese over-indebtedness is considered risky, and the manner in which the debt has accrued, is incompatible with what is required for a flourishing long-term destination for capital. Because of this, Chinese institutions would struggle to maintain trust in the governance and accountability that shareholders seemingly have elsewhere.
- **Fraud**. Fraud involving Chinese companies are over-emphasized in western media. Fraud involving western companies rarely lead newspapers to say the same about their home countries.
- **One dimensionality**. China is considered 'only good at copying' and not creating anything original. Many will recall the same thing said about Japan and Taiwan. Incredibly, 'made in Japan' and 'made in Taiwan' used to be synonymous with poor quality. Today, the most cutting-edge tools in semiconductors and robotics are manufactured in both these countries, and much of the investment, design and R&D is transpiring there Is it so hard to believe that 'made in China' will be a stamp of quality in 20 years' time?

## Pay attention to where China came from

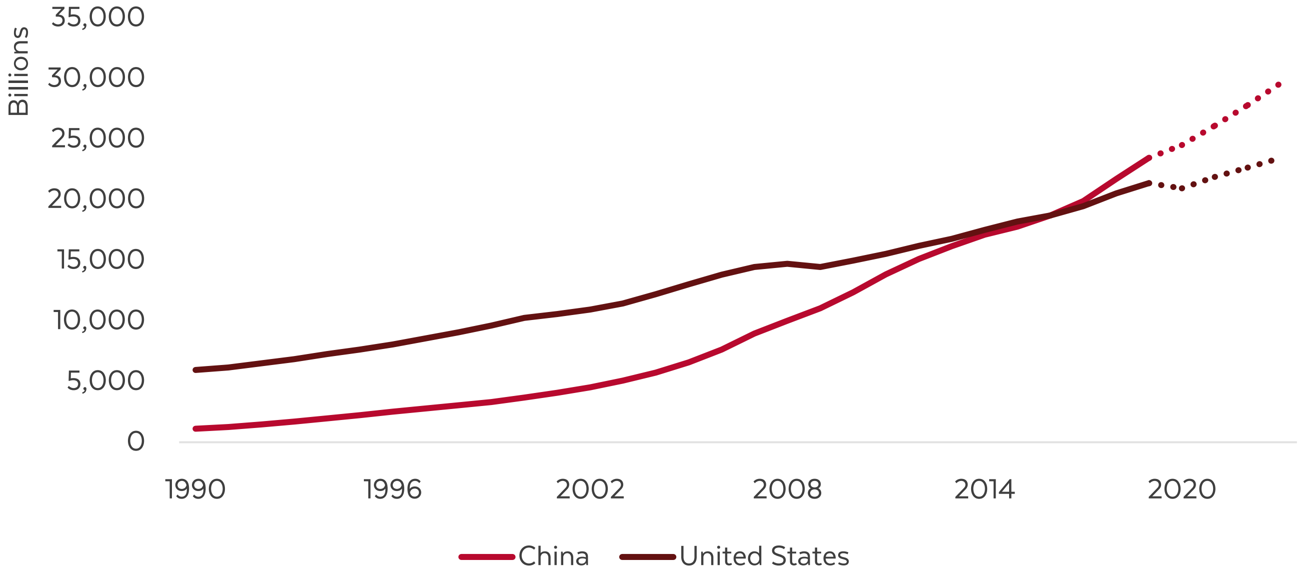
China must be placed within the context of its own history, not our own history in the West. Ethnocentric and narrow views of China's past, it's struggles and its determination to succeed, have enormously hampered a fair and accurate understanding of the Middle Kingdom. Even today, after many years of success, Western observers are quick to continue caging an ancient, powerful and rapidly developing nation as an 'emerging market', a moniker which neatly cages it within a box shared by Russia and Brazil (...and South Africa).

*Even after many years of success, Western observers are quick to continue caging an ancient, powerful and rapidly developing nation as an 'emerging market', a moniker which neatly cages it within a box shared by Russia and Brazil (...and South Africa).*

China has been one of the world's largest economies for over 2,000 years – until well into the 20th century. Perhaps, rather than surprising us, China's return to dominance is a return to the norm. Indeed, the dominance of the Western nations across the whole globe, for nearly 200 years, is something that should surprise us - not the return of China as a regional or global power.

Perhaps the truth is that China has achieved far more than western nations have in recent years. Firstly, it has continued to grow at a breakneck speed, while most economies have contracted. This growth was achieved off of a base which is by no means small, and also through crises (like the GFC and COVID) that floored other nations. Expectations are for the Chinese economy to be larger than the US and Europe combined by 2030.

**Chart 5** GDP at PPP (current $) (source: World Bank)

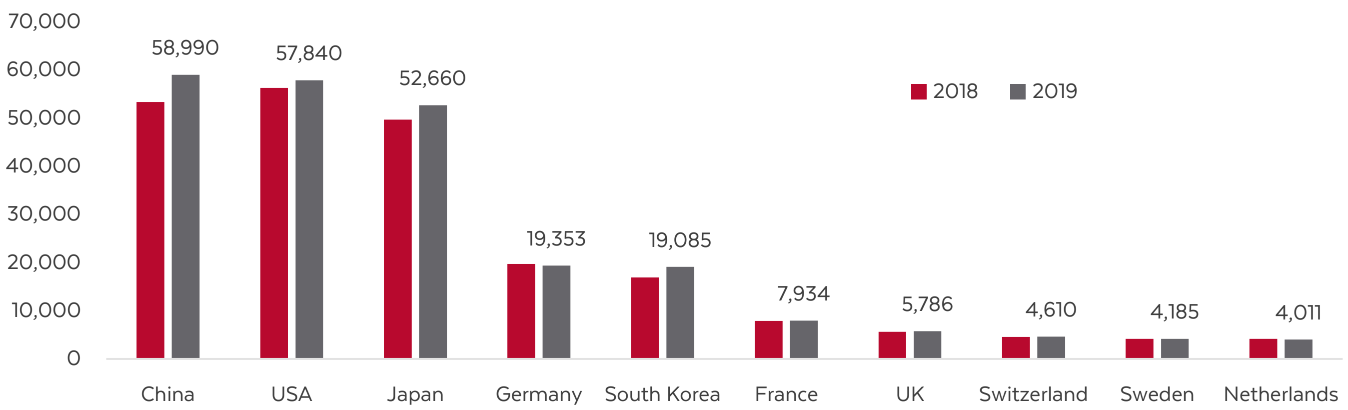



China has a powerful business model. China exports more than it imports, meaning it can run a current account surplus as opposed to most developed nations which run deficits. Its economy is moving away from government spending towards personal consumption, as many economies before it have done in the past. As a country, this places it in a net creditor position, in control of its destiny and not beholden to external pressure. The Chinese bureaucracy is still restrictive, but efficient, as evidence by the leading Chinese businesses that are emerging as global players (Alibaba, Xiaomi, Tencent, Ant Financial).

It has become more innovative. According to the UN, China was the biggest source of applications for international patents in the world last year, pushing the United States out of the top spot it has held since the global system was set up more than 40 years ago. China's figure was a 200-fold increase in just 20 years. China is also poised to overtake the United States in the most-cited 1 percent of published AI papers by 2025, if current trends continue. Though there are some questions about the efficiency and effectiveness of Beijing's push to become a leader in tech, it is undeniable that Washington and Tokyo face mounting competition in innovation.

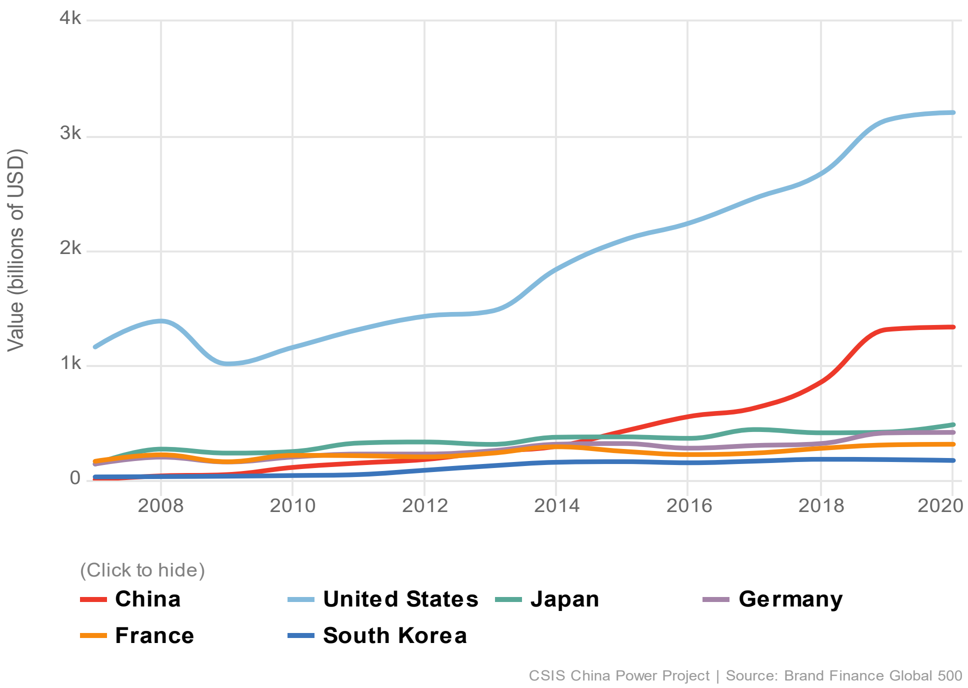
And no, not all of China's innovation or R&D is based on stolen technology even though (like every growing nation in history including the nascent United States in the 1800s when it had little tech of its own) it did benefit from trade secrets and technology being transferred to it. The Industrial Revolution began in Great Britain, and many of the technological innovations of the 19th century were of British origin. How does one suppose they ended up elsewhere in the world? British altruism? Hardly. Like the tech hungry United States of the 19th century, China too has appropriated technology. Note we are not picking on the US per say – but the point is that the process of technological exchange (and theft) is a natural phenomenon in mankind's history.

**Chart 6** International patent applications by origin (source: PCT System)




Where is this innovation leading? Companies can also be compared in terms of brand value. Brand Finance produces an annual ranking of the world's top brands, and in 2020 China's most valuable brands were worth a collective $1.4 trillion. While good enough to earn China the second spot globally, there is work to be done: China's top brands are notably different from those of other economic powerhouses. Large state-owned banks account for four of China's top ten brands, with the Industrial and Commercial Bank of China (ICBC) at the top of that group.

**Chart 7** Gross domestic spending on R&D in real terms (source: Brand Finance)



Even before COVID-19, China was already a digital leader in consumer-facing areas, accounting for 45% of global e-commerce transactions while mobile payments penetration was three times higher than that of the US. By early 2020, according to McKinnsey, ecommerce had reached 24% of total retail value – versus 11% for the US and 9% for Germany – and the pandemic has certainly increased this since then.

China has long offered excellent mass education to its people. More recently, its higher education has been recognized: while Oxford has been named the world's best university for the fifth consecutive year in the 2020 Times Higher Education World University Rankings, the latest rankings show that it is China's universities that are the rising stars of global higher education. Tsinghua University enters the coveted top 20 of the rankings this year, a distinction previously only bestowed on European and US institutions.

China's debt load is large, approaching Japanese levels in the 1960's and Korea in the 1970's. However, it has largely been used for infrastructure. No doubt, like in any country, some has been used for speculation. But anyone who has been to China will acknowledge that the amount of infrastructure that has been built in China over the past 20 years is the most impressive in the shortest period of time that has ever transpired in the history of humanity.

*China is a big country, inhabited by many Chinese – Charles de Gaulle*

Wherever you look, Chinese influence is growing. The largest alcohol brand in the world, the greatest number of CFA's and engineers, the largest manufacturing base, the largest mobile phone market and the largest car market are already all Chinese. The future will see more of these statistics.

**Whatever you may have thought about China, the truth is that their system is working, their economy is growing and their institutions are moving forward.**

As a global investor, rich pickings in the US markets often meant you didn't need to invest in China to make good returns. As Chinese stocks continued to rise, investment managers would be quick to point out the lack of democracy and human rights in China, as well as the challenging legal environment to pursue claims in China, instead of acknowledging that they were perhaps not paying enough attention to China in the first place.

Fast forward to 2020 and the US finds itself on the backfoot. Attacking their own tech companies, threatening to delist Chinese firms from the US bourses, strong-arming Chinese (and Russian) firms out of their markets, and from transacting in US dollars.

For South Africans, the amount of fraud experienced on the local exchange closes the debate on which country has better corporate governance, accounting standards or management caliber. Perhaps it isn't here at home.

The media has played up the unhealthy, biased view that China is a runaway train, a ticking time bomb doomed to failure, at some as yet unknown future point. Instead, we need to embrace that China's rise has important investment implications. It's economy will be larger than the US very soon, and the opportunities available to invest in will be larger as well. Its technology sector is already superior to western incumbents on many levels.

## China's economy will be twice as large as the US when it's per capita income is half the US levels.

Across the investment spectrum, Chinese assets are underrepresented. It's economic foundations are strong, and its equity markets abound with opportunity. It should be as natural a hunting ground for the global investor as any market. To quote Ray Dalio, Chairman of Bridgewater Capital:

> "*In the long run, timeless and universal truths determine why countries succeed or fail. In brief, empires rise when they are productive, financially sound, earn more than they spend, and increase assets faster than their liabilities. This tends to happen when their people are well educated, work hard and behave civilly. Objectively compare China with the US on these measures, as I chronicle in an ongoing study, and the fundamentals clearly favour China.*"

Today, the United States is far and away the single most important asset market globally. America sets the tone for capital markets everywhere else. Global trading starts when New York opens, the Federal Reserve sets global monetary policy, and US institutions, insurers and investment banks deliver the most liquidity to the bond and stock markets.

Yet just as London gave way to New York after economic supremacy passed from Britain to America, the baton for global trading will one day begin in Shanghai. China already has the world's second-largest economy, and in the near future it will be larger than the US and Europe – combined. Its heft in global markets is growing, but on measured Chinese terms. It has opened its mainland markets to foreign investors in shares and bonds, and will one day lift its own capital controls to allow more fluid investing of Chinese capital across the globe. The global balance of power is shifting inexorably. Time, size and momentum are on China's side.

Our objectivity with respect to China has been clouded by sentiment, fear and ethnocentrism. It is going to become a larger force on earth whether we like it or not. As investors, we need to ensure that we capture the best opportunities that China has to offer, while appropriately sizing it in our global portfolios.

Note: Some of the details in this primer were sourced from the excellent insights of Ray Dalio, Chairman of Bridgewater Capital. Where we have agreed with him, or have drawn the same conclusion, we hope to have been additive to the debate syurrounding China's place in the investments landscape.

# Investment Case: Take-Two Interactive


## Summary

- Take-Two Interactive is a video game publisher with excellent management, a wide moat of popular content and execution skills, and significant growth opportunities.
- Its main studio is Rockstar Games, a legendary outfit amongst game enthusiasts. Rockstar Games created Grand Theft Auto, the biggest and most profitable piece of media ever created. Since releasing in 2013, the game has sold over 120 million units as of 2020 amassing $6 billion in revenue since its debut, making it bigger than Star Wars and Gone with the Wind, two of the biggest media properties in history.
- The Company's games are played across a variety of platforms such as Consoles, PCs and mobile devices.
- Consoles generate the lion's share of bookings, which we estimate to be 70% of the total.

Before we delve into the business case for Take-Two, firstly, what's so great about gaming?

*People are realizing that through games we also can have a social experience while we're having an entertainment experience. We can talk to our friends. We can talk to communities. And we can do that in real time all around the world.*

**All the advantages of social media, and more.** Gaming generates inclusivity, collaboration, sharing and engagement through content which is greater than any other cultural participation force we have seen. The advantages for good content owners manifest in incredible user stickiness and multi-year franchise revenue.

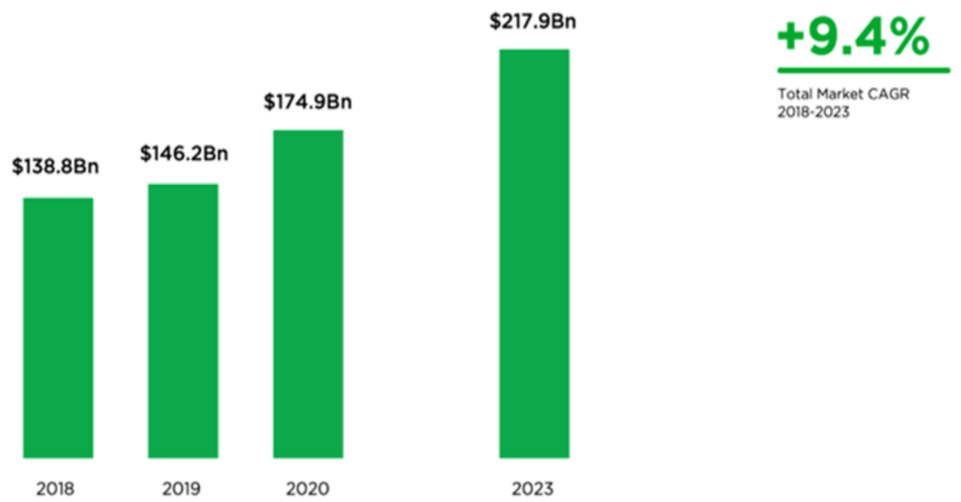
**Subscription revenue.** All the gaming platforms are moving towards subscription models. The Xbox subscription costs $10 per month for its Live GOLD service, and PlayStation is similar. Amazon has unveiled its cloud gaming platform, Luna, which will cost $5 per month. Subscription is a powerful model which can move gaming into the mainstream of consumer discretionary spend across all age groups.

**The advantages of cloud-based services:** Cloud based and streaming video services can help grow the addressable market by making it possible to play games on any screen or connected device. They reduce the upfront hardware cost and free up spend for software and subscriptions. They also allow a seamless experience across screens – you can start on the TV in the living room and then pick up the same game on a mobile or tablet in the bedroom or on the train. In the longer term, having almost unlimited machine processing power in the cloud can drive new gameplay, truer to life experiences, personalization, persistence, and bigger open worlds, which will drive penetration and engagement.

**Vertical integration on the rise.** We expect to see platforms buying publishers and developers to secure attractive content to differentiate their platform, which could result in a strategic premium for video game companies that have strong IP and development capabilities. Successful intellectual property (IP) development takes thousands of developers and billions of dollars in investment. The hit-driven nature of the industry means it takes a long time to build a portfolio of successful games and recognized brands that can drive footfall or choice of one platform over another.

**Growth.** We forecast that the games market will to grow to $217.9 billion by 2023, representing a strong +9.4% CAGR between 2018 and 2023. This is up from the previous forecast of $200.8 billion.

**Chart 8** Global Games Market Forecast to 2023 (source: NewZoo)



# Investment Case

1. It's a successful gaming company. Take-Two has been recognized as having some of the best IP and gaming expertise in the business. Take-Two owns or licenses the intellectual property behind some of the best-selling entertainment series of all time, including Grand Theft Auto or GTA, Red Dead Redemption and NBA 2K.

Their record speaks for itself. GTA specifically has been enormously successful across gaming generations and gaming consoles. GTA and Red Dead Redemption, for which Take-Two owns all the intellectual property, had over 100 million active unique players during its fiscal 2020.

*The scale and success of GTA and Red Dead has created a model of 'engagement begets engagement'.*

*The scale and success of GTA and Red Dead has created a model of 'engagement begets engagement'. Gamers no longer just 'play' the game, they build, extend, and participate in the game with user generated content, competitions and networking. This type of engagement creates an incredibly powerful feedback loop, begetting more engagement.*

The moat is wide and deep, and comprise the people and the intellectual property. Well-regarded brands like Take-Two scales with consumers, which makes switching costs high. Gamers build strong bonds with game franchises: they log hundreds of hours in a game, spend hundreds of dollars on microtransactions and in many cases form meaningful bonds and friendships through the game.

2. It's diversifying and growing its revenue streams. Take-Two is heavily reliant on a lumpy cash flow stream from its hit franchises. Game development times can take between three to five years, and release dates are critical to ensure that games' monetisation covers the expenditure costs as well as the next 5-year development pipeline. This cyclicality made the business unpredictable and difficult to value.

This is changing. Today, the company generates meaningful revenue across console, mobile and PC with more than half that business in the 2020 financial year coming from higher margin digital business including GTA online, and NBA2k and WWE2K on mobile.

Net bookings at Take-Two have grown by double digits over the last 5 years. Going forward, Take-Two has 80 titles planned for release over the next five years, which is significantly more than what has been released in the past 5 years. These new launches will be on console, mobile and PC, diversifying revenue sources from different channels, and will be in gaming models that allow for increasing monetization.

3. Its capital-light and infinitely scalable. Video game production requires an upfront capital commitment (mostly programmer salaries) but afterwards has all the benefits of a software business ('build it once, sell it a thousand times'). Games can be rolled out globally due to the console and PC distribution model. We estimate Take-Two's Return on Invested capital (ROIC) to be north of 25%.

4. The Balance Sheet is rock-solid. At the end of its last quarter the Company reported net cash at 8% of market capitalisation.

5. Management are aligned. Management owns a substantial amount of stock and the company's developers receive stock-based compensation, creating an aligned, shareholder-friendly incentive structure across the organization. Strauss Zelnick, the CEO and Chairman, owns a significant amount of the stock.

## Excellent fundamentals, as well as a margin opportunity

Margins at Take-Two are lower than its US listed peers (Activision Blizzard and Electronic Arts). Margins can increase through scale and channel shift.

Take-Two's biggest issue has been scale. It needs to generate more revenue from its current IP to successfully leverage its cost base like its peers have been able to. This does not necessarily mean more hit games, but better monetization. Recall that only 4% of Candy Crush players, for example, spend on the game. And 10% of this 4% (or 0.4% of users) generate 50% of revenue.

For Take-Two, growth in monetization of existing content will come via GTA Online and Red Dead Online, which provide recurring revenue at zero cost to Take-Two.

Channel shift is a rising tide that is lifting all the gaming companies. According to data from NPD (a games analyst firm), US physical console software sales were $6.5bn in 2019 out of a total market of $25bn at the time (i.e., physical console disk constituted 25% of the US games market). The physical segment is being replaced with digital sales, and the margin impact is meaningful.

With digital sales, there is a higher distribution cost because of the pay-away to Microsoft or Sony game stores (as much as 30% of revenue versus 20% for distributing through physical stores). However, this is more than compensated for by savings on the production of the physical game (box, disc etc.) so net revenue is higher.

There is an additional benefit from digital sales. As this physical market declines and is replaced by consumers purchasing online content, the follow-on purchases of online content increase for that user, since he is more inclined to purchase further content post the initial game purchase (resulting in increasing revenue per gamer).

Further tailwinds for margins that should benefit all video game publishers include the possibility of decreased platform fees and an increasing percentage of revenue from microtransactions, which carry high 70% or 80% margins.

## Valuation

Take-Two isn't a cheap stock by traditional valuation measures. However, we believe that quality, when it is enduring, is worth paying up for. We see a path to $9 in earnings per share over the next 5 years, from a combination of revenue growth and higher margins. Using a premium multiple, we can arrive at a fair value nearly 30% higher than where the share trades today.

# 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.

Your funds continue to perform well. Flagship funds own a selection of businesses that we believe to be of unusually high quality, and will prove to be financially resilient should the prospects for the global economy become less rosy. 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.

As co-investors in all Flagship funds alongside our clients, we will not permit good performance to lead to complacency. We thank you for your support and we hope that you and your families are healthy in this strange time.

*Warm Regards,*

Kyle Wales and Pieter Hundersmarck

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