FLAGSHIP
ASSET MANAGEMENT

Navigate Safely Forward

Quarterly Telescope
Q1 / 2021

Flagship Asset Management • Constantia, Cape Town • +27 (0)21 794 3140 • info@flagshipsa.com

01

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.

02

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 11.7% and 13.7% per annum since inception.

03

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.

Performance to March 31, 2021

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

Global Flexible	AUM	YTD	1 Yr	3 Yr	5 Yr	10 Yr	S.I.
Flagship International Flexible Fund (USD)	**$33.9m**	**0.7%**	**57.6%**	**9.6%**	**8.6%**	**8.8%**	**3.0%**
Composite Benchmark		0.5%	23.5%	6.6%	6.6%	9.6%	3.6%
Outperformance vs. Benchmark		0.2%	34.1%	3.1%	2.0%	-0.8%	-0.7%
Flagship IP Worldwide Flexible Fund (ZAR)	**R475m**	**1.4%**	**27.2%**	**14.3%**	**6.4%**	**11.1%**	**11.7%**
Composite Benchmark		4.5%	19.4%	11.4%	7.3%	11.0%	9.5%
Outperformance vs. Benchmark		-3.1%	7.7%	3.0%	-1.0%	0.1%	2.3%

Global Equity	AUM	YTD	1 Yr	3 Yr	5 Yr	10 Yr	S.I.
Flagship Global Icon Fund (USD)	**$11.5m**	**2.8%**	**%**	**%**	**%**	**%**	**29.9%**
Benchmark (MSCI ACWI in USD)		1.9%	%	%	%	%	20.0%
Outperformance vs. Benchmark		0.9%	%	%	%	%	9.9%
Flagship Global Icon Feeder Fund (ZAR)	**R16.5m**	**8.0%**	**%**	**%**	**%**	**%**	**11.6%**
Benchmark (MSCI ACWI in ZAR)		4.7%	%	%	%	%	1.5%
Outperformance vs. Benchmark		3.3%	%	%	%	%	10.1%

Global Fund of Funds	AUM	YTD	1 Yr	3 Yr	5 Yr	10 Yr	S.I.
Flagship IP Worldwide Flexible FoF (ZAR)	**R303m**	**0.5%**	**12.6%**	**13.0%**	**7.6%**	**13.3%**	**13.7%**
Benchmark (SA CPI + 5%)		2.5%	8.1%	9.1%	9.7%	10.4%	10.4%
Outperformance vs. Benchmark		-2.0%	4.5%	3.8%	-2.1%	2.9%	3.3%

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.

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 first quarter of 2021 as well as how the funds are currently positioned, whereafter he examines the benefits of a focused investing approach. **Kyle Wales** discusses the increasing number of asset bubbles we are seeing and then takes us through our primer on Russia. He concludes with the investment case for **TCS Holding**, a high-quality Russian bank that the Flagship strategies have 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

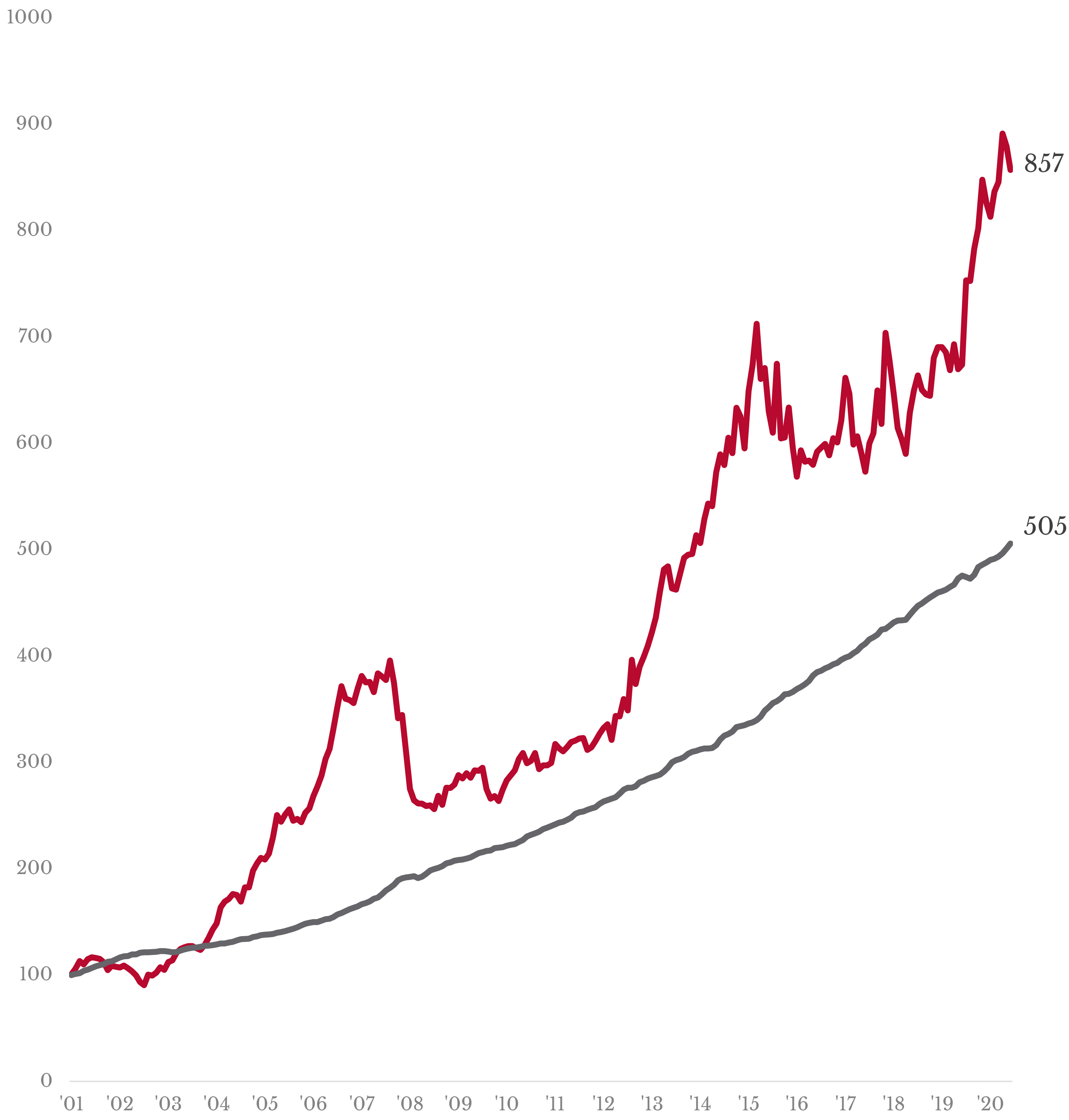
Kyle has been investing internationally for over 12 years. Prior to Flagship, he worked at Coronation Fund Managers for 9 years in the Global and Global Emerging Markets teams and also co-managed a global equities boutique at Old Mutual Investment Group. Kyle is a South African citizen, a qualified chartered accountant and CFA charter holder.

Contents (click to go to section)

The Power of Long-term Compounding

The Flagship IP Worldwide Flexible Fund (net of all fees) vs. SA CPI +3%

from 1 October 2001 to 31 March 2021 (19 years and 6 months)



Q1 2021: Rebuilding after the Storm

Rule number one: most things will prove to be cyclical.

Rule number two: some of the greatest opportunities for gain and loss come when other people forget rule number one.

- Howard Marks

The light at the end of the pandemic tunnel is starting to get brighter. The first quarter of 2021 has ushered in renewed hope of a broad-based recovery across most developed markets. Economies are tentatively reopening around the world, and although there is uncertainty as to the potential for another wave of infection, the worst of the pandemic is firmly behind us.

As we said in our Q4 2020 Telescope, we continue to expect most nations to exit recession in Q2 and foresee a renewal of economic activity in the developed world and a stabilization in hard-hit developing countries across Asia and Africa.

Stock markets have – unsurprisingly - reacted favorably to the positive macroeconomic data, and all global indices are up year-to-date. The MSCI All Country World index, a barometer of global stock markets, has risen +5.2% in USD (+5.6% in ZAR) year-to-date, and over +61.3% in USD (+31.2% in ZAR) over the past twelve months.

The first quarter has seen a shift away from sectors that performed well in 2020. The sectors that benefited most from the pandemic-inspired shift to working from home have fallen hard since late January, as investors favored stocks that would benefit from the improving macroeconomic trends. Rising interest rates have also pushed investors into investments offering more certainty. High priced technology stocks and blank-check companies (or "SPACS") – an absurdity that will need to be addressed in a later Telescope - have tumbled from their highs in January.

US politics have settled since the dramatic events of January, and signs are that newly appointed president Joe Biden is committed to spending his way out of the coronavirus pandemic. Biden's "America Rescue Plan" passed into law on the 11th of March enabled by the new Democratic majority in the Senate. It includes almost $1 trillion in direct aid to Americans, $440 million to businesses and $1.4 trillion in efforts to combat the Coronavirus.

Stimulus, and the growing impact of passive funds and retail investors are playing a growing role in asset markets.

It remains a contentious piece of legislation, however. In one camp are the naysayers who believe it will open the doors to 1970's style stagflation. In the other camp are the supporters of Modern Monetary Theory "MMT" who believe that the ability of governments to run deficits and monetize them through quantitative easing is almost infinite.

Stimulus, and the growing impact of passive funds and retail investors are playing a growing role in asset markets. In US equities, passive funds are now roughly as large as the actively managed investment universe after a decade of rampant growth, while retail investors now account for nearly as much as all mutual and hedge fund trading combined.

Retail investors, often with scant regard for fundamentals and acting on the basis of advice given on Reddit blogs, are increasingly coming to the fore. Though often dismissed by professional investors as "dumb money", the professionals are beginning to learn that if you cross them, you do so at your peril. A group of hedge funds lost billions of dollars of their investors' capital in Gamestop shares due to a short squeeze initiated by retail investors "going long", which drove the share price to peak at over $500 versus its value of $17.25 at the start of the year.

While we hail the retail trading boom as a way for more people to benefit from the world's stock markets, we continue to view the trading activities in Q1 – specifically the Gamestop saga - with amazement. The $1,400 stimulus cheques sent out to millions of Americans in the past month is likely to fuel another spasm of retail trading before activity settles down to a still-elevated level. We believe passive and amateur traders – both of whom are mostly valuation agnostic - will remain a powerful feature in US equities for some time, fueling volatility and opportunities for long-term investors.

Equity valuations remain elevated, with the 12-month forward price-earnings-ratio (or P/E ratio) of the S&P 500 at 23x at the time of writing versus its 30-year average of 17.3x. We have noted that as earnings expectations have increased for 2021, the P/E ratio has declined as share prices have moved sideways in recent months.

Inflation expectations have ticked up. The advent of inflation – and the monetary tightening that follows it – has traditionally been the destroyer of bull markets, so it's logical that market participants would worry about it. Oil (c.+25% year-to-date) and copper (+16%) are driving inflation, as well as benefitting from it through investor safe haven status.

US inflation expectations have jumped sharply in 2021

Expected average annual inflation rate over the coming five years, as derived from inflation-proofed Treasuries (%)

Source: St Louis Fed
© FT

We will delve into our thoughts on inflation – and how we deal with it – under the asset allocation section of this Telescope.

Besides the rise of amateur investors and SPACS, another area where we are treading unchartered waters is in the realm of international relations and geopolitics. While relations between China and the West have been poor for some time, they appear to be spiraling ever lower. Rhetoric on human rights issues is increasing on both sides, culminating in the US, Canada, UK and Europe imposing sanctions on officials in China's Xinjiang region for the apparent treatment of Uighur Muslims in the province. China responded quickly with reciprocal sanctions.

China is becoming increasingly bold. Its economy is already the largest in the world on a purchasing power parity "PPP" basis, and it will overtake the US economy in nominal terms in the not-too-distant future. We note that China has taken unilateral action in Hong Kong by curbing personal freedoms in violation of the Sino-British joint declaration of 1997 and its sights are now firmly on Taiwan. Any actions it takes there, however, may spiral into a broader conflict that is likely to result in no side emerging better off. Saner heads indeed...

Risk management is critical in the current heady environment

The Scottish philosopher and historian Thomas Carlyle is known for having described economics as a dismal science. Sadly, he is less famous for wisely suggesting that "for every hundred men who can handle adversity, there is but one who can handle prosperity", or for urging us to the task of present duty as our principal endeavor. "Our main business," he wrote, "is not to see what lies dimly at a distance, but to do what lies clearly at hand."

"Our main business," he wrote, "is not to see what lies dimly at a distance, but to do what lies clearly at hand."

Despite pressures to react differently, we continue to do just that. As we have mentioned in previous Telescopes, there is no doubt in our minds that the world's monetary and financial system is suffering from enormous and profound dislocations. Rather than rail at the folly thereof, we must recognize that this a feature of the current environment that we invest in. In this environment, and all others, it is vital that we continue to execute the strategy that we follow without heed for the changing tastes for our stocks in the short term.

In a world seemingly awash with money and easy returns, it's easy to lose sight of what long-term investing is all about. At its core, being an investor is all about one very profound decision we've all made, which is choosing to make sacrifices now in order to benefit in the future. Our job is to take this sacrifice and maximise our clients' future returns with the *lowest possible risk.*

Thankfully, our equity and flexible strategies have the mandates and tools to achieve this risk/reward balance.

Strategy Performance

Our **Global Equity Strategy** consists of two identical funds, differing only in their domicile or 'entry' point for our investors.

- The Flagship Global Icon Fund [USD] returned 2.8% for the quarter, bringing its return since inception on July 30, 2020 to 29.9% versus the MSCI ACWI return of 20.0%.
- The Flagship Global Icon Feeder Fund [ZAR] returned 8.0% for the quarter, bringing its return since inception on July 30, 2020 to 11.6% versus the MSCI ACWI return of 1.5%.

Our **Global Flexible Strategy** consists of two identical funds, differing only in their domicile or 'entry' point for our investors.

- The Flagship International Flexible Fund [USD] returned 0.7% for the quarter, bringing its total 1-year return to 57.6%, versus its benchmark of 23.5%.
- The Flagship IP Worldwide Flexible Fund [ZAR] returned 1.4% for the quarter, bringing its total 1-year return to 27.2%, versus its benchmark of 19.4%.

Our **Global Fund of Funds Strategy** consists of one locally domiciled fund.

- The Flagship IP Worldwide Flexible Fund of Funds [ZAR] returned 0.5% for the quarter, bringing its total 1-year return to 12.6%, versus its benchmark of 8.1%.

The largest contributors to performance in both our Global Equity as well as our Flexible Strategies were **Tinkoff Credit Systems (+76.7%)**, a Russian Bank, which has been profiled in this edition of the Telescope, **Cartrack Holdings (+41.4%)** and **Capri Holdings (+21.4%)**.

Cartrack is the only South African domiciled company we hold in your fund. It has recently applied to move its primary listing to the Nasdaq, where it will trade as Karooooo. Many of you may be familiar with Cartrack because its largest segment is its Telematics business in South Africa. While it has managed to grow this business despite the weak local economy, it is the potential for growth in both Europe and Asia that we are excited about.

Capri Holdings is the holding company for the Michael Kors, Versace and Jimmy Choo brands. Capri has been a holding in the funds for a long time, and we have shared our thoughts on the prospects of the business in Value Investor Insight, a US publication, found here. The growth prospects for the three brands, and especially Michael Kors, remain compelling, and the valuation of 13.7x forward 12 months earnings is attractive.

The largest detractors were gaming company **Ubisoft (-20.9%)**, Brazilian payments company **Pag Seguro (-19.6%)**, and **Zalando (-11.4%)**. While some of the gaming companies we owned performed poorly in the quarter, gaming companies - and specifically Netease - have performed excellently over longer periods. Zalando also performed poorly this quarter, but has been one of the top contributors over longer periods. We have added to all three positions during the quarter.

The stand-out performer in our Global Fund of Funds Strategy was Guinness Global Innovators, which rose +5.3% in ZAR. The worst performer was Artisan Global Discovery which fell -2.9% in ZAR. We redeemed from Mondrian Global Equity in the quarter and added to the existing allocations, leaving total equity exposure unchanged.

Equity selection

Flagship Global 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 two shares to the portfolio (Duck Creek Technology and PayPal) and sold out of three shares (Booking.com, Ferguson and Xero).

IN
Duck Creek
PayPal

OUT
Booking.com
Ferguson
Xero

Duck Creek Technology sells cloud-based software to the short-term insurance industry to assist them with policy administration, billings and claims. Its product suite is powerful and will allow considerable growth opportunities in its home market of the US as well as internationally. We believe its total addressable market is north of $20bn, versus expected revenue in 2021 of $250m.

PayPal, our second new addition, is the third company in which we have invested in the payments space. The other two are Global Payments, which is a legacy merchant acquirer in the US, and Pag Seguro, which is a disruptive innovator in Brazil. We like PayPal not only because it serves the role as a merchant acquirer in the online space but because 277 million people globally have PayPal digital wallets which enables them to provide an end-to-end solution, posing a challenge to networks like Visa and Mastercard.

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

Asset allocation

"'Devaluing a currency,' one senior Federal Reserve official once told me, 'is like peeing in bed. It feels good at first, but pretty soon it becomes a real mess.'"

- Francesco Guerrera, The Wall Street Journal, 2013.

It's easy to see how the recent surge in energy and agricultural prices – largely a correction of the pandemic supply and demand imbalances – will stoke inflation this year.

Inflation expectations are rising, and this has implications for asset allocation as well as currency valuations.

It's easy to see how the recent surge in energy and agricultural prices – largely a correction of the pandemic supply and demand imbalances – will stoke inflation this year. The knock-on effects of higher energy costs will impact global trade, for example, through higher shipping costs and tighter supply chains. These factors will lead to an uptick in the price of manufactured products, feed into global consumer price indices and will result in headline inflation increasing in the short term.

However, for long-term, meaningful increases in price levels that lead to prolonged increases in the consumer price basket there would need to be more than just cyclical moves in food and energy prices. Both of these are temporary in nature and will normalize. Of far more consequence is understanding these moves in light of the continued deflationary impact of global production processes (due to technology), disruption and the low-cost geographies that will allow these to proliferate into lower prices.

Inflation, particularly in emerging markets, typically leads to weakening local currencies, something we take into account for our emerging markets position sizing.

Although we don't expect inflation to become entrenched in the global economy any time soon, we have taken a position in commodities (gold specifically, which traditionally acts as a hedge against inflation expectations), as well as copper.

For copper specifically, the 'green economy' is an enormous driver of the use case for copper. Electric vehicles need around four times more wiring than those with combustion engines, while solar panels and wind farms need up to five times that needed for fossil fuel power generation, according to industry estimates.

Growing demand for renewable infrastructure projects and electric vehicles will help drive global consumption of refined copper up from 23.4m tonnes in 2020 to 33.3m tonnes in 2030. Refined copper production is currently around 23.8m tonnes.

Since this new demand was not catered for by existing supply, unless new mines are discovered and developed quickly, prices will need to rise to incentivize production. While the earth's crust has no shortage of copper, high-grade projects in mining friendly jurisdictions are becoming harder to find.

Even when discoveries are made, they are often in locations lacking infrastructure, such as Russia's far east, and are being developed by companies with less mining experience. The world has a challenging task to meet this new demand.

While commodities only account for 10% of the Global Flexible Strategy, the impact they can have on fund performance can be meaningful. Outside of that 10%, high-quality businesses with convincing growth prospects will continue to dominate the Flagship asset allocation.

Why do we follow such a concentrated investing approach?

Elton and Gruber found that moving from a 20 to a 20,000-stock portfolio would only cut risk from 21.7% to 19.2% and 90% of the risk reduction resulting from this strategy came from the first 15 shares.

There is a well-regarded investing book called *The Zulu Principle: Making Extraordinary Profits from Ordinary Shares* by Jim Slater. The name itself came to Slater after his wife read a four-page article on the Zulu tribe in Readers Digest and he concluded that, from that short article alone, his wife knew much more than he did about the Zulus. Taking it a step further, he reckoned that if she then went to the library and read more about the Zulus, she'd probably know more than anyone in town. If she lived in South Africa to study the Zulus for six months, she'd know more than anyone else in Britain.

The lesson is that, by focusing on a niche, one can easily become an expert on the subject at hand rather than trying to master everything. This is also consistent with the age-old advice of investing in your circle of competence (think Peter Lynch's story of Supercuts).

Andrew Carnegie famously advised his friends that "the way to become rich is to put all your eggs in one basket and then watch that basket". By focusing on fewer stocks, you arguably become more of an expert in those stocks.

But what about diversification? A famous 1977 study by EJ Elton and MJ Gruber*, published in The Journal of Business, found that the average standard deviation of a share was just shy of 50%, meaning a share's value would go up or down by more than half.

However, if you bought another share, the combined standard deviation fell to 37% - meaning the portfolio became less volatile. And increasing the portfolio to ten shares cut this further to 23%. This is positive of course, and well understood.

However, there is a point at which you can over-diversify. Our readers may be surprised to discover that most studies show that having anything more than 15-20 shares in a portfolio has little impact on the amount of risk (as measured by the volatility of your returns, at least) you're taking.

For example, Elton and Gruber found that moving from a 20 to a 20,000-stock portfolio would only cut risk from 21.7% to 19.2% and 90% of the risk reduction resulting from this strategy came from the first 15 shares.

You then have to take into account the fact that, as well as providing little risk benefit, buying more shares increases your trading costs as well as depleting the attention you can ascribe to the stocks you own.

No portfolio manager, however bright or motivated, can effectively focus his or her attention on 40 stocks.

Now let us turn to the second part of this discussion. The idea of risk requires defining, or else what are we trying to protect ourselves from?

Sellers of investment advice will say that the higher the standard deviation of past returns, or the higher the correlation with a stock market index, the higher the risk. We reject this idea. Our concern is not about the volatility or correlation of prices. Instead, we want to avoid a permanent loss of capital. This shifts the focus away from share prices and moves the focus to *the actual business.*

Mainstream advice will also seek to reduce the volatility of expected returns with diversification, and advocate holding numerous securities whose returns are seemingly uncorrelated between themselves.

We disagree completely. Adding new assets not only adds new and different risks but it also reduces one's level of understanding of the assets owned. We are sceptical of any investment approach that proposes we can understand the whole by ignoring what lies beneath the portfolio, as well as what is behind the share price (a company).

What type of portfolio does our approach lead to?

- We spend a lot of time understanding the business models we invest in and making sure we are invested in the right businesses rather than the right statistically irrelevant 'mix' of businesses.
- We stick to a number of shares that we can manage (between 20-25)
- Our universe is high quality companies, so you can imagine that we say no a lot.
- We rarely sell shares or trim them into strength, as we believe they will continue to grow stronger over the next five to ten years.

Extraordinary popular delusions ...

It has been a number of years since I read this book (or most of it, it certainly doesn't make for light reading) but I find it has increasing relevance to the world today. The book (*Extraordinary Popular Delusions and the Madness of Crowds*) written by Charles Mackay and originally published in 1841 details a number of "asset bubbles" and their ramifications, which often had the effect of decimating the savings of those who invested in them. In its first three chapters it details the Mississippi Scheme, the South Sea Bubble and Tulipomania. All of these bubbles took place in the 1700's.

Much has changed since then. Motors propel ships across the sea. Wagons have been replaced by motor cars. People can now fly both above the earth and into space. Despite advancements in technology and increasing human development, it seems that not much has changed in the way that group psychology can take over and cause crowds to behave in a manner that is contrary to the rational way in which we ordinarily conduct ourselves, especially with regards to investing.

The chart below illustrates this tendency well. Investor emotions do tend to fluctuate between depression (at the bottom of the cycle) and euphoria (at the top of the cycle) and despite the fact that we have seen the same movie play out over and over again, there always seems to be appetite for another re-run.

While I believe within share markets it is possible to find pockets of value – and here at Flagship this is central to what we do - there are some shares where stock specific fundamentals seem to matter less and less and their valuations are simply a function of investor sentiment.

Tesla will have to triple its revenues and double its operating margins to trade on thirty times earnings.

Tesla is the first example of a share that appears to have been caught up in this wave of investor goodwill. It currently has a market cap that exceeds that of Toyota, Volkswagen, Daimler and General Motors combined. Tesla's revenues would have to triple from current levels and its EBITDA margins would have to double to justify its current valuation. Even then it would trade on a steamy multiple of around 30 times earnings. Not impossible, for sure, but this is an awful lot of credit to give them upfront.

Another company would be GameStop. GameStop predominantly sells computer games through a network of physical stores. One of the original value propositions it had for its customers is the fact that you could return a game you had purchased (in physical format) for a store credit which you could partially use to fund your next physical game purchase. Clearly this is a business model that is ripe for disruption now that you can purchase games on digital platforms and many of these games are sold on a "freemium" model, allowing constant upgrading and customisation that physical retail never could.

The reason why a cohort of retail investors is trying to drive the price of GameStop shares up is to wage war on a group of hedge fund managers who they collectively blame for profiting from the world's ills. These hedge fund managers had been short GameStop which meant they were positioned to make money when the GameStop share price went down (and conversely, lose money when it went up). Driving GameStop's share price up was a very clever way for these retail investors to inflict harm on the "hedgies". However, I cannot see how the share price of a company can be propped up indefinitely even when its business ceases to be viable. At this stage, surely, the business would need to make endless capital calls on its investors to simply stay afloat, and the million-dollar question is: will this cohort still be around then? I can think of many better ways to spend money.

Share markets are not, however, the only asset classes where we are seeing certain parts of the markets exhibiting "toppish" behaviour. The most egregious examples have been in alternative asset markets.

Bitcoin aside, certain assets in the broader crypto-currency world look frothy.

Bitcoin has always been a contentious asset but there is an increasingly long list of accomplished investors making strong arguments for its use. This list includes Bill Miller, Paul Tudor Jones and others. Most of the arguments in favour of Bitcoin are premised on money losing its role as a "store of value". With short-term interest rates at or below zero, longer-term interest rates yielding negative real returns and endless rounds of quantitative easing, they certainly have a point. I therefore understand the potential role they are hoping for Bitcoin to play (even at its current price). Where I differ with them is that I believe that there are more established asset classes (like Gold) that can perform this role better.

There are, however, other places in the broader crypto-currency world where investor behaviour has become divorced from reality. The market cap of one "alt-coin" (alternative digital currency to Bitcoin) called DogeCoin has risen to $8bn despite its co-founder saying on Reddit that he created it as a "joke".

Bitcoin's usage has begun impacting the share price behaviour of a company called MicroStrategy; whose CEO became one of the first proponents of keeping Bitcoin in a company's treasury as an alternative to cash. While his foresight with respect to the pop in the Bitcoin price is commendable, in my view he is the definition of a "one trick-pony". Unlike many tech/online businesses that have grown their businesses (and consequently the share price of their businesses) at phenomenal rates, MicroStrategy's share price had flatlined for two decades before it decided to buy Bitcoin. Now it has essentially become a closed-ended hedge fund that only invests in Bitcoin, emphasized by the fact that the word "Bitcoin" appears 365 times in its form 10-K (the US equivalent of its Annual report).

The market seems to like this strategy. It trades on a 30% premium to its net asset value versus Warren Buffet's Berkshire Hathaway (which has a multi-decade track-record of creating value for shareholders through multiple avenues) which trades on a premium to its net asset value of only 5%. While part of this premium could at one time have been attributed to the fact that the mandates of many institutional investors prevent them from investing in Bitcoin directly and "MicroStrategy" offered a way to indirectly invest in Bitcoin, surely this reason has fallen away since the first Bitcoin ETF in North America began trading in February 2021? The premium, however, persists.

What does the word 'ownership' mean?

The latest manifestation of this euphoria appears to be non-fungible tokens or "NFTs". Two occurrences stand out in my mind. Jack Dorsey, founder of Twitter, sold his first tweet as an NFT for $2.5 million on March 9th. A mere 7 days later, an artwork by digital artist "Beeple", sold in the form of an NFT, fetched a staggering $69 million at Christies.

An NFT is a secure digital file which validates ownership within the Ethereum blockchain system. The *exact. same. file* remains in the public domain because you can copy a digital file as many times as you want. You are not purchasing rights to a future income stream in the same way that you would if you bought an artist's back-catalogue. There is also no exclusive way to physically enjoy it in the same way that the purchaser of an Old Master would be able to hang it on his wall. Ownership is reduced to being recognized as the owner of something. As it turns out, the purchaser of the Beeple artwork was MetaKovan, the owner of the biggest NFT fund, although that latent conflict of interest shouldn't inhibit the inexorable rise of NFTs going forward. All it takes is a little bit of hope (excuse me: faith).

I wonder what Charles MacKay would say if he released an upgraded version of his book today.... Unfortunately, while the original is not available for purchase through a non-fungible token, a three-volume first edition which has been described as "exceedingly rare" by some, is available for purchase through www.abebooks.com for USD 8,522.70. Seems like a bargain to me.

Flagship Primers: Russia

"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

Summary

Russia is the largest nation on earth, covering eleven percent of the world's landmass, and its population of 144 million people makes it the world's ninth most populous country.

While estimates vary widely, Russia is likely richer in natural resources than any other country in the world. In particular, the abundance of oil and natural gas has made Russia virtually self-sufficient in energy and a large-scale exporter of fuels, while the forests of Siberia contain an estimated one-fifth of the world's timber.

Because of this, Russia has in some respects fallen prey to "Dutch disease[1]". Today, Russia remains heavily reliant on resources and its fortunes are inextricably linked to the commodity cycle; and to hydrocarbons in particular.

Russia has a large and well-educated workforce, and ranks very highly in terms of its human development index "HDI". It also performs positively on macro indicators such as inflation and unemployment, while its public finances are amongst the best run amongst all developed and emerging nations.

Russia's political system has won it few friends abroad, and this has led to investors demanding a higher risk premium for investments they make in the country.

A scarcity of capital and opportunities provides a landscape where a few selected companies can generate high returns for patient investors if they can withstand higher volatility.

[1] Dutch disease is the apparent causal relationship between the increase in the economic development of a specific sector and a decline in other sectors

In our series of "Flagship Primers", we provide insight into some of the emerging markets where the Flagship Strategies are invested.

While the developed markets (and, increasingly, China) are the natural hunting ground for Flagship's global suite of funds, emerging markets can also provide opportunities where the risk and reward balance is favorable. As many of our readers may know, Pieter and I have spent many years investing in emerging markets, and we like to believe our experience (often learned the hard way!) leads to better outcomes for our clients.

As at Q1 2021, investments in emerging markets (ex-China) constitute just over a quarter of the equity exposure in our Equity Strategies. Russia constitutes a small percentage of this exposure, at 6.8% of the Flagship Global Icon Fund, and 5.7% of the Global Flexible Strategy.

Russia's political system has also won it few friends abroad, and this has led to investors demanding a higher risk premium for investments they make in the country.

Our Russian exposure is taken entirely through our investment in Tinkoff Credit Systems "TCS", a Russian Bank and Fintech company, profiled later in this Telescope.

My first visit to Moscow, and to Russia, was in 2012

Moscow is a remarkable city. The rich and varied history of Russia is evident from the structures that sit within the city's "Golden Ring", chief among them being the Kremlin which has, over the years, served as the Moscow residence of the Tsars, the arena for meetings of the Communist Party, and the final resting place of Lenin (whose mummified body remains on display for those who wish to see it). The Kremlin is the largest active fortress in the world, spanning more than 27 hectares (67 acres) in the heart of Moscow.

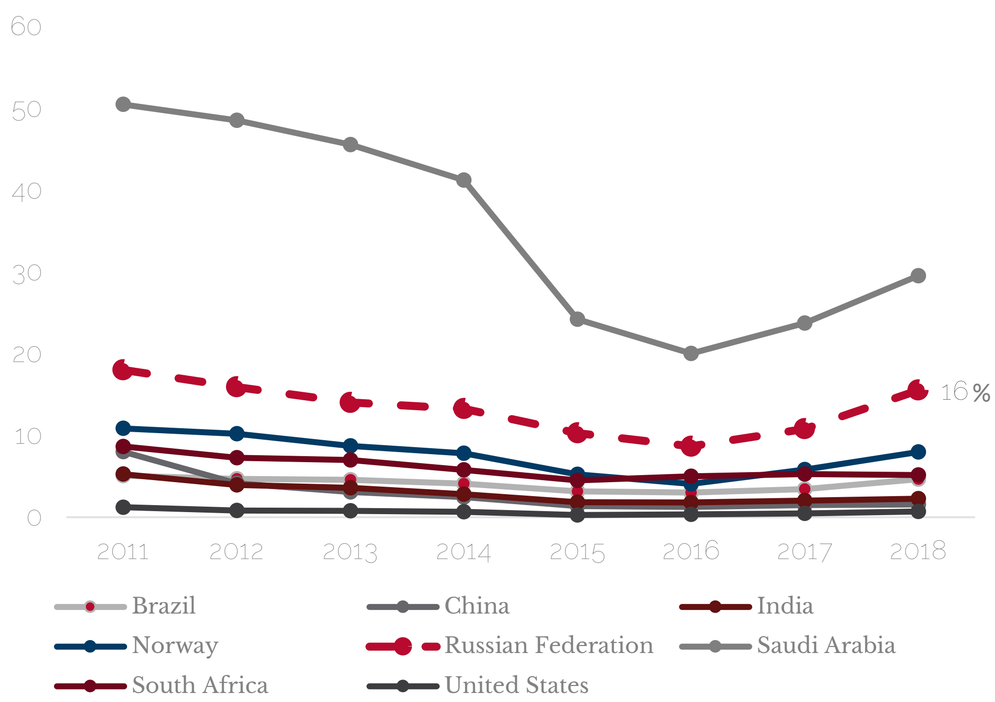
Outside its walls you'll find the Red Square (which has nothing to do with communism, but derives from the word "krasnyi", which once meant "beautiful") and the remarkable St Basil's cathedral on one side. You'll also find the 1812 museum which commemorates the turning point of the French invasion of Russia of that year, where the demoralized French were forced to retreat because their supply lines had been exhausted.

Russia, as a country, is no less remarkable. Russia spans over seventeen million square kilometers, covering one eighth of the world's area and spans eleven time zones. It is the largest country in the world by a large margin, almost twice as large as the second largest country in the world, Canada. It is also incredibly rich in natural resources. It ranks eighth in the world in terms of oil reserves, but also commands large deposits of diamonds (Russian diamond company Alrosa is the second largest diamond company in the world after De Beers), gold, timber, palladium (it has the second largest platinum group metal reserves after South Africa), iron ore and coal.

Russia's fortunes remain tied to the commodities cycle

Resources are a large part of its economy, making up around sixteen percent of the country's GDP directly, and more if one counts the impact on other sectors of the economy. This is second only to Saudi Arabia amongst the larger resource dependent countries. As a basis for comparison, resources make up only five percent of the Brazilian and the South African economies which are also considered to be resource-reliant. Russia's dependence on resources is also evident from the fact that they account for 70% of its exports and as much as 50% of its tax receipts.

Natural resource rent as a % of GDP – Russia at 16%, second only to Saudi Arabia



Similar to many countries that are resource-rich, this has proven to be both a blessing and a curse. Russia has been far less successful at tilting its economy towards manufacturing (like China) or services (which constitutes the bulk of the GDP within OECD countries). We have seen encouraging (if slow) signs of change, however, particularly in the local tech sector, which continues to be vibrant and competitive.

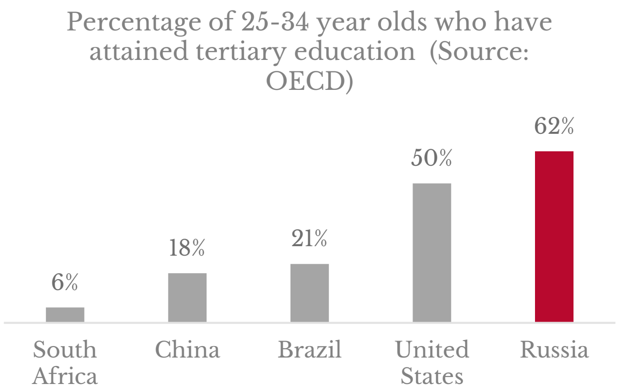
Hydrocarbons in particular remains a large constituent of foreign currency earnings, as well as a large employer. While the oil price has subsequently recovered and both Brent and WTI are now sitting at around $60 each, the market is still fixated by the long-term impact on oil demand caused by, amongst other things, the rise of electric vehicles (EVs).

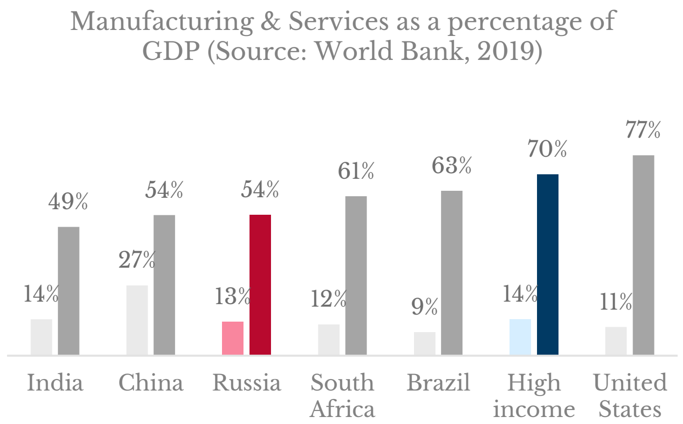
While the rise of EVs bodes poorly for the oil price in the long term, the medium term is somewhat different. The use case for oil, even with the most aggressive EV assumptions, remains compelling over the next decade. Low oil prices over the last few years have cut exploration budgets, meaning less oil supply will come on stream in the near to medium term, positively impacting prices. This is an excellent example of the self-correcting nature of markets: low prices lead to less exploration which in turn lead to lower supply and higher prices. This will lead to more breathing room for Russia to transition its economy over the next decade.

An educated workforce and prudent macroeconomic policy

Russia has a high human development index. As the chart below shows, a greater proportion of Russians have attained tertiary education compared to other EM peers, as well as most countries in the OECD. Its services sector is comparable in size to its EM peers, and continues to grow.

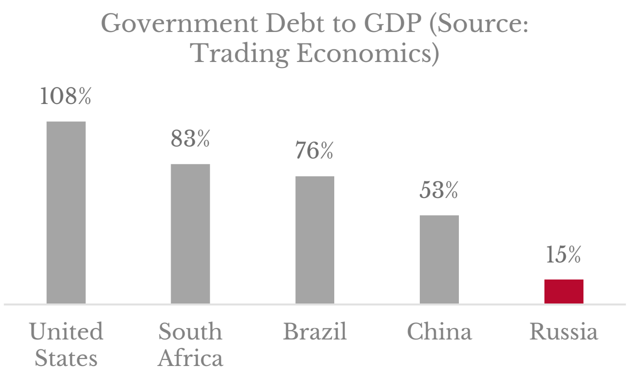
Russia has a high human development index and a growing services sector versus EM peers

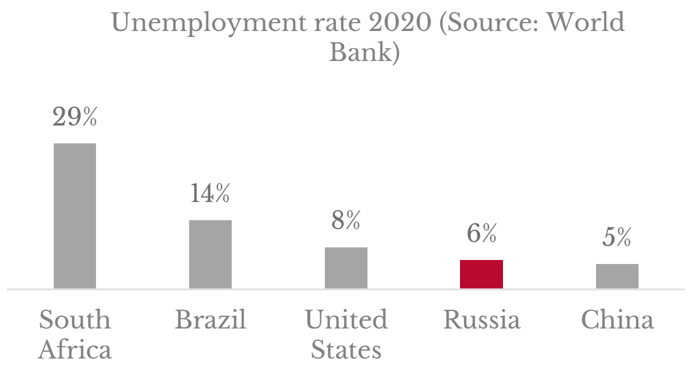




Russia's macroeconomics are very prudently run. It has the lowest debt to GDP and the highest government surplus among the 20 largest emerging economies. It also ranks fourth among the same set of countries in terms of its current account surplus and foreign exchange reserves. The Russian central bank is a reputable inflation targeting institution, and unemployment is low by international standards.

Low government indebtedness coupled with low unemployment are remarkable feats in both DM and EM





Unknown to most of the outside world, the Russian internet is a vibrant and competitive space. Russia's fiercely nationalistic tendencies, coupled with an antagonistic relationship with Europe and the United States has led to the creation of a national, parallel internet ecosystem within Russia. For example, Google is not the largest search engine in Russia, Yandex is. Instead of Amazon, Russians shop online at Ozon, Wildberries and AliExpress. The dominant hiring website is Head Hunter. Ride hailing is dominated by Yandex Go and inDriver, while Mail.ru is the largest social media company, exceeding Facebook in the size of its Russian user base.

Political concerns drive perception

Like Singapore and China, Russia operates a political system dominated – effectively – by one party. Even though the economic model has transitioned from communist to capitalist, political power remains concentrated in the hands of Vladimir Putin's United Russia party. Recently passed constitutional amendments by the party have allowed an extension of the presidential term, meaning Putin could remain in power from when his term ends in 2024 through to 2036.

There are negative social and financial consequences to this form of single party dominance. Putin has at times launched vicious attacks against those who pose a challenge to him, and foreign shareholders have at times been "collateral damage" in these attacks. Judiciary independence is questionable, and there are limited alternative opportunities for aggrieved parties to seek redress.

The first example of this I recall was the collapse of Yukos, then one of Russia's largest companies, in 2003 when its owner, Mikhail Khodorkovsky, crossed paths with Vladimir Putin. Yukos's and Khodorkovsky's assets were subsequently transferred to various Russian state-owned entities at a fraction of their worth and, not just Khodorkovsky, but also its large foreign investor base, were put severely out of pocket.

> There is an opportunity to make abnormal returns when the market incorrectly applies the same risk premium to all local companies, regardless of their quality

A second example is that of Bill Browder, whose hedge fund "Hermitage" was at one stage the largest foreign investor in Russia. Bill Browder's activist style of investing had uncovered cases of corporate malfeasance which also put him at loggerheads with Vladimir Putin, initiating a multiyear struggle detailed in his book "Red Notice" which is an informative read.

These events have led to investors placing extraordinarily high risk-premiums on all investments they make in Russia. Like all generalisations, this is flawed. There is an opportunity to make abnormal returns when the market incorrectly applies the same risk premium to all local companies, regardless of their quality.

Perspective, experience and risk management are key to generating returns on Russian investments

We are not blind to the risks that investing in Russia entails. As a reminder, our investment process encompasses a wide ambit of risk measures, including sovereign risk. In fact, some of our readers might even find it strange that, when applying our risk framework across emerging markets, we would be hesitant to apply more capital to South Africa than we do to Russia.

While most Russian businesses do not fit our quality criteria or are trading at levels which we regard as too expensive, we believe TCS offers a compelling investment opportunity today. Not only are we very constructive on TCS based on its individual dynamics but, as a bank, TCS stands to benefit more than most from any recovery post-Covid.

While Russia may not be Flagship's "natural" hunting ground in terms of looking for investments, we have doubled our investors' capital on TCS at the time of writing. From this perspective, we hope many companies like this cross our desk in the future, even if - perish the thought - they are based in Russia.

Investment Case: TCS Holding

Summary

Tinkoff Credit Systems (TCS) is Russia's most innovative bank and its second largest credit card issuer.

TCS has grown rapidly since its founding in 2006, but its market share of retail banking assets (excluding mortgages) in Russia is still only 2%, a level far too low in comparison to the value it offers Russian consumers.

TCS has embraced technology throughout its operations, and has linked many of its banking services to e-commerce and logistics services that increase stickiness as well as the number of products per customer.

TCS is run very prudently and has thrived through the Global Financial crisis, the Russian Crisis of 2014 and the Covid Crisis. It is well-funded, well capitalized and has a strong track record of credit underwriting.

TCS trades on an undemanding multiple of 15x for a business of high quality, with multiple sources of optionality and a growth trajectory which will span decades.

TCS – the digital "Capitec" of Russia

The first time I looked at a Russian Bank was Sberbank in 2008. Sberbank or 'Savings Bank of Russia' is a state-owned behemoth which has by some accounts a 30 percent market share of the Russian market by total assets. It is a bell weather of the Russian economy.

Despite the fact that Sberbank and Tinkoff Bank "TCS" are both Russian and both banks, they couldn't be more different.

TCS is an entrepreneurial bank founded in 2007 as a credit card monoline, and has since grown into a fully-fledged bank which now offers a complete slate of products, excluding primary mortgages (on the personal loan side) and large corporate loans (on the commercial side).

Importantly, TCS has diversified its sources of funding from a sole reliance on wholesale funding to offering retail debit cards, which provides it with a more stable funding base. With a loan to deposit ratio less than 100%, it has sufficient debit account funding to cover the size of its loan book and then some.

The distinction between Sberbank and TCS is important as it has huge ramifications for the investment cases of each.

Sberbank, because of its size, is at the end of its journey in terms of taking market share. It is unlikely to exceed its current share of thirty percent, only creeping ahead of this number when its bankers are more aggressive in granting loans than the rest of the market and dipping below this number when they are more cautious.

> Given that investor sentiment towards Russia has never been overwhelmingly positive Sberbank has always traded on very cheap multiples of earnings or book value despite the fact that it generates very high ROEs.

This has implications for both the way its business performs as well as how its share price performs.

Provided there are no market concerns around its solvency, Sberbank's business performance is a proxy for the performance of the Russian economy as a whole (and the price of oil on which the Russian economy is so dependent) because it is very unlikely to "outgrow" the Russian banking sector given its large market share.

Similarly, because of its "proxy-like" status, the way its shares perform often mirrors investor sentiment towards Russia. It is then no surprise then that the nadir of its performance as a share was reached during the "Russian Crisis" (when Russia invaded Crimea in late 2013/early 2014). Furthermore, since investor sentiment towards Russia has never been overwhelmingly positive, Sberbank has always traded on very modest multiples of earnings or book value despite the fact that it generates very high ROEs.

Sberbank is the very definition as what some might describe as a "value" investment case because it is an investment case primarily premised on mean reversion. To use the words of Benjamin Graham: "in the short run the market is a voting machine, but in the long run it is a weighing machine (meaning business performance trumps investor sentiment)".

[1] Statista: In 2020, the total assets' value of the Russian banking sector exceeded 96.5 trillion Russian rubles.

Weak Russian economic performance (which is typically felt in its credit loss ratio) or poor investor sentiment towards Russia (because collectively, investors tend to over-react to news of this nature) has knocked Sberbank's share price since listing. However, a minority of investors have done well by buying Sberbank at low levels and enjoying strong returns as its share price improved alongside Russian sentiment.

TCS is an entirely different animal. TCS was named after Oleg Tinkoff, one of Russia's best known serial entrepreneurs who, by some accounts, is the Russian 'Richard Branson'. Over the years, Tinkoff has started ventures in the retail industry, the frozen food industry, "Tinkoff Beer" and TCS. He is no longer involved in the operations of TCS, although he remains its largest shareholder. Today TCS's president is Oliver Hughes, a British businessman who previously headed Visa's Russian business.

TCS is a challenger bank which has managed to grow its credit card customers from 900,000 in 2010 when it IPO'ed to over 5 million today. Its market share remains miniscule: if one had to compare the size of its retail loan book (excluding mortgages) to that of Sberbank, it is still only $1/15^{th}$ of Sberbank's size.

It has also managed to scale in this manner prudently. TCS thrived through the Global Financial Crisis "GFC", the Covid crisis as well as the Russian Crisis. Part of its resilience is due to its robust underwriting standards and part is due to its capital position sitting at a massive 15.2% on a Basel III CET basis at the time.

Unlike Sberbank, TCS is a market share story rather than just a proxy for the Russian economy or investor sentiment towards Russia. A large part of TCS's investment case is premised on the degree to which it can outgrow the Russian banking sector.

A large part of TCS's investment case is premised on the degree to which it can outgrow the Russian banking sector.

TCS runs the largest door-to-door delivery service within Russia making between 35,000 and 40,000 deliveries per day.

It has obviously been successful as a challenger bank but it is not just within banking that TCS is making its presence felt. TCS has always been branchless. When TCS's credit card business was in its infancy its primary distribution was the direct mail channel operating through the Russian Federal Post Office. However, even in its early days, TCS could see that the internet would become its largest distribution channel and it has gradually tilted its business towards being on-line only.

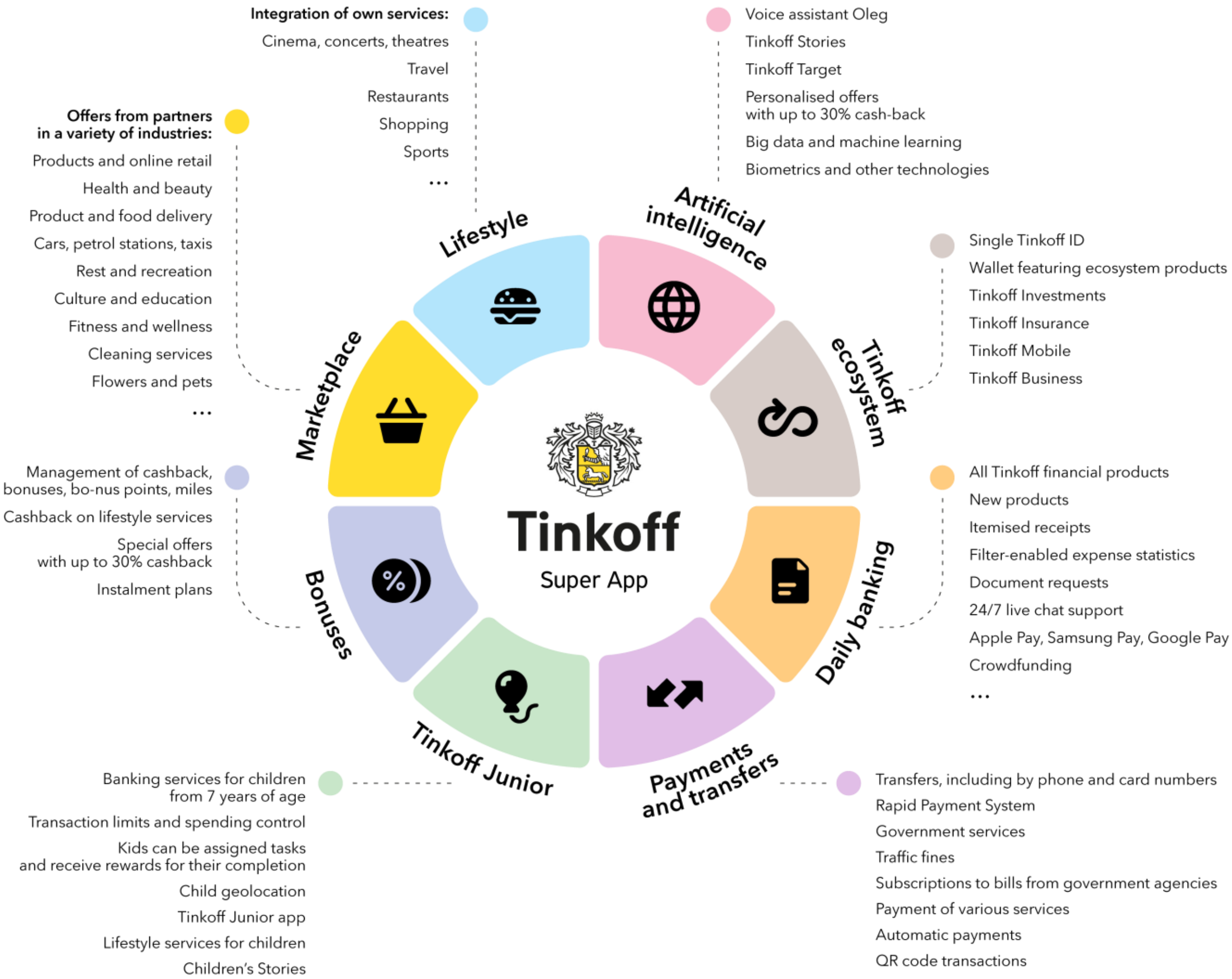
This was easier said than done. A quirk of Russian banking regulations is that "face identification" is required to comply with Russian Know Your Client "KYC" requirements, so a representative of the bank has to meet a new client in person. In order to support its online only model, TCS has had to develop the largest door-to-door delivery service within Russia. While this vast network was originally used to deposit debit or credit cards or meet new clients, today it makes between 35,000 and 40,000 deliveries per day and has opened to delivering third party goods as well.

Tinkoff's banking app has scope to become the next lifestyle "SuperApp" within Russia.

Its online successes don't stop here. Tinkoff's mobile app is quickly becoming a super-app within Russia which places it in direct competition with Yandex (Russia's equivalent of Google) and Mail.ru (Russia's equivalent of Facebook) who are looking to expand their core offerings in search and social media to other areas within the online world.

Apart from its core banking functions, TCS's app offers lifestyle services, like the ability to book restaurants and purchase concert and aeroplane tickets, the ability to buy insurance or trade shares, get news through "Stories" which is a landing page for TCS-generated content created by 600 specially dedicated journalists (similar to "News24" in South Africa), or buy products through integrations with 3rd party ecommerce players who give cashbacks to Tinkoff customers.

Tinkoff's 'SuperApp' is a powerful tool to encourage transaction fees as well as user stickiness



TCS is also very profitable. Unlike many Fintech companies globally, which often are prepared to lose money (sometimes hand-over-fist) on their customer acquisition journey to achieve "critical mass", TCS has been profitable from day one. Part of the reason for this is because capital is so scarce in Russia. At TCS, every line of business has to clear a 30% hurdle rate on its own, with the exception of its retail debit card business which it monetizes through cross-selling. In 2020, Tinkoff's return on equity exceeded 40%.

TCS is an example of a business that we like to own in your funds. Not only does it have the hallmarks of a great business, but it has a long growth journey ahead of it. Warren Buffet said the ideal investment period is "forever". While our selling discipline does not allow us to a hold a company "forever" if its share price exceeds our fair value, we believe that TCS is an example that will steadily compound shareholder value in the future.

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.

Flagship funds own a selection of businesses that we believe to be of unusually high quality, and will prove to be financially resilient whatever the prospects of the global economy. 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.

Warm Regards,

Kyle Wales and Pieter Hundersmarck

FLAGSHIP
ASSET MANAGEMENT

Navigate Safely Forward

T +27 21 794 3140

E info@flagshipsa.com

www.flagshipsa.com

Specialist Global Asset Management. Your Future is Safe with those who Know.

Disclaimer

This report has been prepared by Flagship Asset Management. The information provided does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided and consider seeking advice from a financial adviser if necessary. You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. Returns are not guaranteed and so the value of an investment may rise or fall.