# FLAGSHIP
ASSET MANAGEMENT

# Quarterly Telescope Q4/2021

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## 01

# We are a global specialist investment boutique

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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## 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 over two decades, and have generated benchmark-beating returns since inception.

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## 03

# We are long term investors who manage concentrated portfolios

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 December 31, 2021

| Global Flexible Strategy | AUM | YTD | 1 Yr | Annualised<br>3 Yr | 5 Yr | 10 Yr | S.I. |
|---|---|---|---|---|---|---|---|
| **Flagship International Flexible Fund (USD)** | **$32.5m** | **-3.7%** | **-3.7%** | **11.7%** | **7.6%** | **11.7%** | **2.5%** |
| Composite Benchmark (50% equity, 30% bonds, 20% cash) | | 7.6% | 7.6% | 10.8% | 7.7% | 12.2% | 4.0% |
| Outperformance vs. Benchmark | | -11.3% | -11.3% | 0.9% | -0.1% | -0.5% | -1.5% |
| **Flagship IP Worldwide Flexible Fund (ZAR)** | **R488m** | **4.8%** | **4.8%** | **13.6%** | **8.7%** | **11.1%** | **11.5%** |
| Composite Benchmark (60% equity, 20% bonds, 20% cash) | | 18.5% | 18.5% | 13.8% | 10.4% | 11.6% | 9.8% |
| Outperformance vs. Benchmark | | -13.7% | -13.7% | -0.2% | -1.7% | -0.5% | 1.7% |

| Global Equity Strategy | AUM | YTD | 1 Yr | Annualised<br>3 Yr | 5 Yr | 10 Yr | S.I. |
|---|---|---|---|---|---|---|---|
| **Flagship Global Icon Fund (USD)** | **$13.3m** | **-3.4%** | **-3.4%** | | | | **15.1%** |
| Benchmark (MSCI ACWI in USD) | | 18.5% | 18.5% | | | | 26.5% |
| Outperformance vs. Benchmark | | -21.9% | -21.9% | | | | -11.4% |
| **Flagship Global Icon Feeder Fund (ZAR)** | **R36m** | **5.6%** | **5.6%** | | | | **6.4%** |
| Benchmark (MSCI ACWI in ZAR) | | 29.1% | 29.1% | | | | 17.4% |
| Outperformance vs. Benchmark | | -23.5% | -23.5% | | | | -11.0% |

| Global Fund of Funds Strategy | AUM | YTD | 1 Yr | Annualised<br>3 Yr | 5 Yr | 10 Yr | S.I. |
|---|---|---|---|---|---|---|---|
| **Flagship IP Worldwide Flexible FoF (ZAR)** | **R353m** | **17.0%** | **17.0%** | **14.5%** | **11.2%** | **14.3%** | **14.0%** |
| Benchmark (SA CPI + 5%) | | 10.8% | 10.8% | 9.4% | 9.7% | 10.4% | 10.4% |
| Outperformance vs. Benchmark | | 6.2% | 6.2% | 5.1% | 1.5% | 3.9% | 3.6% |

Note: All performance is net of fees. 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 respective Fund domicile and pricing currency. Collective Investment Schemes in Securities (unit trusts) are generally medium to long term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily a guide to future performance.

# Contents

# The Flagship Global Investment Team

## 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 CA (SA), CFA

Kyle is the co-manager of the global funds at Flagship and has been investing internationally for over 13 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.

## JJ Brink CA (SA), CFA

JJ is an equity analyst on the global team at Flagship. Prior to Flagship he spent 3 years at Deloitte. During his articles he predominantly serviced the asset management sector and gained great exposure to the industry. JJ graduated from Stellenbosch University with a BA (Accounting) with Honours in 2016 and qualified as a chartered accountant in 2020. JJ is a CFA charter holder.

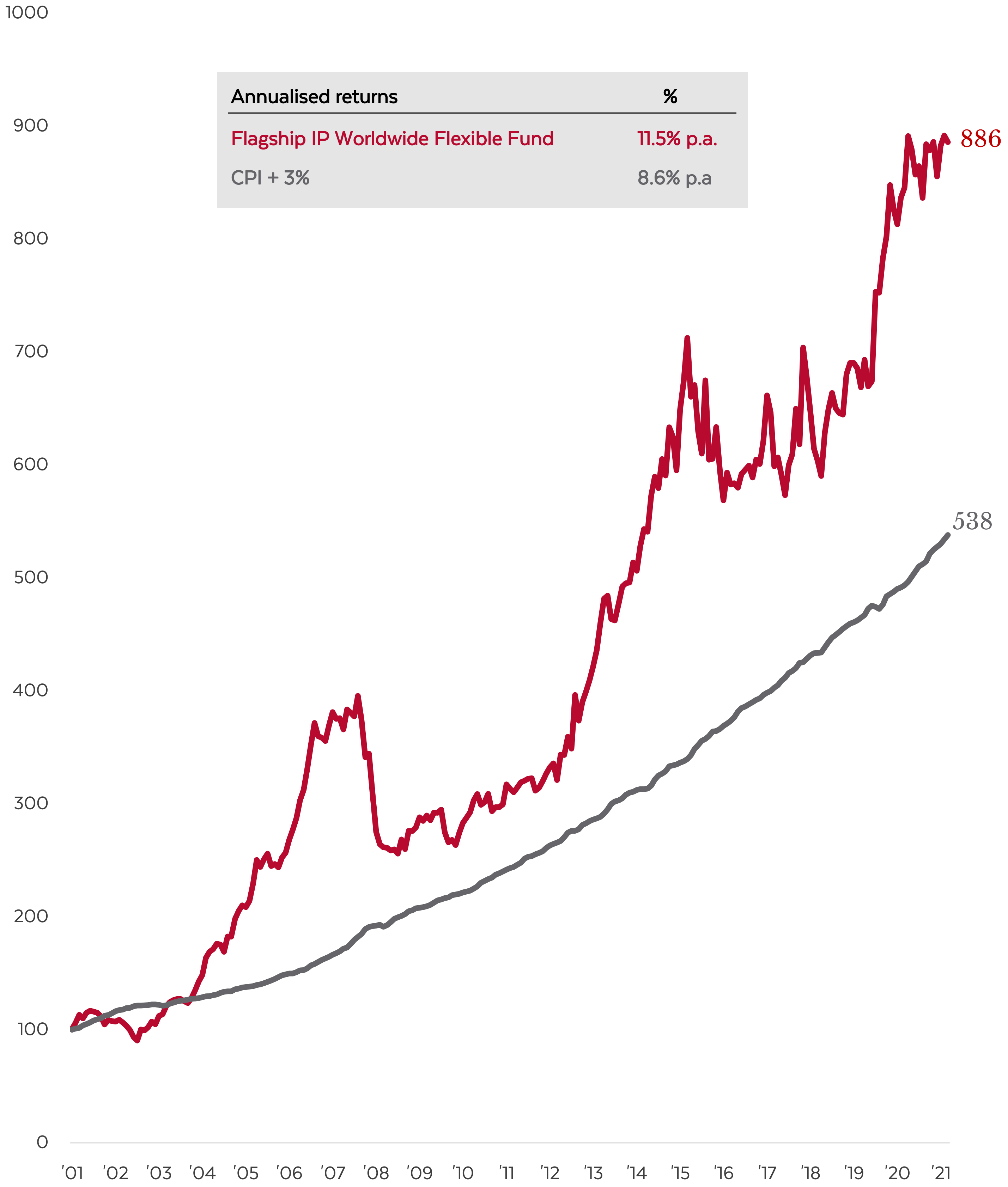
## JD Hayward (B.Eng.)

JD is an equity analyst on the global team at Flagship. Prior to Flagship he worked as an engineer and also spent 2 years at an Edu-tech startup in Cape Town. JD graduated from Stellenbosch University with a B.Eng. (Civil) in 2016 and is currently a CFA level III Candidate.

# The Power of Long-term Compounding

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

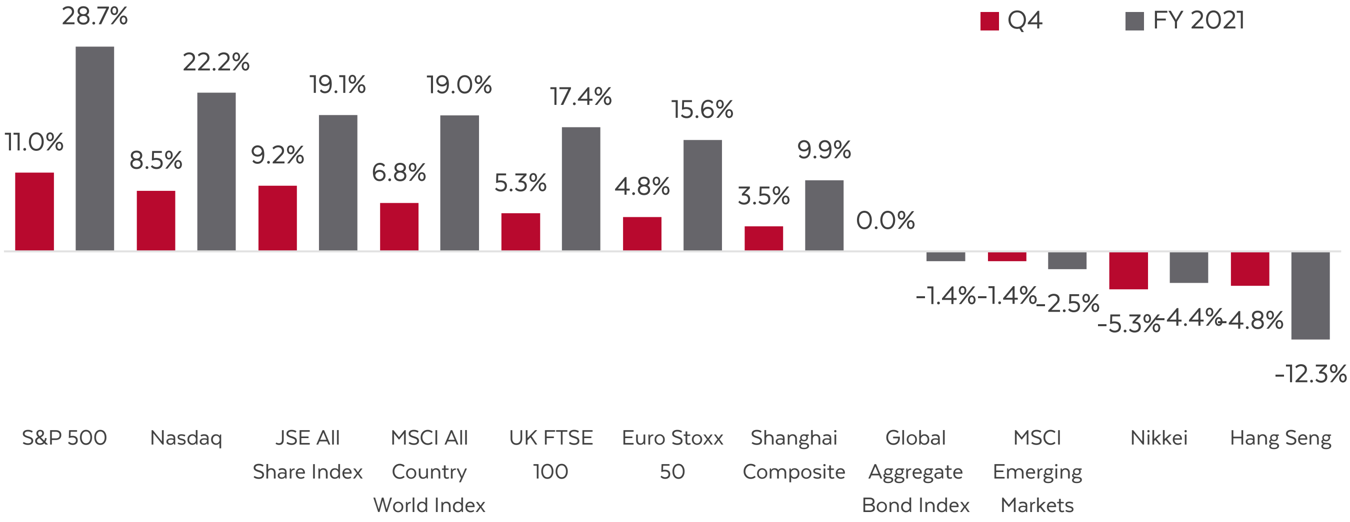
from 1 October 2001 to 31 December 2021 (20 years, 3 months)




| Annualised returns | % |
|---|---|
| Flagship IP Worldwide Flexible Fund | 11.5% p.a. |
| CPI + 3% | 8.6% p.a |

# 2021: A(nother) Strong Year

"Money is made by discounting the obvious and betting on the unexpected."
- George Soros




**It was a great year for global stock markets.** With the exception of Japan, Hong Kong and the emerging market complex, all the major equity indices continued to rise in Q4 2021, notching up mid-teen returns for the year on average.

The performance of the US stock market once again stands out. Since 1980, the S&P 500 has been up for the year a remarkable 83% of the time. The performance since the GFC has been most notable, with the market up 12 out of the past 13 years (92% of the time). The one down year was low single digits, while the 12 up years were high-teens. Such one-sided returns make experienced investor Drew Dickson from Albert Bridge Capital remark *"…. makes me wonder if anyone under 30 – through no fault of their own – thinks that this is the way markets always work."*

Within the US market, returns were concentrated in a few technology related stocks. In 2021, 32.6%, or just under 1/3, of the US market's overall return was driven by five stocks: Microsoft, Apple, Nvidia, Alphabet, and Tesla. At 27.9x, the forward PE ratio of the tech sector is near its highest level since 2004, and well above the 21.3x of the broader US market. Incredibly, Apple is worth $1 trillion more than it was nine months ago, yet the tech giant's prospects haven't changed that much in that time.

The performance in the second half of the year tell us that these strong returns may be cooling. The first few trading days of 2022 tells a similar story.

Looking back at the year, it is astonishing how stocks powered through negative news that could have induced more selling pressure. A contested US presidential election, an assault on the US Capitol, accelerating inflation, a promise from the Fed to raise rates, continued supply chain disruptions, new COVID variants and lockdowns in Europe - none of these events prevented stocks from notching all-time highs.

The performance in the second half of the year tell us that these strong returns may be cooling. While the early months of 2021 saw c.90% of constituents in the S&P 500 trading above their 200-day average, that fell below 60% as the year wore on, according to figures compiled by Yardeni Research. The first few trading days of 2022 tells a similar story.

Higher inflation, and concerns about how that might derail economic growth and the stock market, was one of the biggest stories of 2021.

There is a healthy debate on the nature and duration of the current inflationary environment, and - more importantly - the monetary policy response. There is no doubt that expectations of monetary tightening are reflected in the damage done to the (mostly) profitless thematic tech segment of the US market in recent months. Even before Q4, the market breadth of many of these counters had deteriorated meaningfully, making them ripe for a pull back. The widely followed ARK Innovation ETF has emerged as the unfortunate poster child for this pull back, down over 20% in 2021.

While we do believe inflation will slowly reassert itself from ultra-low levels of the past decade, we remain unconvinced that inflationary forces are greater than the deflationary forces of demographics, technology and financialization over our investment time horizon. We are also not convinced that the appetite exists in any large nation for a large rise in policy rates that would meaningfully derail asset markets. The seeds of the US Fed's habit of supporting markets were sown in the LTCM bailout, followed on by the GFC bailout and, most recently, the COVID-19 bailout. Fiscal policy has joined in the narrative to provide even more support. The precedent that has been set is nearly impossible to undo.

In late 2020 we went on record as saying the markets will be volatile and we wouldn't be surprised by negative returns from global equities in 2021 as the Fed tightens and the exuberance of the past 12 years fades.

We were wrong. Or early. Nevertheless, for the coming year we maintain the same cautious view. This does not make us bearish necessarily, it simply means we understand that markets are cyclical and prone to corrections at least two or three times every decade, and current prices in relation to prospects are higher than normal. It's a clearly observable feature of the market, and we aren't unique in stating it here.

> The opportunities that this disruption has created for a large number of global businesses are incredibly attractive, and their near-term valuations deserve to be high.

We do understand why stock valuations are above normal. Notwithstanding the obvious (increased liquidity and monetary / fiscal support), we are living through an age of disruption. The opportunities that this disruption have created for a large number of global businesses are incredibly attractive, and their near-term valuations deserve a premium.

However, their massive success and resultant large market caps mean these businesses are over-represented in indices, which continue to climb ever higher. Valuation, as well as market breadth, ultimately matters. When prices are this high, stocks are vulnerable to changes in the narrative. We know that as soon as the prospects for the mega cap tech 'disruptors' dim, or they begin to show signs of a mature growth profile, their sky-high valuations will fall. And the indices will fall with them.

This brings me to an important point. We have two critical – and sometimes conflicting – goals in the Flagship strategies. Our overarching goal is to invest and grow our clients' capital. This means putting capital at risk into one of the 25 companies that comprise our equity holdings at any point in time, as well as other asset classes when they become attractive. On the other hand, we are trying to protect client capital from losses over a three to five-year cycle. This means steering away from expensive shares with fragile investment cases, which is the case with many growth stocks today in our view.

Flagship strategies hold no profitless tech stocks, most of which have no proper valuation underpin. This is not because we don't understand how powerful many of these business models or their prospects are, but rather because their valuations are so high as to make their investment cases fragile to any small change in their narrative.

Making money by buying a thematic growth stock in the hope of selling it to someone else for a higher price means, ultimately, someone gets stuck with the hot potato when the theme stumbles or the company's execution of that theme fails. That is a game of musical chairs we would rather not play.

> Making money by buying a thematic growth stock in the hope of selling it to someone else for a higher price means ultimately someone gets stuck with the hot potato when the theme stumbles or the company's execution of that theme fails.

Instead, we aim to generate strong returns from fundamentally sound, mispriced businesses that exhibit asymmetric payoff profiles. In our mult-asset funds we can extend this investment strategy by managing equity exposure so that our portfolios can withstand shocks and profit from the fear that they engender. March 2020 was a perfect example of how we took advantage of the excess fear at the time to substantially increase equity exposure, allowing our Flexible Strategy to meaningfully outperform in that year.

Currently, the Flagship Flexible Strategy has zero exposure to global bonds and is at 80% equity exposure. The equity exposure excludes hedging instruments that rise in value when global equity indices fall. We have no plans to increase our equity exposure. Should our equities outperform, we will sell down to the same equity exposure. Should our equities underperform, we will increase it.

## Strategy Performance

For the full year 2021:

- Our Global Equity Strategy returned +5.6% in ZAR and -2.3% in USD
- Our Global Flexible Strategy returned +4.8% in ZAR and -3.7% in USD
- Our Global Fund of Funds returned +17.0% in ZAR and +7.8% in USD

When looking at the calendar year returns, we are naturally disappointed. Underperformance over a calendar year is never welcome, but it is inescapable when managing money in any active strategy.

Part of the reason for the recent underperformance is the high base on 2020. Our Global Flexible Strategy delivered +26.3% in ZAR and +27.0% in USD for 2020, with our equities delivering a gross performance of +43%, substantially outperforming the MSCI ACWI and the S&P 500. Notably, our Flagship Global Icon fund has delivered 24.3% in USD since inception on July 30, 2020.

> The main source of underperformance is from 'our big winners winning a bit less' in the short term.

Even considering this last year's poor performance, looking at the past three years we are comfortable with a return profile we have generated with the amount of risk taken.

| | 2021 | %Δ 2YR | %Δ 3YR |
|---|---|---|---|
| Flagship Worldwide Flexible Fund (ZAR) | 4.8% | 15.1% p.a | 13.6% p.a |
| Flagship International Flexible Fund (USD) | -3.7% | 10.6% p.a | 11.7% p.a |
| Flagship Worldwide Flexible Fund of Funds (ZAR) | 17.0% | 12.3% p.a | 14.5% p.a |

There were two main reasons for the underperformance. The first is that our large contributors in 2020 (Zalando, Netease, Endava, TCS and PagSeguro) saw a meaningful pullback in 2021, due mostly to temporary concerns regarding growth as global economies reopened.

Secondly, we saw idiosyncratic impacts from Duck Creek, Ubisoft and Alibaba that led to steep declines in their share prices in H2 of 2021.

There is a third reason that impacts our Flexible Strategy specifically, which is our cash holding, which detracts from performance in a rising market.

A few things to highlight:

- The main source of underperformance is from 'our big winners winning a bit less' in the short term. We are still up substantially on our purchase price for many of our holdings. To us, this is a source of underperformance that is distinct from losing client capital on poor investments.
- The Global Icon Fund contains a range of high-quality businesses that will fare better than many lower quality (and higher valued) shares that fill the indices.
- The Flexible Strategy's mandate is to grow and protect investor capital over a 3-5 year cycle, and, without sounding dismissive, one year of staid returns in a frothy market is not of great concern to us.

We continue to believe in the investment cases for our underperforming stocks, most of which continue to report revenue and earnings numbers ahead of consensus. In fact, we have used the opportunity to increase our holdings in the positions that have performed poorly.

| OUT |
| --- |
| US Foods |

| IN |
| --- |
| Ultra Clean Technologies |
| Informa |

The largest contributors in the fourth quarter of 2021 in both our Global Equity as well as our Global Flexible Strategies were **Capri**, **Karooooo** and **Microsoft**. The largest detractors in the quarter were **PagSeguro**, **Zalando** and **Duck Creek**.

In our Global Fund of Funds, the top contributors to our total return of +7.8% for the quarter were Guinness Global Innovators and GQG Partners, while the lowest contributors were Lindsell Train and the iShares World Value ETF.

During the fourth quarter we added **Ultra Clean Technologies** and **Informa** to the equity portfolios and sold out of **US Foods.**

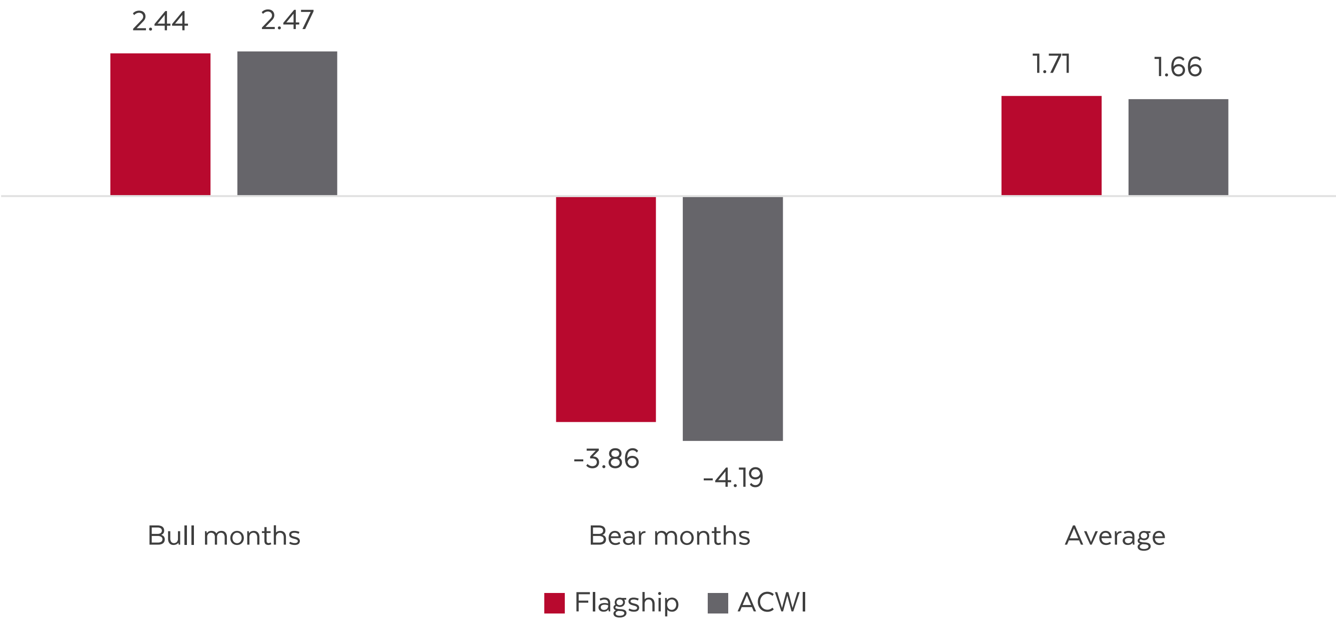
**Ultra Clean Technologies (UCT)** is one of the largest suppliers to the Semiconductor capital equipment providers. The Company has a long pedigree of growing its market share in its key product areas of gas delivery systems and cleaning services, and has recently begun diversifying into new customer segments. We believe UCT will be able to grow its revenue at a CAGR of 20% through 2025 – continuing to meaningfully outperform the broader semiconductor market, while expanding EBIT margins by 3% over this timeframe. UCT is currently trading on 11.5x earnings, representing a favourable rerating opportunity when compared to its long-term average of 12.4x. We believe the shares are worth north of $75, providing meaningful upside in a high-quality stock in an industry benefitting from secular tailwinds.

**Informa** is the largest organizer of trade shows in the world with a global market share of around 7%. Its business took a large knock as a result of Covid but we expect it to emerge stronger as concerns around Covid abate because: (1) there are significant benefits to physical attendance of trade shows which cannot be replicated through digital delivery mechanisms and (2) its investments in digital delivery mechanisms have significantly expanded its total addressable market. Informa trades on a post recovery multiple of a mere 11.1x earnings which is far lower than a business of its quality should trade at given the network effects that it enjoys as well as its high returns on equity and free cashflow conversion ratio.

As regular readers know, we run concentrated portfolios of a maximum of 25 stocks, and our investment universe is small, consisting of roughly 500 high-quality businesses that the portfolio managers know well. Our focus on high-quality businesses leads to desirable portfolio outcomes, being higher profit margins, faster profit growth and less susceptibility to cyclicality.

The resilience of the Flagship equity portfolio in bull markets and bear markets is shown in the chart below. Bull and bear months are defined as months where the Index moves up (bull) or down (bear). The average return that Flagship has achieved during bull months (2.44%) is roughly the same as the average move for the index, and the average performance during bear months (-3.86%) is superior to the index average of (-4.19%).

**Flagship Equity Composite in Bull & Bear months (1 June 2019 – 31 December 2021)**




Note: The Equity Carve Out begins from the date that the Equities in the Flexible Fund transitioned to the selection determined by the current global team, on June 1, 2019. The carve out excludes trading costs, fees, and other fund expenses. From August 2020 the returns of the Icon Global Equity Fund Class "C" are used. The C class carries zero management fees, but incurs Manco fees of 30bps annually.

# Asset allocation

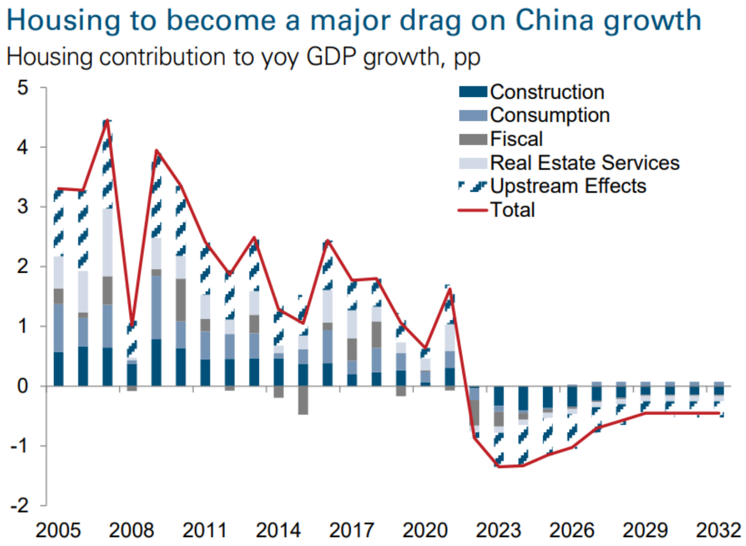
By Pieter Hundersmarck

Three major asset allocation themes currently dominate our thinking. Firstly, the slowdown in China and its effect on the global economy and businesses, secondly, the outlook for inflation, and finally, the investment case for bonds versus equities.

We hold two Chinese businesses in the fund, JD.com and Alibaba, neither of which are affected by the first-round effects of a slowdown in housing, and only marginally to second round effects. Their share prices remain incredibly cheap versus their long-term prospects.

### Slowing Chinese economic growth

Much of China's economic growth remains investment-led, and a large proportion of investment has gone into home construction. The chart below (and there are many others that corroborate this) shows that instead of the tailwind it has been for nearly 2 decades. the contribution from housing is set to become a headwind to GDP growth. Simplistically, this means the 6% GDP growth rate we have become accustomed to can halve if other sectors of the economy (consumption, government spending or net exports) don't fill the gap.



*Source: Haver Analytics, Goldman Sachs GIR.*

There are severe knock-on effects. China's economic growth has been the enabler of growth across the western world, where many listed businesses generate their revenues. As the Chinese economy slows, investors will need to calibrate their expectations across the commodity, trade and manufacturing industries.

### Inflation

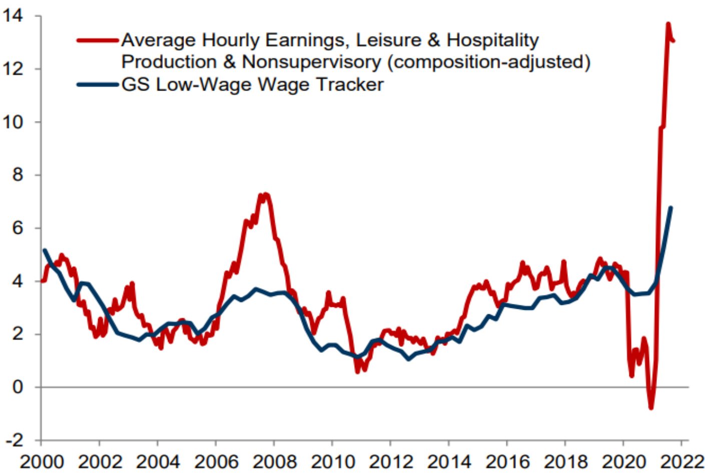
While we do believe inflation will slowly reassert itself from ultra-low levels of the past decade, we remain unconvinced that inflationary forces are greater than the deflationary forces of demographics, technology and financialization over our investment time horizon. According to Viktor Shvets (Macquarie) "Evidence for the regime change is weak". Three data points support the view that change will be gradual (and manageable).

1. The markets are not signalling higher inflation. US 30-year bond yields are below 2% and the US 5-year / 5-year (the five-year expectations of inflation in five years' time) also remain low. Inflation in Europe remains very low, and monetary policy remains accommodative.

2. While wages, especially in the US, are rising, increases are heavily concentrated in disrupted segments (i.e., transport and warehousing, travel-related). In other areas we see no such increases. In Europe and Asia, we see no evidence of wage growth.

Wage growth is especially elevated for low-wage workers

Percent change vs. year ago




*Source: US Department of Labor, Goldman Sachs GIR.*

3. Social inequalities are high on government agendas, as expressed by the rising percentage of the population that are asset owners (who benefit from higher inflation) versus those that own relatively fewer assets. Interest rates must keep abreast of this dynamic, making a sharp reset incredibly unpopular, and thus unlikely.

For the past 3 years, the decision to steer clear of bonds in favour of equities has been the correct one. But as inflation rises, is this still the correct stance?

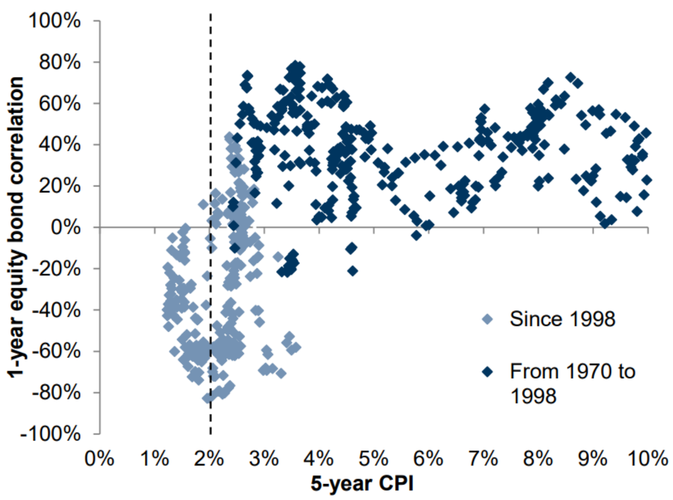
**The investment case for Bonds**

Since the GFC, and the financial repression that has taken place in world's fixed income markets, the pressure for investors to move up the risk curve is high. For the past 3 years, the decision to steer clear of bonds in favour of equities has been the correct one. But as inflation rises, is this still the correct stance?

The chart below shows that the correlation between equities and bonds tends to turn positive in times of higher inflation. Therefore, the risk of investing in bonds relative to equities increases with greater inflation as returns (both up and down) will be more correlated, but with bonds carrying arguably more price risk.

Equity/bond correlation tends to turn positive with high inflation

Equity/bond correlation vs. realized US CPI




*Source: Haver Analytics, Goldman Sachs GIR.*

In the absence of an attractively priced fixed income allocation, the current environment suggests a higher allocation to cash. A large cash allocation doesn't help in terms of real returns, but allows the managers greater discretion to adjust to market conditions aggressively when the time is right. It also greatly reduces fund volatility.

# Market Expectations and PE multiples

**What works in investments and valuation has changed**

By Pieter Hundersmarck

In the early 1990s, intangible investments exceeded tangible investments for the first time in the United States. This trend has snowballed, and today corporate intangible investments outweighs tangible investments by nearly 2:1. Despite this, traditional investment analysis, which focuses on the balance sheet and treats intangible investments mostly as expenses, has changed very little.

For many businesses today, earnings are generated from sources not found directly on the balance sheet, but rather through network effects, key technical know-how and intellectual property. Traditional financial statements need meaningful adjustments to account for the enormous investments into these intangible assets (which are expensed on the income statement, and hence reduce profitability). Likewise, 'true investments' are understated, flattering returns on invested capital (ROIC).

As the age of disruption continues, we will continue to see investments masquerading as expenses, confounding traditional valuation metrics. Already the Price / Earnings multiple applies more to a mature business than to businesses investing with 10-to-20-year time horizons. Static measures such as reported EPS or estimates of next year's EPS do not capture future performance, and ultimately let investors down, especially when the investment case is long-dated. To be completely clear, investors cannot reasonably conclude that a stock is undervalued or overvalued by simply looking at PE multiples. The same goes for indices.

> Amazon, for example, should never have been valued using a PE multiple. Any investor who used a PE to value Amazon missed out on one of the greatest investments of the past two decades.

Amazon, for example, should never have been valued using a PE multiple. Any investor who used a PE to value Amazon missed out on one of the greatest investments of the past two decades. There are hundreds of examples like this.

At Flagship our valuation philosophy accounts for this. We rarely speak of near-term PE multiples unless we feel it is appropriate for a specific stock or market index, and place limited emphasis on it in even in those circumstances. Instead, our valuations focus on two main things: Net Operating Profit after Tax (NOPAT) and Free Cash Flow. We then use proprietary earnings multiples, associated with market related discount rates, to determine the value of a business. This approach allows us to understand what the market price is implying for a business, and helps us grasp downside risks.

In their latest book, *Expectations Investing*, Michael Mauboussin and Alfred Rappaport do an excellent job of explaining how to use the market pricing mechanism as an input into valuation. It also rightfully dismisses the PE as the correct measure to determine whether something is expensive or cheap. Rarely have we read a book where the authors approach so closely mirrors our own approach to investing, as well as other excellent points applicable to all investors, in our opinion. In the book the authors mention 10 rules for investing that we thought was so good that we published them in their entirety on the following page.

One of the key points of the book is clear. Investors who do not understand that the landscape has changed will remain tied to looking at measures of profitability and returns based on accounting standards. Long duration, high return businesses require far more analysis than what can be found in the financial statements.

You need to know what the market's expectations are today before you begin to assess where they are likely to move in the future.

The ten rules for investing through disruption in today's markets (source: Expectations Investing by Michael Mauboussin and Alfred Rappaport).

1. **Follow the cash.** Investor returns come from two sources of cash - dividends and changes in share prices. Stock prices reflect transactions between investors willing to sell the present value of a company's expected cash flows and buyers who are betting on higher cash flows in the future. Cash flow is how the market values stocks.

2. **Forget earnings and price-earnings multiples.** Savvy investors don't rely on short-term metrics such as earnings and price-earnings multiples because they fail to capture the long-term cash-flow expectations implied by the stock price. Indeed, the most widely used valuation metric in the investment community, the price-earnings multiple, does not determine value but rather is a consequence of value.

3. **Study market expectations implied by stock the price.** Rather than forecast cash flows, expectations investing starts by reading the collective expectations that a company's stock price implies. You need to know what the market's expectations are today before you begin to assess where they are likely to move in the future.

4. **Look for potential causes of revisions in market expectations**. The only way for an investor to achieve superior returns is to correctly anticipate meaningful differences between current and future expectations. Investors do not earn superior returns on stocks that are priced to fully reflect future performance.

5. **Concentrate analysis on the value trigger (sales, costs, or investment) that has the greatest impact on the stock**. Identifying the so-called turbo trigger enables investors to simplify their analysis and channel their analytical focus toward the changes with the highest payoffs.

6. **Use competitive strategy analysis to help anticipate revisions in expectations**. The surest way for investors to anticipate expectations revisions is to foresee shifts in a company's competitive dynamics. For investors, competitive strategy analysis integrated with financial analysis is an essential tool in the expectations game.

7. **Buy stocks that trade at sufficient discounts from expected value.** The greater the discount from expected value, the higher the prospective excess return—and hence the more attractive a stock is for purchase. The sooner the stock price converges toward the higher expected value, the greater the excess return. The longer it takes, the lower the excess return.

An acquiring company's choice of cash or stock often sends a powerful signal to investors.

8. **Sell stocks that trade at sufficient premiums over expected value after accounting for taxes and transactions costs**. The higher a stock price's premium to its expected value, the more compelling the selling opportunity.

9. **Don't overlook other significant value determinants that are misplaced, or don't appear, in the financial statements.** For example, companies are increasingly investing in intangible assets that show up as expenses on the income statement. Reclassifying those investments results in higher earnings and a higher rate of investment, but do not change free cash flow.

10. **Heed the signals sent when companies issue or purchase their own stock**. An acquiring company's choice of cash or stock often sends a powerful signal to investors. Under the right circumstances, buybacks provide expectations investors a signal to revise their expectations about a company's prospects. Correctly reading these signals provides investors with an analytical edge.

# Capri: Yet another argument for offshore diversity

**Global markets offer more investment choices**

By Kyle Wales

At Flagship, we have always argued that at a portfolio level, achieving diversification (rather than trying to take advantage of short-term movements in the Rand) is the key reason why investors should increase their exposure to global assets within their portfolios. However, diversifying one's portfolio to include a greater proportion of offshore assets not only has benefits from a portfolio risk perspective but from a portfolio return perspective as well, because it enables one to gain exposure to many investment opportunities that one would otherwise not be able to gain access to on the JSE. This is especially true for actively managed funds which are able (and willing) to take concentrated positions in their best ideas.

One such example is Capri Holdings, a luxury goods company and the largest holding in your funds. Currently, when compared to Richemont, we believe Capri is a far more attractive holding.

**Richemont is the third largest luxury goods company in the world**

Since 1988, Swiss listed luxury goods company Richemont has been a staple in the portfolios of South African investors. It is currently the third largest luxury goods company in the world behind LVMH and Kering.

Rising Asian demand, and an increasing cohort of middle- and upper-class consumers in the western world bode well for the prospects of Richemont. However, is Richemont the best way for South African investors to gain exposure to this promising global theme? Because Richemont is the only listed luxury goods company listed on the JSE, many South African investors are ignoring the myriad of alternatives in the luxury goods industry available to them if they only turned their sights globally.

> Diversifying offshore not only has benefits from a portfolio perspective (because it reduces risk) but from a stock specific level as well (because it can boost the return profile of a portfolio).

The luxury goods industry is divided into "hard luxury" which consists of jewellery and watches, and "soft luxury", which consists of accessories and apparel. Richemont, like luxury watchmaker Swatch, competes in the "hard luxury" space, with almost 60% of its revenues generated by its "jewellery Maisons" segment led by flagship brand Cartier. The balance of revenue comes from a myriad of smaller Swiss watch brands, as well as online luxury platforms Yoox and Net-a-porter.

**"Hard" luxury has significantly underperformed soft "luxury"**

Unfortunately for Richemont, "hard luxury" has underperformed "soft luxury" by a considerable margin over the past five years.

Despite the fact that Richemont's latest (FY21) results were very favourably received by the market, the total return that Richemont has been able to deliver over the last five years is 20% p.a. in USD which, although commendable, pales next to the 38% and 33% p.a. respectively that its "soft luxury" peers LVMH and Kering have been able to deliver.

According to Third Point, which recently acquired a stake in Richemont, some of this underperformance may be attributed to missteps by Richemont management.

This, however, is not the only reason.

The economics of “hard luxury” simply do not stack up that favorably next to “soft luxury”. Richemont’s margins are far lower than its “soft luxury” peers. Its cashflow dynamics are also worse. Richemont has almost twice the investment in working capital (as a % of sales) that LVMH or Kering have. The bulk of this additional investment sits within inventories as it takes longer to sell higher priced jewelry and watches than (relatively cheaper) handbags and apparel.

**Despite poorer economics, Richemont trades at a demanding valuation**

Richemont’s valuations don’t reflect its poorer economics. It trades at similar multiples to its soft luxury peers which, on 29 times forward earnings, are just shy of industry leader LVMH, which trades on a blended forward multiple of 31 times, according to Bloomberg.

This illustrates the extent to which it is becoming difficult to purchase high-quality companies at reasonable prices.

> Looking beyond the Michael Kors brand, Capri believes it can double revenues from Versace from $1bn to $2bn and Jimmy Choo (from $500mln to $1bn) by 2024.

**Enter Capri Holdings**

One company that is an exception to this rule is Capri Holdings. Capri trades on a modest multiple of just 11 times earnings despite owning some coveted brands and being firmly ensconced in the “soft luxury” space. Capri generates the bulk of its revenue from “accessible luxury” brand Michael Kors, with the balance from high end brands Versace and Jimmy Choo.

The low valuation versus bright prospects is likely due to the fact that the market completely misses how the Michael Kors brand has been rejuvenated post its restructuring in 2019. Looking beyond the Michael Kors brand, Capri believes it can double revenues from Versace (from $1bn to $2bn) and Jimmy Choo (from $500mln to $1bn) by 2024.

While these targets are ambitious, they are looking more and more plausible as the Versace brand, in particular, has been delivering blistering y-o-y growth.

We believe achieving $2bn in annual revenues is only scratching the surface of Versace’s potential. Notably, only 25% of its revenue comes from leather goods today versus 50% or greater for many of its peers (an example would be Prada).

**There are still many opportunities for valuation sensitive investors**

Many people are becoming increasingly concerned by the overall valuation of markets and what that means for equity allocations. However, we believe good value can still be found in attractive industries without compromising our quality requirements.

All it means is casting one’s net a little bit wider than the limited opportunity set available on the JSE.

# Flagship Primers: The Open-RAN industry

"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*

By JJ Brink

- ⇒ The premise of Open Radio Access Network (or O-RAN) networks is that, as the name suggests, the system is open and "unbundled", allowing products from different vendors (both hardware and software) to be mixed and matched, resulting in cost optimization.
- ⇒ Japanese company Rakuten (discussed later) is to date the largest adopter of O-RAN technology globally.
- ⇒ Despite its effectiveness, adoption of O-RAN has been slow. Telcos, like other large corporates, are slow to adopt new technologies due to the risk of upsetting their service and brand, as well as the enormous level of spending required.
- ⇒ This creates an opportunity for disruptive players to enter the industry and build a new network from scratch, unencumbered by the burden of legacy assets.

The premise of O-RAN is to lower costs by tackling the archaic architecture of the telecom industry. But what is O-RAN? And why is it central to Rakuten's mobile strategy?

The premise of O-RAN is that it is designed to lower costs by tackling the archaic architecture of the telecom industry.

Let's start at the beginning. When Rakuten decided that it would enter the mobile business it was a late entrant to an industry that already had large incumbents. In order to be successful, they would need to offer very competitive pricing plans. Since the incumbents already had scale - and much of the equipment that the incumbents used to operate their own mobile networks was already fully depreciated – such aggressive pricing would be suicide for a new entrant.

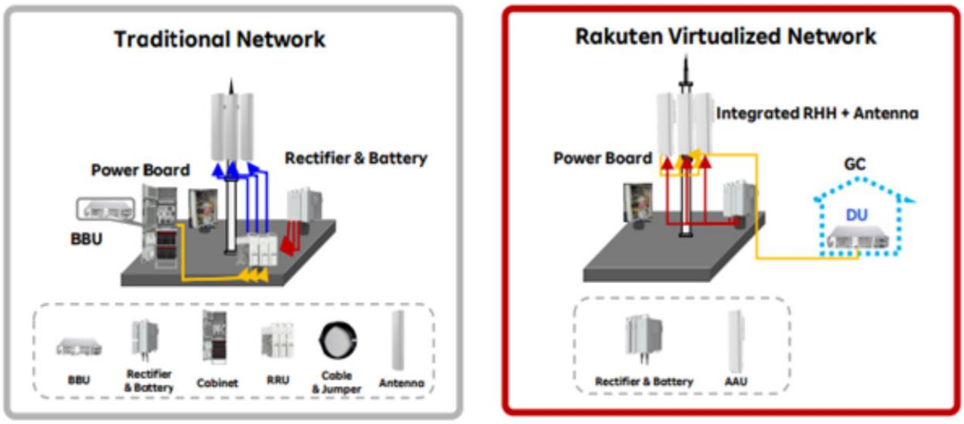
In fact, the only way they could potentially compete on the same footing as the incumbents would be to build a low-cost network from scratch, leveraging new industry technology to build the world's first fully virtualized O-RAN network. This was not without its risks.

The prize, however, is large. If Rakuten are successful at rolling out O-RAN, they will not only have been successful at rolling out a new, viable mobile network, but will also be able to monetize their network-building experiences by opening the technology to telecom operators around the world.

Let's first understand the basic pain points in the traditional telecom supply chain. To build a network, you need sophisticated communications hardware placed at base stations at the nodes of a network. Usually, these were "proprietary boxes", and the vendors (usually Nokia and Ericsson in developed markets) had full control over the hardware and software stacks. Operators are locked into procuring these from a single vendor, resulting in networks that are expensive to build and inflexible because negotiating power rested firmly with the vendor.

The premise of O-RAN networks is that, as the name suggests, the system is opened up and "unbundled", allowing products from different vendors (both hardware and software) to be mixed and matched, resulting in cost optimization.

But open-RAN is more than just about this unbundling. It is also about reconstructing a more efficient network that reduces hardware redundancy. The diagram below illustrates the simpler base station hardware setup at an O-RAN network compared to a traditional network:




The premise of open-RAN networks is that, as the name suggests, the system is opened up and "unbundled", allowing products from different vendors (both hardware and software) to be mixed and matched, resulting in cost optimization.

Consider the Baseband Unit (BBU), which is a core computing hardware component of the base station (its function is to determine the "capacity" of the system). Under a traditional network, BBU is required at every base station. But under O-RAN, a virtualized network allows for base stations to be built without the BBU. A single BBU can be run from a centralized location, which connects to dozens of nearby base stations, and allows for computing resource to be scaled up/down dynamically as needed.

Essentially what this is doing is putting the BBU on the cloud. So, what does all of this accomplish from a financial point of view?

1. **A 40% reduction in network capex.** For a traditional telco network, the cost mix is roughly 30% software, 45% hardware, and 25% deployment. For Rakuten's network, the cost of software remains at 30%, but hardware cost can be reduced by 60% and deployment by 50%, resulting in overall savings of nearly 40%.

2. **A 30% reduction in opex**. This comes from reduced power consumption, reduced maintenance/site visits, and reduced site lease fees, all due to the lower hardware footprint. Traditional networks require one engineer per 1,000 subscribers, while Rakuten's network only requires one engineer per 20,000 subs.

You may be wondering - if this technology makes so much sense, then why haven't most existing telcos adopted this already?

Indeed, most industry experts seems to agree that the industry technological roadmap is headed towards this direction of openness and virtualization. However, adoption takes time. Think of why conservative enterprises, such as banks, stick to using their legacy systems for ages even long after it has ceased to be competitive. Telcos are averse to swapping out parts of their network to avoid the risk of disrupting service delivery. They are also wary of the enormous level of spending required, despite the lower running costs associated with the higher upfront spend.

Also, legacy vendor dependencies and relationships are in place. The ability for disruptive players like Rakuten to come into the industry and build a new network from scratch, unencumbered by the burden of legacy assets is a real advantage. It fits into the pattern that often disruptive opportunities exist precisely thanks to the fact that incumbents have vested interests in not changing. This is also why the early adopters of this new technological framework will likely not be the traditional telco players, but rather the new entrants or emerging market players who have a greater need for lower cost and more flexible networks.

While O-Ran is just one of the many parts that make up Rakuten's business, it is the part of Rakuten's business that the market is most bearish about and which has allowed us to build a stake in a business of Rakuten's quality at a reasonable valuation. I will discuss the broader investment case for Rakuten in the next section.

# Investment Case: Rakuten

By JJ Brink

⇒ Rakuten is the one of the largest e-commerce businesses in Japan and also has businesses in fintech services and a (loss-making) mobile business which the market has taken a very dim view of.

⇒ While Japan is a slow-growing economy with an ageing population, Rakuten's core e-commerce and fintech businesses have robust growth prospects and should continue to grow for many years.

⇒ We share the market's concerns about Rakuten's mobile business, but we believe Rakuten "core" of e-commerce businesses trade on a very reasonable multiple, and that there is value even if one assumes that Rakuten's mobile business simply breaks even (with optionality to the upside if it is profitable).

The global portfolio management team visited Japan in 2018 and came across a company called "Rakuten", which means "optimism" in Japanese. Founded in 1997 by billionaire Hiroshi Mikitani, a former investment banker and Harvard MBA graduate, Rakuten has been an incredible growth story. From 2000 through to 2015 the company dominated the e-commerce space in Japan and the stock delivered an incredible 2200% return.


Today, Rakuten is a multinational company that employs 15,000 employees worldwide, operates in 29 countries and generates revenues in excess of ¥900 billion ($8 billion). The company is still dominant in its home country of Japan.

Rakuten classifies its operations under 3 main segments:

1. **Internet Services**, which includes an online retail e-commerce business (Rakuten Ichiba) boasting more than 115 million customers in Japan (the 5th largest in the world and almost 90% of Japan's population uses Ichiba). Rakuten Ichiba is on track to hit ¥5 trillion ($44 billion) in Gross Merchandise Value (GMV) this fiscal year, which gives it a respectable 25% market share in Japan's ¥20 trillion e-commerce market. Rakuten Ichiba's growth has outpaced the broader e-commerce market and with Japanese e-commerce penetration at only 8% (vs. China 20%, South Korea 19% and the US 12%), there is still a long runway for growth ahead.

2. **Fintech Services**, which includes Rakuten Card (24 million card holders), Rakuten Bank (11 million accounts & the largest neo-bank in Japan) and Rakuten Securities (6 million users).

3. **Rakuten Mobile**, the company's latest undertaking which began operations in 2017 and promises to disrupt the incumbent telecom players in the industry through its Open Radio Access Network or "O-RAN" architecture.

Rakuten has massive scale, market dominance and an appetite to challenge the incumbents in markets in which it is a new entrant. Yet, the share price today is 80% lower today than it was in 2015, despite generating double the revenue it did in 2015. Behind every share price, there is a story to be told.

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**Rakuten – what happened?**

Quite simply, Rakuten Mobile happened. A very ambitious and very expensive undertaking, but one that the Japanese consumer desperately needed. Mobile pricing in Japan has been the subject of public discontent for quite some time. A report by the Japanese government showed that Japanese consumers spent 3.7% of household expenditure on telecom expenses, which was the fourth highest among OECD countries (vs. Korea 3.1% and US 2.5%).

Surveys have shown that many Japanese consumers viewed their telecom industry as predatory and unfair. The issue was further escalated in 2018 when Japan's Chief Cabinet Secretary publicly denounced the telecom industry and stated, "carriers should be able to cut their prices by 40%". This kind of rebuke by a high-ranking politician was unprecedented. The government was willing to support a fourth player that could disrupt the industry's cosy status quo. It was under this backdrop that Rakuten decided to enter the industry.

Rakuten Mobile set out to offer a disruptive pricing model via the world's first fully virtualized network (O-RAN). The company believes that its offering is a compelling alternative to legacy and proprietary networks.

Rakuten Mobile set out to offer a disruptive pricing model via the world's first fully virtualized network (open RAN).



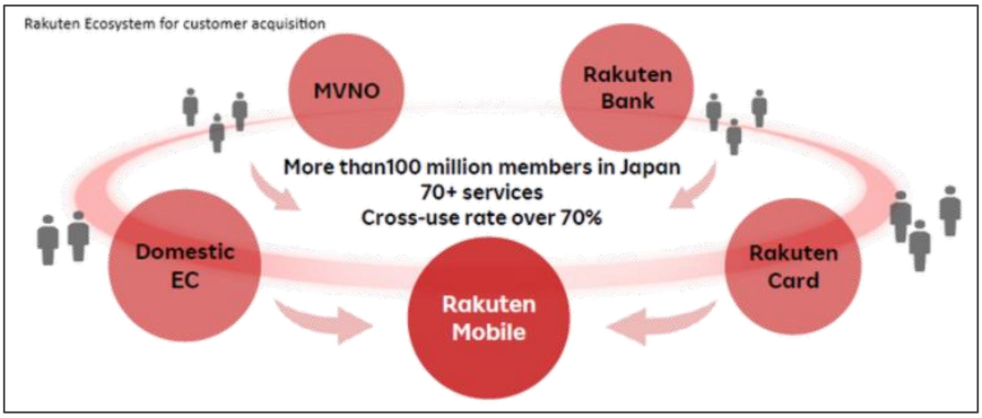
Besides the competitive opportunity, Rakuten saw two further benefits:

**1. Expand the cross-selling opportunity in their ecosystem**

Every consumer tech company has the desire to own top-of-the-funnel. This is the reason why Microsoft and Google make phones. Google pays Apple enormous amounts of money to stay the default search engine on iOS, but still decides to make its own phones. Today, our mobile phones are considered an extension of our body as consumers spend so much time on their mobile devices. This is the "top-of-the-funnel" from a consumer spending standpoint.

In Rakuten's case, the mobile application process is simple, quick and online and having a mobile operation could be the glue to the 70 plus services across 100 million members in the Rakuten ecosystem. This can be seen in the graphic on the next page.

So far, the undertaking has destroyed earnings.



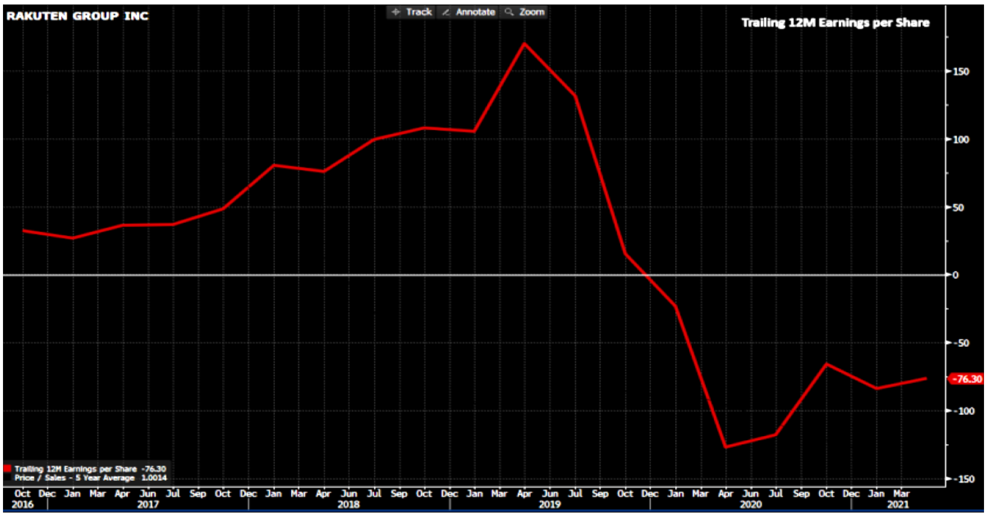

### 2. Rakuten Communication Platform (RCP) can be monetized

Recall the discussion earlier around O-RAN and what it means for mobile operators. Rakuten has the benefit of having a mobile operator (that consumers use) as well as owning the infrastructure that the operators use (operators pay network providers for usage of their network).

In more recent months Rakuten Mobile won its first major contract to export 5G network-building technology to German wireless carrier 1&1. The contract is for 10 years and should contribute up to ¥300 billion ($2.6 billion) in revenues for Rakuten. German wireless carrier 1&1 has 11 million subscribers, and it is promising to see that Rakuten Mobile can export its technology internationally. Therefore, it is quite possible that Rakuten's O-RAN infrastructure could become a desirable global product.

### Execution so far has been costly and slow

So far, the undertaking has destroyed earnings. Investors fled at the idea of a cash burn between ¥1.5 – ¥2.0 trillion ($18 billion) over 5 years (the equivalent of its total market capitalisation today). This can clearly be seen in the graphic below which illustrates how earnings plummeted when mobile base station deployment began in 2019.

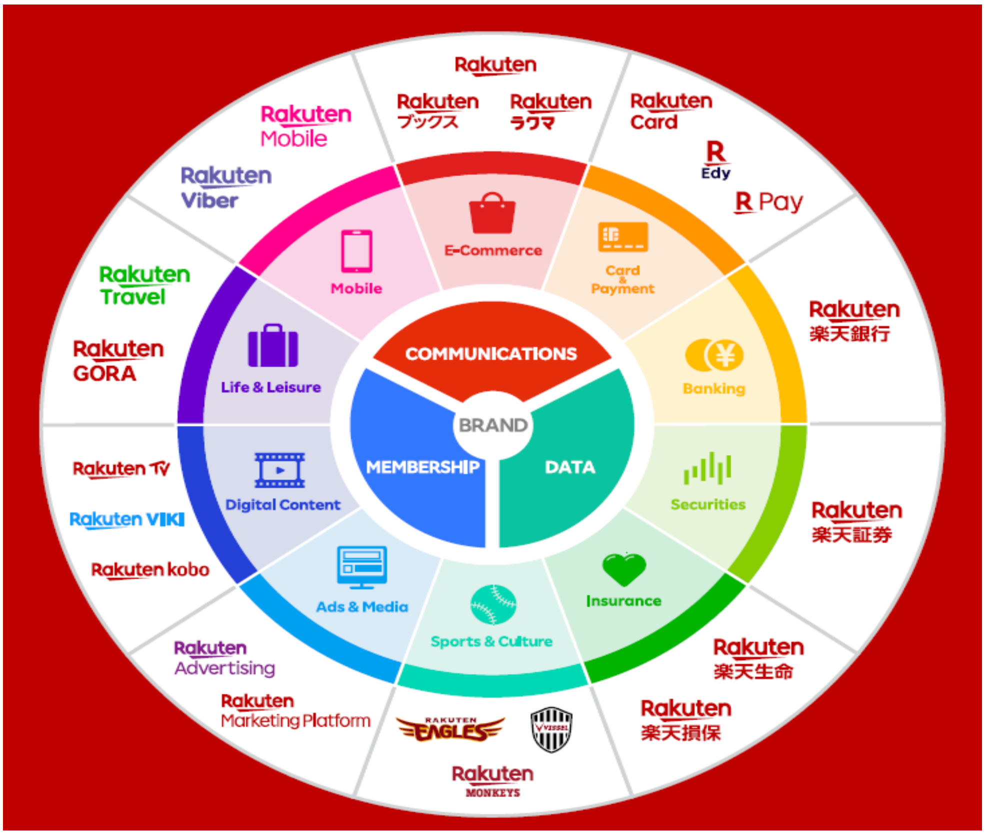



The question that comes to mind is at what point do long-term investors start looking through the storm to the pot of gold sitting under the rainbow?

Is the above graphic representative of the growth in Rakuten's operations and success in its future initiatives? We believe it isn't. Ex-mobile, Rakuten has still grown its revenue 15% year over year for the past 5 years. While the mobile expansion and some investments into its e-commerce logistics operation have been a drag on margins in recent years, these changes have been necessary for the company to remain competitive. Despite the exuberant capital outlay on the mobile business, the question that comes to mind is at what point do long-term investors start looking through the storm to the pot of gold sitting under the rainbow?

Rakuten already has two strong business segments (Internet & Fintech) that have been profitable for many years. These two business segments continue to be profitable and act as a funding mechanism to Rakuten Mobile. Rakuten's earnings have been bogged down heavily by the mobile expansion, however, the worst of this is behind them. We believe the market will slowly catch on to this, allowing the shares to reflect their true value.

The mobile business will add to the compelling ecosystem that Rakuten has built since 1997. The suite of Rakuten's offerings can be seen in the graphic below.




The beauty of a one-stop shop is that there are synergies between Rakuten's various products and consumers are incentivized to use as many of Rakuten's products as possible through its rewards programme. So far, the synergies are working: 74% of Rakuten users use two or more products.

We believe through examining recent earnings results, and our interactions with management, that the worst is behind Rakuten Mobile, and that we are getting to a point where long-term investors can see through the storm to a great asset being sold at a bargain price. If Rakuten Mobile can get to a break-even point by 2023, and the e-commerce and Fintech businesses continue to deliver results in line with their historical averages, there is more than 100% upside to the stock.

If Rakuten Mobile can get to a break-even point by 2023 and the E-commerce and Fintech businesses continue to deliver results in line with their historical averages, there is more than 100% upside to the stock.

Looked at through a different lens, if we assume that the mobile business is break-even by 2023, the stock trades on 12 times forward earnings. Remarkably, this is without considering the optionality that Rakuten Mobile becomes a highly successful operation.

# In conclusion

We write these Telescopes so that our investors know what it is we are doing, and why we are doing it. For many of you, we are the caretakers of a large portion of your global investments, and 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.

We believe it is of the utmost importance that all clients feel a true sense of the word "Partnership" in how we are aligned. Our portfolio management team reflects this with significant personal investments in the Flagship strategies.

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.

*Warm Regards,*

Pieter, Kyle and the Flagship Global Team

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