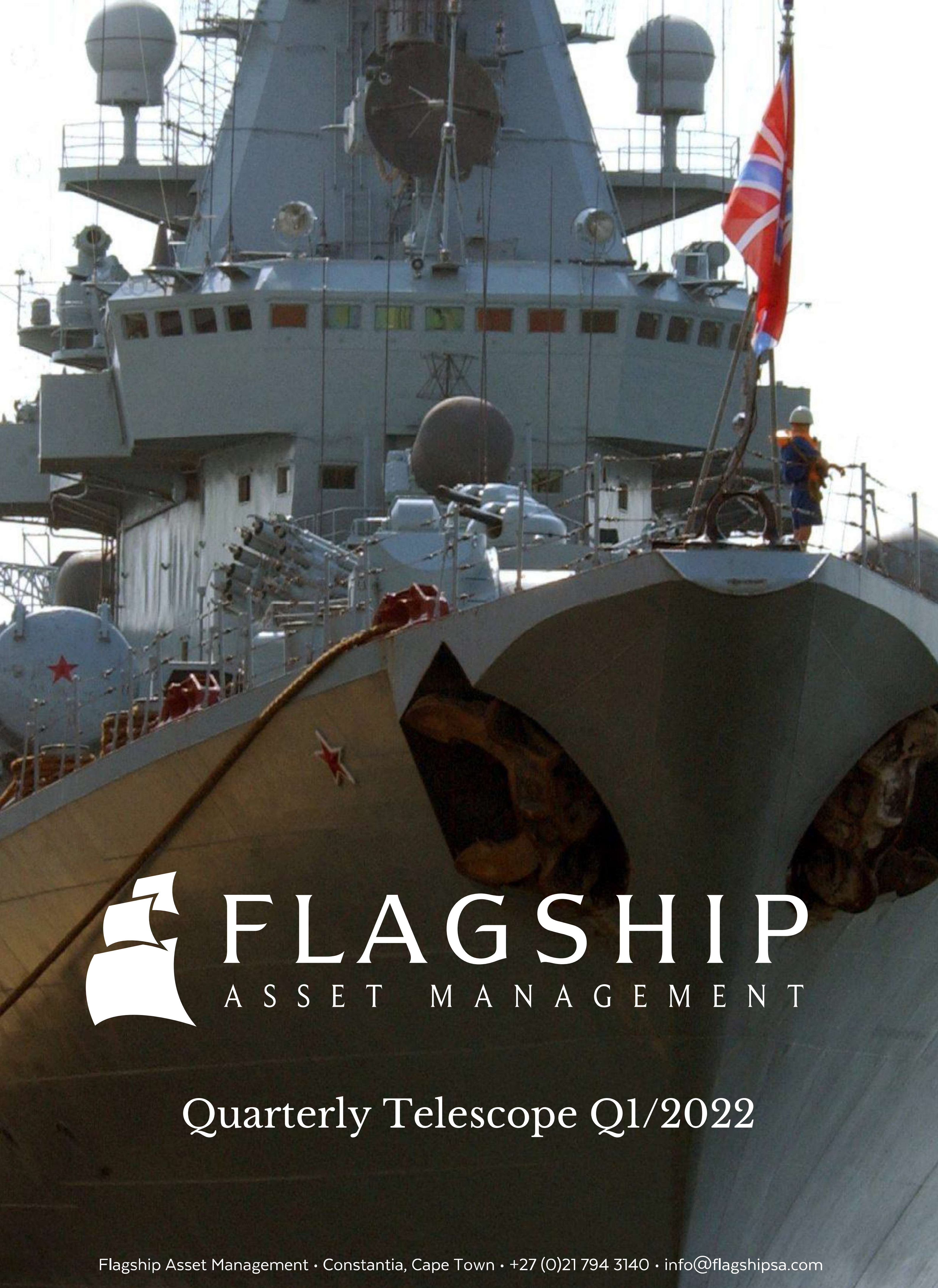

# FLAGSHIP
ASSET MANAGEMENT

## Quarterly Telescope Q1/2022

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

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 Funds 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.

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# 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 15 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 14 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.

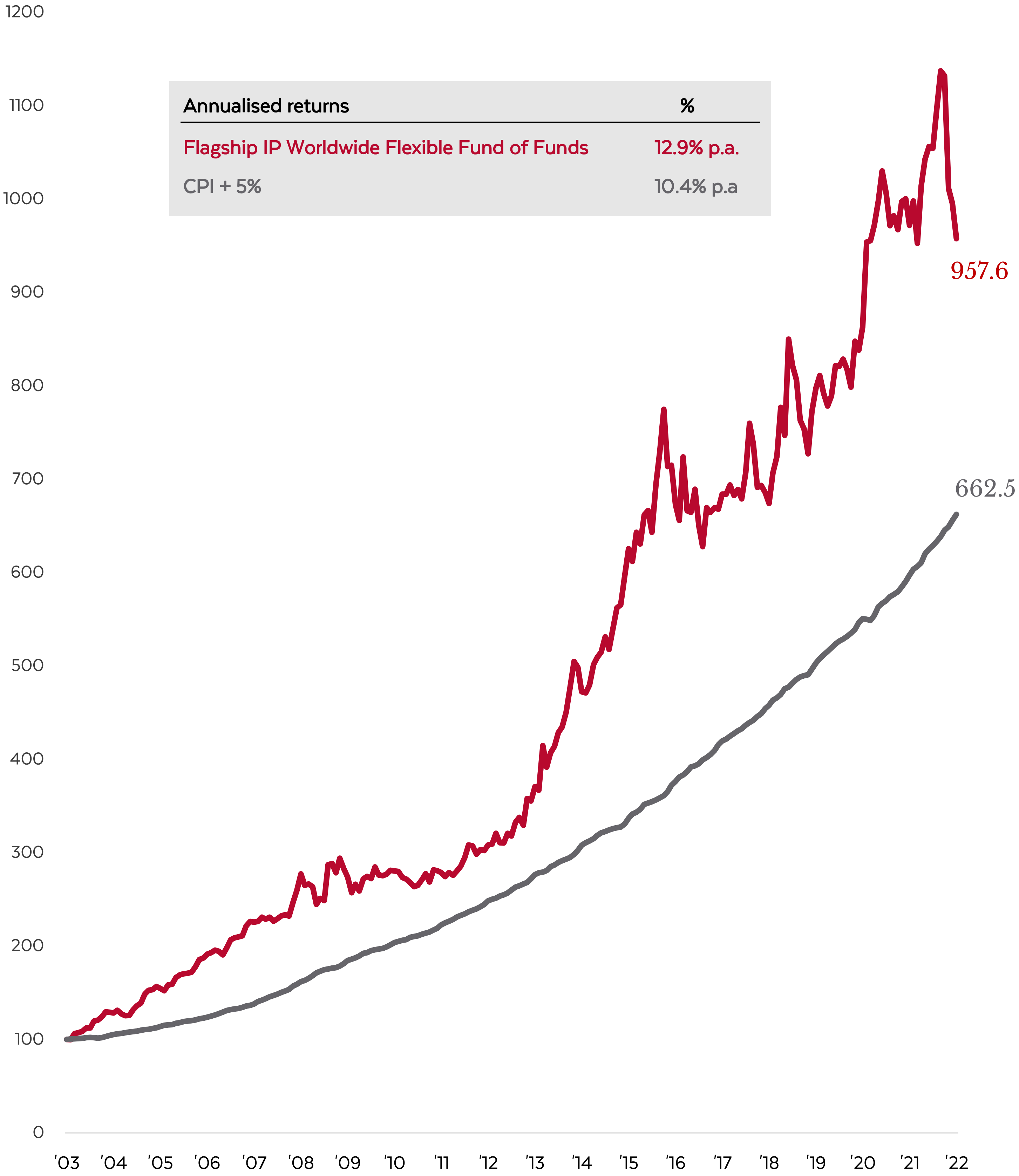
## JD Hayward (B.Eng.)

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 has passed all three levels of the CFA exam.

# The Power of Long-term Compounding

The **Flagship IP Worldwide Flexible Fund of Funds** (net of all fees) vs. SA CPI +5%

from 1 October 2001 to 31 March 2021 (20 years, 5 months)



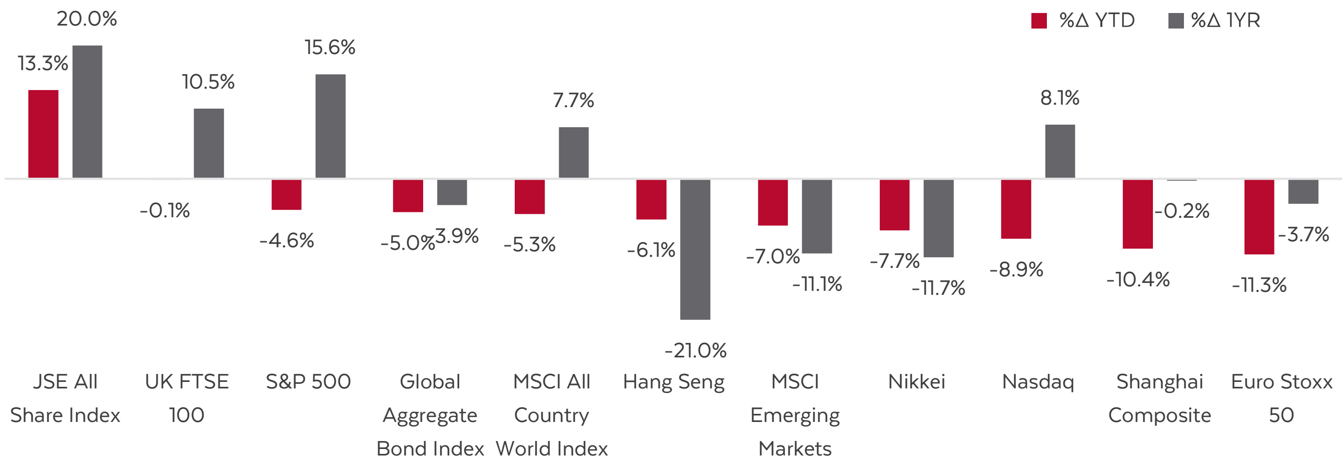
# War, Inflation and Wealth

"Successful investing is about getting everyone to agree with you…later."

-Jim Grant

"A lot of financial debates are just people with different time horizons talking over each other"

-Morgan Housel




**The first quarter has been dominated by Russia's invasion of Ukraine.** While US Intelligence sources had highlighted the build-up of troops on Ukraine's borders for a while, the market had assigned a very low probability of it actually happening … until it did, on the 24th of February. The world's reaction was swift. The largest package of sanctions ever announced against a country soon followed, with the assets of the Russian central bank being frozen, the quick exit of many companies from Russia (even if this involved massive write-downs of their investments), and individual sanctions levied against a number of prominent Russians.

While this move has very serious consequences for both Russia and Ukraine, it has had serious consequences for the rest of the world as well. Inflation was already sitting at elevated levels due to COVID-related supply chain disruptions, and now the removal of Russian supply from various commodity markets has added to the pressure.

Inflation was already sitting at elevated levels due to COVID-related supply chain disruptions.

It has also placed certain countries, like Germany, in a compromised position as they rely disproportionately on Russian hydrocarbons for over 40% of their energy needs. Finding alternative sources of supply will be difficult and will not happen overnight.

For forty years the EU has been happy to outsource their defence, manufacturing, energy and food production needs to other nations. Now it will have to insource many of these at greater cost. Energy is not the only item which is affected. Germany's chancellor has proposed the creation of a special EUR100bn fund for extra defence spending, as well as increasing annual defence spending to 2% of GDP.

The realization is also dawning that the concentration of certain supply chains, for example semiconductors in Taiwan, poses geopolitical risks. In response, the EU is now offering incentives to semiconductor companies, such as Intel, to build fabrication plants closer to home.

The Fed cannot sit idly by while inflation rates shoot up to their highest level since the 1970's. Inflation is a dangerous beast because it feeds upon itself: high rates of inflation translate into higher inflation expectations, which further fuels ever-higher rates of inflation.

This dynamic has pushed the Fed response from quantitative easing (QE) to quantitative tapering (QT). Until now we have seen benign signalling from the Fed, but the market has reacted swiftly to its more hawkish stance. US treasuries have sold off heavily, down 5.6% for the quarter, and a Fed Funds rate of 2.7% is already being priced in by the end of the year. Stocks have not been immune, with the MSCI ACWI down -5.3% for the quarter and the Nasdaq down -8.9%.

Since the global financial crisis the Fed has been a source of dampening volatility: responding to every bout of volatility with more liquidity. GDP growth has been very low but the world's stock markets have exploded, largely due to low interest rates. This is changing.

The loose monetary policies of the past 10 years have been beneficial to financial assets and their withdrawal is net negative for financial assets going forward.

While the fear of unanchored inflation expectations was always a risk, we did not anticipate the speed at which inflation expectations are changing. The loose monetary policies of the past 10 years have been beneficial to financial assets and their withdrawal is net negative for financial assets going forward. It will also have implications on our asset allocation. As inflation trends higher, the attractiveness of equity and bonds recede, and the attractiveness of real assets like gold and real estate increase.

The long period of globalisation which has characterised the last 4 decades has also changed. COVID, as well as the increasing bellicosity of China, the brittleness of global supply chains and increased nationalism are all behind these changes. For years we have been in an environment where companies sought out the cheapest places to make things. This was enormously beneficial to corporate profit margins, but in the western world, real median disposable incomes have suffered. Companies are now facing the decision to invest in locations which provide more security of supply, but this will come at a higher cost, which will put further upward pressure on inflation.

We are going through a volatile time, and this fact is reflected keenly in the Flagship Strategies. During this difficult time it is imperative that we continue to manage the portfolios according to the signals around asset prices that we are seeing, and allocate capital to the best ideas. In a rising interest rate world, the type of asset classes we invest in may change. However, the underlying principle of investing in high-quality, attractively priced assets will not change.

Currently, the steep draw down across the strategies means that our equity portfolio has over 60% upside using conservative assumptions. This implies attractive rates of returns for the coming years.

# Strategy Performance

The first quarter of 2022 saw negative performance across all our strategies:

- Our Global Fund of Funds Strategy declined -7.9% in USD and -15.4% in ZAR
- Our Global Flexible Strategy declined -16% in USD and – 23% in ZAR
- Our Global Equity Strategy declined -19% in USD and -25.6% in ZAR

In our Global Fund of Funds strategy, we saw a good showing out of GQG as well as our value managers given the rotation out of growth stocks into value stocks. It is worth mentioning that our growth managers have still substantially outperformed our value managers over longer-term time horizons.

In our Flexible and Equity strategies, we are not proud of what has been another bad quarter. This is entirely due to equity selection. The equity building block of all the funds is a concentrated selection of global equities that has performed poorly over the past 6 months. The falls have been led by 7 stocks that have fallen in excess of 50% since August last year: Zalando, Meta, PagSeguro, Ubisoft, PayPal, Alibaba and Duck Creek. The stocks currently account for 25.2% of the equity component and account for 2/3 of the underperformance. As the table below shows, for the six months to the 21st of April 2022, their share prices have fallen by 50% in aggregate. There are two major observations to make regarding the table below.

The first is that the underperformance has all come in the last 6 months. This is a relatively short time period in stock markets and there is strong evidence to suggest that – for good companies – the underperformance should prove transitory.

Regular readers know that we do not construct the equity portfolio with any cognizance of the index by sector or geography. It shouldn't and doesn't look like the index in any given year.

**Table 1: Major detractors in the Flagship Equity Portfolios**

| Stock | %Δ 6M | 1 Year Fwd P/E Ratio | Expected Revenue CAGR (FY0 - FY3) | Expected EPS growth (2 year avg) | PEG Ratio | Net debt to EBITDA | EV/FY2 Sales | Cumulative FCF next 3YR (as % of mcap) |
|---|---|---|---|---|---|---|---|---|
| ZALANDO | -47% | 31.7x | 16.0% | 39.5% | 0.8x | -0.9x | 0.8x | 3.5% |
| META PLATFORMS | -41% | 12.4x | 14.0% | 11.7% | 1.1x | -0.6x | 3.3x | 19.7% |
| PAGSEGURO | -58% | 11.0x | 23.0% | 32.3% | 0.3x | -0.5x | 1.4x | 13.7% |
| UBISOFT | -26% | 14.6x | 7.1% | 13.0% | 1.1x | 0.6x | 2.0x | 14.2% |
| PAYPAL HOLDINGS | -61% | 16.6x | 18.0% | 23.7% | 0.7x | -0.1x | 3.1x | 21.2% |
| DUCK CREEK | -47% | 123.8x | 15.2% | 44.0% | 2.8x | -18.1x | 5.6x | 1.2% |
| ALIBABA GROUP | -50% | 11.1x | 14.9% | 15.3% | 0.7x | -5.0x | 1.1x | 25.9% |

Rather, the themes affecting these stocks fall into a macro and a micro related camp. Zalando, PagSeguro and Alibaba have sold off for more macro related reasons (inflation and the effect on valuation multiples, German macroeconomic concerns, Brazilian macroeconomic concerns, Chinese regulation) while Meta, PayPal, Duck Creek and Ubisoft have sold off for business specific issues (Meta's pivot to the metaverse, PayPal slowing growth to prioritize higher value users, Duck Creek executing too slowly on its opportunity, and Ubisoft investing heavily into new game launches with uncertain payoffs).

It is important to note that none of these business cases are impaired. Each of the companies has grown their revenues in their latest financial year and is expected to continue growing their revenues in the next three years, each enjoys high (and, for most, increasing) levels of profitability, and with the exception of Ubisoft, are net cash.

Secondly, their valuations are undemanding in relation to the quality of business. With the exception of Zalando and Duck Creek where profitability (the 'e' in the PE) is depressed due to investments, the PE ratios of the stocks in the table are all below 17x next financial year's earnings. The cumulative free cash flow generation over the next three years of the shares in the table is, with the exception of Zalando and Duck Creek, in the mid to high teens. We believe that the future returns will look very different to the index, just like our past returns have looked very different to the index. ICON today has a weighted average P/E (1 year forward) of 21.2x. If we exclude Zalando (a large position that trades on a high multiple due to depressed profitability), the ICON PE is 18.5x. At the time of writing, the S&P 500 PE (1 year forward) is 18.9x. The weighted average ROE% of our holdings is 20.3% and the weighted average upside is over 60%.

**Table 2: Equity Portfolio Metrics**

| Metric | Flagship Equities |
|---|---|
| Top 10 (% of fund) | 56.3% |
| Weighted Average P/E (forward) of the portfolio | 21.2x |
| Median P/E (forward) of the portfolio | 18.1x |
| Weighted average ROE % | 20.3% |
| Weighted average Upside % | 62.8% |

We build investment cases that often do not see immediate return on our efforts. The fact that we have identified value doesn't mean that all our positions will express their value all at once, and it nearly never does. It has happened in the case of Capri, TCS and others. Sometimes the market seems to agree with our assessment of value and then changes its mind (like Zalando and PagSeguro). Sometimes we wonder if the market will ever come to realise just how cheap one of our shares really is (like Ubisoft or Alibaba).

An additional headwind for us in the quarter has been the strength of the Rand. Many competitors in the Worldwide Flexible sector have substantial exposure to South Africa which would have benefitted from both the good performance of SA stocks (due to the JSE being resource heavy) as well as the strong Rand. While the outlook for the Rand is positive shorter-term, we believe in the longer term it will continue to depreciate by greater than the inflation differential between South Africa and the United States due to declining South African competitiveness.

# Dealing with Drawdowns

While we believe that the drawdown in your investments will be temporary, this doesn't make it less painful.

What has exacerbated the current drawdown is that our equity benchmark, the MSCI World or MSCI ACWI (depending on which fund you are invested in), have both appeared relatively unperturbed as the positive performance of sectors which we are structurally underweight (like oil, commodities and financials) has offset the negative performance in sectors which we believe are our natural hunting ground (like consumer and technology stocks).

The reason why we are structurally underweight oil and commodity businesses is that we believe they are (in general) lower quality. This is based on the fact that they are price-takers (using oil companies as an example, they have no influence on the price of oil, which can exhibit wild swings and whose influence is felt right through their income statements), their reserves (or barrels of oil that they have claim to but haven't extracted) are in a state of drawdown unless they invest in exploration (many haven't) and finally, they are capital intensive.

Financials are similar to commodities businesses except the "commodity" they sell is money (in the case of banks) or risk-protection (in the case of insurers) rather than a physical resource. Banks and insurance companies compete for deposits and loans, and insurance companies for premiums primarily on the basis of price. These are macro related variables which are very difficult to gain conviction on.

Sometimes, however, the cycle provides us with opportunities to invest in commodity and financial businesses at prices less than what we believe they are worth.

While these businesses will never be the bulk of our holdings, sometimes, however, the cycle provides us with opportunities to invest in commodity and financial businesses at prices less than what we believe they are worth. Such is the case with HDFC Bank, as well as Suncor and Schlumberger.

For good quality businesses, we believe their share prices will ultimately reflect the earnings power of their businesses. Their deep moats, excellent management, low capital intensity and high free-cash flow conversion will compound at higher rates over time.

None of the companies that we hold which reported during the quarter gave us cause for alarm. We view the extreme sell-offs as an opportunity for the long-term investor. We welcome our investors to contact us should they require more detail on their investments with us.

# Value and Growth

One of the dynamics that was evident in the quarter was the rotation out of growth stocks into value stocks. The reason for this is that with growth stocks a larger part of their "value" sits in the future and when interest rates rise, that future value is discounted at a higher rate of return. At Flagship the equity discount rate we use is built up from the bottom using long-term prints for inflation and equity risk premiums, so we have already accounted for this.

While we hold certain stocks that contain growth in their valuation multiples, only 4 stocks in the portfolio today have a PE greater than 25x. This is just as many as the number of stocks that have single digit PEs.

# Equity Portfolio Changes

| OUT |
| --- |
| Endava |
| HDFC Bank |
| Antofagasta |
| TCS |
| JD.com |
| Huuuge Games |
| Wilson Bayley Holmes |

During the first quarter we exited **Endava**, **HDFC Bank**, **Antofagasta**, **TCS**, **JD.com**, **Huuuge Games** and **Wilson Bayley Holmes**.

**Endava** has long been a holding in the strategies, and has returned 108.8% since the inception of ICON on 29 July 2020. While it remains a great business, the expectations around growth and the multiple on earnings that it trades on are both at risk of declining in a rising interest rate environment.

**HDFC Bank** has returned 23.4% since the launch of ICON, and while the business remains robust, it was sold due to concerns around the Indian economy in a higher commodity price environment. Banks are, to a large degree, macro creatures and require cognizance of their specific regional risks.

**Antofagasta** was sold due to deteriorating operational issues experienced in Chile, where its mines are located. Drought conditions have seriously curbed the copper output that Antofagasta will be able to generate this year, while ongoing cost overruns are foreseen due to labour and inflation issues in the country. It's total negative return for ICON shareholders was a mere 0.13%.

**TCS** was sold for a large profit prior to the Russian invasion of Ukraine. The stock has been the largest contributor to all the strategies since inception. **JD.com** was sold due to the consolidation of the fund's holdings in China to reflect the increasing regulatory and macroeconomic risks apparent in that country. Our sole Chinese equity holding is now Alibaba.

**Huuuge Games** and **Wilson Bayley Holmes** were both sold due to the investment thesis on those stocks being proven incorrect. In Huuuge Games' case, the thesis was for a consolidation of the Polish gaming space and further diversification from their single franchise (Huuuge Casino), which did not materialise. In Wilson Bayley Holmes the thesis was for profit to increase across its divisions as construction activity in SA resumed, but much of this benefit was offset by their expensive exit from Australia.

We expect to make mistakes in our investment cases from time to time, and the risk and reward for both these positions was sized appropriately in our view. By identifying the mistake and selling early we have protected capital for our investors: Huuuge Games was sold at PLN 25 versus a current share price of PLN 16 (as of April 25, 2022).

**IN**

| |
|---|
| Suncor |
| Schlumberger |
| Adobe |
| Dick's Sporting Goods |

During the first quarter we added **Suncor**, **Schlumberger**, **Adobe** and **Dick's Sporting Goods.**

**Adobe** is a business we have owned before, which, after a 40% fall from its peak last year, is now looking attractive again. **Dick's Sporting Goods** will be discussed later in this Telescope.

**Suncor** is a Canadian Oil Sands and Syncrude Business. With their substantial capital costs and oil-focused production mix, Canada's oil-sand producers are among the biggest beneficiaries of higher crude prices. Suncor is effectively a capital management investment case, with higher crude proceeds going to pay down debt and buy back shares. Suncor may distribute as much as 12% of its market cap in 2022 to shareholders, on top of the 10% distributions in 2021. They are in a very secure jurisdiction (Canada) and have highly regarded management. Suncor's diversified model, with a strong upstream position complemented by a robust downstream presence, is the ideal mix for the global oil market outlook for this decade. The stock trades on 6.5x 2022e earnings and a 4.2% dividend yield.

**Schlumberger** provides a wide range of services, including technology, project management, and information solutions to the international petroleum industry as well as advanced acquisition and data processing surveys. The Company is diversified across Well Construction (37% of '21 revenue), Production Systems (29%) and Reservoir Performance (20%), while digital services provide the balance of 14%. Due to the lack of capex committed to the petroleum industry over the last 4 years, Schlumberger's revenues in 2021 were only 70% of what they were in 2018 (when oil prices averaged $71 per barrel). We see this situation changing as the world economy realises that greater investment into petroleum is required to meet the energy requirements of the world over the next decade, when we expect renewables to become a larger part of the energy mix. Schlumberger trades on a 6.2% 2023 FCF yield and a 15.4x PE multiple (2023).

# Bottom fishing in emerging markets doesn't always work

**When price-earnings (P/E) multiples fall and never recover**

By Pieter Hundersmarck

There are two occasions when bottom fishing or "catching a falling knife" doesn't work. The first instance is classic overvaluation, which is when the valuation of a share discounted over-zealous prospects at the time of purchase. Because you overpaid, buying all the way down will rarely generate a great return, unless you apply more than your initial capital (which few investors do). The second instance is when there is a structural shift in the way a geography or sector is valued by the market.

**Be careful to buy overvalued stocks just because they have fallen**

Cisco provides a good example of the first. At the turn of the new millennium, the IT hardware, software and networking equipment company was one of the hottest stocks in the US stock market. From early 1999 to March 2000, the shares rose over 200% to $80 per share, backed by euphoria about the technological shifts brought about by the internet. The thesis was solid: as a provider of networking equipment, Cisco was the "shovel-seller in the internet gold rush".

But the thesis was also well understood. At the March 2000 peak, Cisco's P/E multiple stood at over 200 times. As the dotcom bubble deflated, Cisco's share price collapsed by 80%, a total market capitalisation loss of $431 billion. Today, Cisco's shares trade at $56, still 30% below their peak reached over 20 years ago.

**Changing narratives can permanently impair the earnings multiple the stock market will attach to a country**

The second example of bottom fishing not working out is perhaps more intriguing. Structural shifts in the narrative around a specific geography can destroy market multiples as well as any reversion-to-mean argument. Russia provides a recent example of how this shift can damage portfolios. China provides a worrying example of another shift that may be taking place.

The popular investment narrative around emerging markets goes something like this: emerging markets are volatile, and they go in and out of favour due to commodity and currency flows. Timing these various macro-related flows will allow you to reap generous rewards, or lose your shirt.

Not all emerging markets are the same, and its high time investors stopped bundling them together.

For example, commodity producers like Brazil, Russia and South Africa benefit from commodity price booms until their local inflation gets out of control and their currencies tank. Russian shares are a play on oil and gas-related revenues and their effect on the economy. Commodity importers, like India and Turkey, typically benefit from low oil prices and perform poorly when commodities rise.

Not all emerging markets are the same, and it's high time investors stopped bundling them together. Besides their various commodity or economic blessings or curses, the main variance comes in the type of government, and the type of equity culture that this creates.

Equity culture covers two aspects. The first is the willingness and ability of a population to invest in equity as an asset class.

Investors in many emerging markets typically put their money into tangible assets, such as real estate or gold, before they are lured into the financial market. As wealth rises, this changes. However, a lack of trust in regulation and financial institutions is one reason why emerging populations may be wary of financial assets.

South Africa, as well as Chile, are the rare exception to the rule. Retirement investment in individual capital accounts was made compulsory for Chilean workers in 1981. As a result, a local equity culture, which includes significant overseas investments, has developed. South Africa has one of the most developed life insurance markets, dating back to when companies like Old Mutual were founded at the turn of the last century.

The second aspect is the regulatory and institutional environments that protect investments in financial assets. Most emerging markets are highly protectionist, domestically focused, and overseen by considerable amounts of government intervention. In China, for instance, the state typically has a majority stake in listed companies, so there is at least the potential for a conflict of interest between the regulators and minority investors.

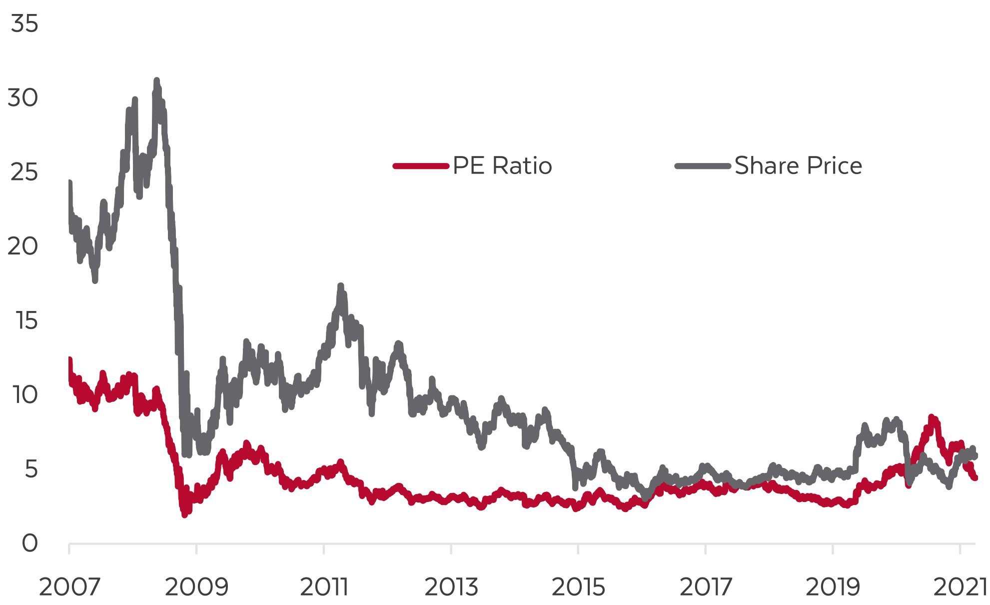
Democratic, capitalist countries like India and Brazil have a chance at becoming better places for equity cultures to thrive.

Democratic, capitalist countries like India and Brazil have a chance at becoming better places for equity cultures to thrive. Repressive regimes like Turkey, Russia and China offer far less opportunity for the required frameworks and trusted institutions to be created.

When these institutions are weak, or there is a risk that the conflict between state and shareholder is irreconcilable and subject to change at whim, then investors are on dangerous ground.

The largest stock in Russia, Gazprom, is a good example of how narratives can change. When Russian stocks opened for global investors in 1996, the first 10 years saw the Russian Trading System (RTS) Index rise 2 662% to its peak in December 2007. Much of this was due to a low base effect as well as strong commodity prices. However, many Russian stocks also attained similar P/E multiples to their developed market peers. Gazprom in particular began trading at over 11 times earnings in 2006, which was on par with BP plc.

**Chart 1: Gazprom's Share Price and PE Ratio (Jan 2007 – March 2022)**



However, things changed. In August 2006, the Yukos Oil company expropriation changed the risk appetite for Russia. The misalignment between the state and shareholders became obvious as Gazprom and other state-influenced firms pursued initiatives that marginalised shareholder interests. Even as commodity prices recovered post the global financial crisis, Gazprom's P/E multiple sank to an average of 3.5 times from that point on, never to recover.

The most recent example of the tension between the state and minority shareholders is Chinese equities. Investing in Chinese equities like Tencent requires investors to differentiate between business-specific risks (including structural changes that are occurring in the Chinese tech/gaming and e-commerce markets) and market risks (including the P/E multiples that Chinese shares should trade at relative to global peers). This can be a tricky call. Is the past a good indicator of what P/E multiples Chinese shares should trade at versus their global peers? An investor betting on the multiples of Russian shares in 2006 mean-reverting to their long-run average with global shares would have been spectacularly wrong.

Certain geographies provide an altogether different risk profile beyond the risks apparent in developed equity markets.

China and Russia are not uninvestable per se. But things can change. Certain geographies provide an altogether different risk profile beyond the risks apparent in developed equity markets. Investors need to know their risks, especially their tail risks, for when structural changes are happening.

Equity investing works over the long term primarily due to the institutional and regulatory bodies that protect equity as an asset class. They allow members of capitalist democracies to participate in the growth of their economies and to use that growth to build capital for retirement. Since the US and Europe have a long history of equity culture and their retirement funds, their pensions, and their foundations all invest in equities, there is a certain sense of '"we're all in this together". Tail risks are lower.

In China, Turkey and Russia, none of these conditions hold. There are a few large pension funds that need to invest in regulated equity markets to provide for citizens' retirement. There aren't many retail investors investing in their local markets. Instead, the main funder of retirement is the government pension system (which is effectively a claim on tax revenue). Equity prices are primarily a function of international investors dipping in and out of the country.

**Could China be the next Russia?**

Given the precipitous falls in Chinese stocks, there are many armchair investors who have been buying the dip, in the hope that their contrarian stance is proven correct. Things move in cycles after all, and the current disgust with Chinese shares due to heavy-handed regulation may also pass.

While they may be correct in the shorter term, for many investors, all the wrong lessons will be learned. As Chart 1 shows, investing with the rear-view mirror offers false confidence. Russian stocks may yet recover, but the shares will most certainly trade at depressed multiples versus their previous levels. It would be interesting to see if Tencent ever trades at over 30 times earnings again.

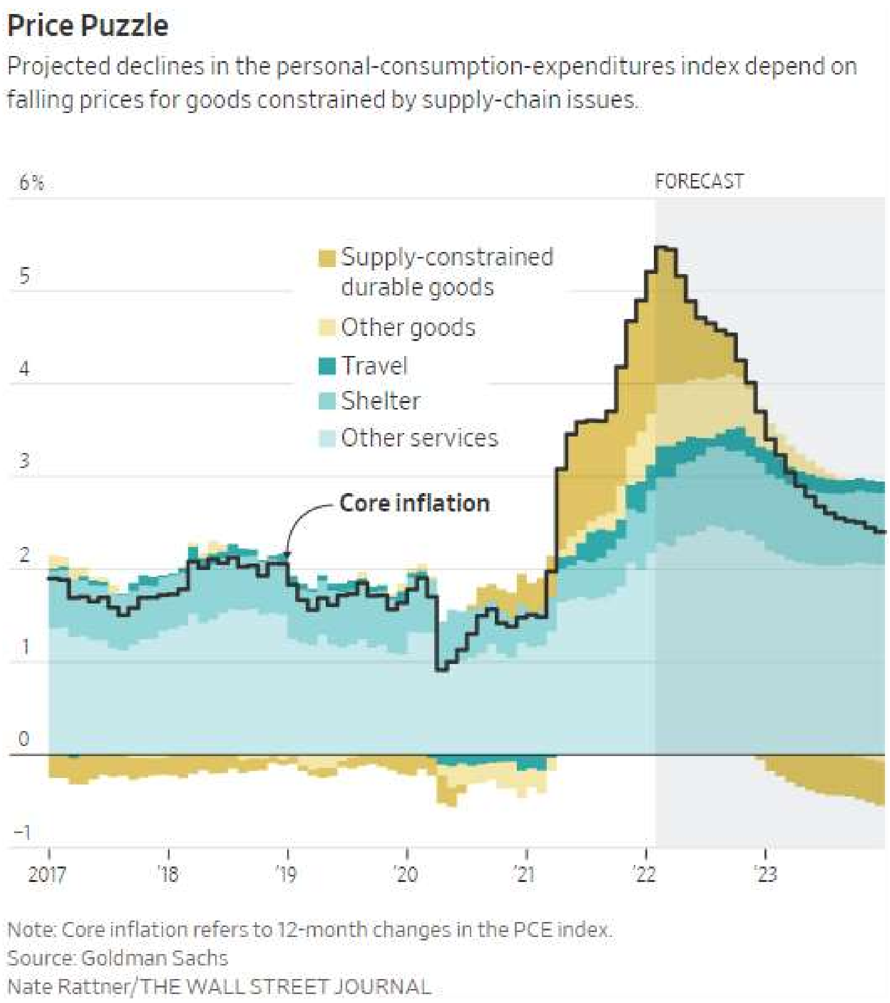
# Why is inflation bad for the economy?

By Kyle Wales

For the last year opinions around the future path for inflation were divided into two camps. The inflation hawks backed the thesis that inflation was likely to be transient, due to the once-off nature of the supply chain disruptions brought about by COVID. The second camp believed that inflation would rise faster and persist far longer due largely to loose monetary policy.

Today, as the chart below shows, most economists still expect that inflation will be transient, with US CPI forecast to be 6.2% y-o-y in 2022, then tapering swiftly to 2.6% y-o-y in 2023 and 2.2% y-o-y in 2024 (forecast as of April 4, 2022). Risks, however, remain to the upside. This is evident from the fact that the dispersion around 2023 forecasts has increased, with some banks expecting inflation to be as high as 3.6% in 2023.

**Chart 2: Inflation expected to ease into 2023**




The removal of Russia from global markets has had a huge impact on inflation.

Ukraine has played a substantial role in this. The removal of Russia from global markets will have a huge impact on inflation globally due to the outsized role Russia plays in many of these markets. In commodities as diverse as petrochemicals, wheat, nickel, diamonds, platinum group metals, Russia is either the largest or second largest producer. Of these, the rise in the price of oil to north of USD 130 per barrel will be most keenly felt because it affects the prices of a myriad of other items.

It is only when inflation crosses a certain (high) threshold that it begins to have a deleterious effect on economic growth.

But let's take a step back.

Instead of merely observing that inflation rates are rising globally and with them interest rate expectations, a question I believe is not asked often enough is: "Why is inflation bad for the economy?"

Opinion is actually divided as to whether inflation that is not 'too high' is actually bad for the economy. The reasons for this are far from clear cut. When inflation is moderately high, which is the case currently, academic research on the subject is actually divided as to whether it is bad for the economy. It is only when inflation crosses a certain (high) threshold, that opinions on this subject begin to align. When this high level is reached, there are three main reasons why it has deleterious effects on economic growth.

**Inflation erodes purchasing power**

The first reason is that very high rates of inflation erode the purchasing power of economic actors. If the same basket of basic items costs a lot more than it used to, ordinary people have less money to spend on discretionary items. Consequently, businesses which sell these items experience a decline in their sales.

Yes, workers may be successful at negotiating higher wages to compensate for higher prices but this normally happens with a lag so there will be a period where workers are out of pocket. This is especially the case when there is very high ... and rising ... inflation.

**Inflation discourages investment**

The second reason why very high inflation is bad for economic growth is because it discourages investment; a key driver of economic growth. Robert Solow's growth accounting equation deconstructs economic growth into three factors. I have provided a modified version below.

<u>Solow's equation</u>

*Rate of economic growth = (1) (rate of) increase of productive labor + (2) (rate of) increase in physical (as opposed to financial) capital + (3) increase in productivity.*

When inflation is very high, people are less likely to leave money sitting idle in their bank accounts and it is this money which banks loan to aspiring entrepreneurs to invest in physical capital or invest in productivity enhancing measures.

**Inflation is bad for asset prices**

The final reason why very high inflation is bad for economic growth is that inflation is bad for asset prices. It is no secret that inflation is bad for nominal bonds because it reduces real (after inflation) interest rates. What may come as more of a surprise is that very high rates of inflation are bad for equity prices as well.

The table (Exhibit 7) on the following page assesses the whole range of possible return streams in the context of their returns as inflation rises. It shows the average return of a range of assets/factors since 1970 conditioned on the level of inflation in a given year. Equities are one of the most effective assets to hold as inflation rises, at least until inflation reaches the 5% level.

While equities, especially high-quality equities which are able to pass on rising costs, do a pretty good job of preserving their earnings in real terms in the long term, in the short term they are likely to sell-off alongside everything else when inflation is very high because they are long duration assets. During the decade of the 1970's – which is the decade best remembered for its high inflation rates – the returns US equities provided were two percentage points below the inflation rate itself.

EXHIBIT 7: **Factor and asset performance in different inflation regimes**

| Since 1970 | US Equities Total Return, yoy | US Bonds Total Return, yoy | Equity: Price to Book, yoy | Equity: Dividend Yield, yoy | Equity: Momentum, yoy | Equity: Variance, yoy | FI Momentum, yoy | FI Carry, yoy | FX Carry, yoy |
|---|---|---|---|---|---|---|---|---|---|
| <-1 | -23.12 | 7.63 | -2.53 | -4.97 | -46.11 | -8.43 | -4.72 | 1.46 | -7.10 |
| -1 to 0 | -8.75 | 10.63 | -6.46 | -3.17 | -2.95 | 25.66 | 4.48 | 2.64 | -5.31 |
| 0 to 1 | 2.54 | 4.39 | -9.18 | -0.57 | 12.61 | 16.44 | 0.90 | 1.85 | -5.43 |
| 1 to 2 | 14.68 | 8.98 | 0.96 | 1.66 | 5.68 | 5.72 | 1.12 | 3.02 | 1.90 |
| 2 to 3 | 17.94 | 5.97 | 4.32 | -0.59 | 4.27 | -2.01 | -0.25 | 0.54 | 4.63 |
| 3 to 4 | 12.86 | 11.19 | 3.75 | 2.44 | 11.51 | 4.92 | 0.31 | 2.04 | 3.59 |
| 4 to 5 | 10.98 | 8.75 | 4.66 | 1.71 | 5.89 | 10.69 | 0.12 | 0.41 | 4.98 |
| >5 | 5.19 | 5.29 | 8.51 | 4.45 | 12.86 | 6.60 | 0.31 | 4.66 | 2.01 |

| Since 1970 | US REITS, yoy | Real Estate Index, yoy | GSCI Commodity Index, yoy | Brent Oil, yoy | Gold, yoy | US Energy relative, yoy | US Metals & Mining relative, yoy | Silver, yoy | High Yield Bonds, yoy |
|---|---|---|---|---|---|---|---|---|---|
| <-1 | -37.47 | -9.25 | -53.16 | -42.59 | 7.86 | -11.56 | -15.63 | -1.98 | -0.17 |
| -1 to 0 | -11.10 | -4.34 | -42.22 | -42.91 | 2.40 | -8.41 | -19.51 | -11.55 | -4.72 |
| 0 to 1 | 3.67 | 3.95 | -34.74 | -39.21 | -5.11 | -20.19 | -27.82 | -13.80 | -2.31 |
| 1 to 2 | 17.71 | 5.37 | -8.32 | -11.06 | 4.35 | -8.73 | -9.11 | 2.75 | 8.66 |
| 2 to 3 | 22.50 | 4.26 | 9.31 | 15.37 | 7.00 | -1.72 | 6.03 | 11.04 | 12.85 |
| 3 to 4 | 21.90 | 4.68 | 18.98 | 19.68 | 10.58 | 4.54 | 1.41 | 11.78 | 8.82 |
| 4 to 5 | 4.20 | 4.04 | 21.51 | 17.57 | 5.74 | 6.69 | 6.73 | -2.32 | 5.92 |
| >5 | 9.41 | 8.00 | 20.10 | 39.07 | 21.39 | 5.70 | 1.57 | 22.90 | 1.48 |

Note: Returns for Energy, REITS, and Metals & Mining are from 1974, returns for FX Carry are from 1975, returns for GSCI Commodity index and Oil are from 1971, and High Yield Bond returns are from 1987. Equity PBK, Dividend Yield, Momentum, Variance, Residual Variance and FI Momentum, FI Carry and FX Carry factor strategy returns are Long-Short. Energy and Metals & Mining sector returns are relative to broader US equity market. Real Estate Index returns are from Robert Shiller's Real Estate return database.

Source: Ken French database, AQR, Robert Shiller's database, FactSet, FRED, Datastream, and Bernstein analysis

Why is this relevant? In economics there is a behavioral effect known as the "wealth effect" which suggests people spend more money as the value of their assets rise. This provides stimulus to the economy as a whole. The inverse is also true. When the value of people's assets decline, they spend less and this withdraws stimulus from the economy.

### Conclusion

The world has benefitted from stable, low inflation for a number of decades. In this respect, it has been helped by the shift of supply chains from high labor cost regions like the United States to low labor cost regions like China and other places in Asia. This trend may be reversing. It has also benefitted from a shift to a knowledge-based economy where there isn't a 1:1 relationship between inputs and outputs. Software companies, for example, do not have to increase their labor force at the same rate they increase their sales. Fortunately, this trend remains intact.

My base case would be for current high rates of inflation, assisted by a monetary policy response from the Fed, to be temporary. However, this does not detract from the fact that inflation risks are more elevated than they have been for a very long time and policy-makers as well as investors need to monitor the situation carefully.

# Flagship Primers: State of the US consumer

"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 JD Hayward

The United States remains the largest and most influential cog in the global economy. At ≈$22 trillion it accounts for roughly 25% of global GDP.

⇒ The United States remains the largest and most influential cog in the global economy. At ≈$22 trillion it accounts for roughly 25% of global GDP. This compares to ≈$17 trillion each for China and the entire EU.

⇒ Data from the IMF suggests that US GDP growth will slow down over the coming years, having seen a boom in 2021 on the back of a shrinking economy in 2020.

⇒ Inflation is approaching the 8% mark - the highest levels it's been since the early 1980's. Growth concerns coupled with surging inflation has sparked comparisons between the stagflation that characterized the US market in the late 70's, and the state of the US economy today.

⇒ Although US households have built up $2.5 trillion in excess savings over the last two years, the global pandemic, Russian invasion and threat of recession have all caused consumer confidence to decline.

⇒ This, along with increasing mortgage rates, has prevented and will likely continue to prevent consumers from spending excess savings, rather opting to pay down debt and invest in a number of savings vehicles.

⇒ Consumers are therefore likely to find themselves with less debt and more savings, but with an unwillingness to increase their discretionary expenditure at this stage.

The saying that the world catches a cold when the US sneezes remains very much the status quo. At 5.8% YoY growth, US economic expansion in 2021 was the fastest seen since 1984. Of course, this does come on the back of the single worst year of GDP growth in more than 70 years, which saw total output decline by 3.4% as COVID-19 ravaged the global economy. The International Monetary Fund expects growth to remain relatively high for 2022, then slowing down to roughly 1.7 % annually in the coming years.

Of more concern than the slowing growth, is the rampant inflation levels in the US economy - approaching 8% YoY and hitting 40-year-highs on a monthly basis. The average YoY increase +1 standard deviation since 1950 is 6.3% (the horizontal line in the chart on the next page), a level that was breached in 2021, having previously done so in 8 out of 9 years in the mid 70's to early 80's.

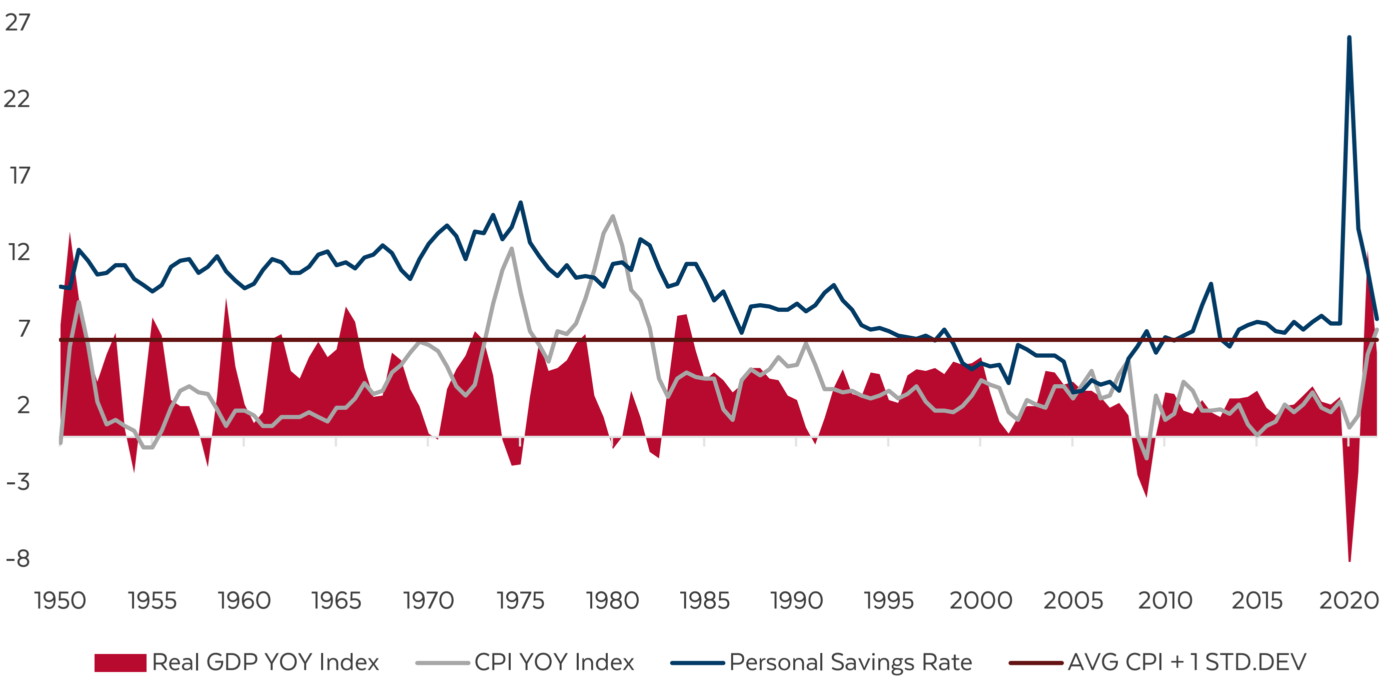
The prospect of slowing growth, high inflation and surging oil prices have understandably stoked debate about the differences and similarities with the 70's, and whether we might be heading towards another period of stagflation.

Other than similarities such as slowing growth (from 1979 – 1982 in the chart below, GDP growth averaged 0.6%) and inflation reaching unsustainably high levels, there is also the eerie similarity of a war resulting in a rapid oil price shock. In the 1970's we saw an oil embargo enforced by major oil producing countries at the time, today we have a Russian invasion putting pressure on global energy prices.

There are, however, a number of important factors that are very different if we start comparing now with then.

1. From a US perspective, the OPEC countries that enforced the oil embargo controlled a much larger share of the market than Russia does today.
2. The embargo sent oil prices surging more than 300% in little more than a year. A shock of such magnitude is unlikely in the current environment, barring a situation where the invasion evolves into a full scale European or World War.

**Chart 3: Real GDP growth, inflation and the personal savings rate in the US**




3. Energy consumed for each unit of GDP generated was about 3.5 kWh per USD in the 70's. Efficiency gains means this has come down to less than 1.5 kWh per USD, meaning a shock of the same magnitude will have less effect on economic output.
4. Wage pressure in the 70's and 80's was much higher than it is today. This would have created more inflationary pressures in the economy at the time.

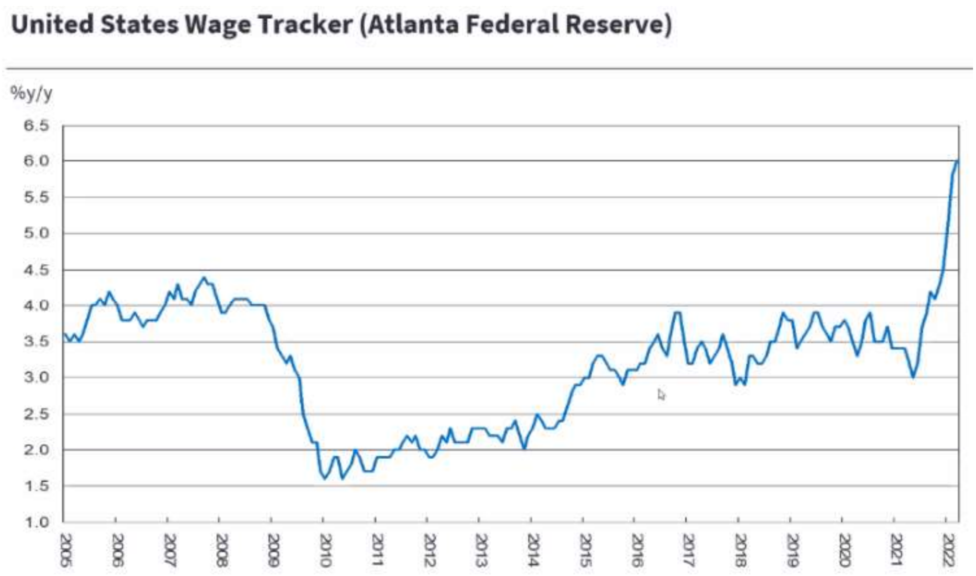
While there are a number of reasons to believe that we will not see a repeat of the stagflation that characterized the 1970's, it remains something to be cognisant of.

**The US consumer: Fine, but not flourishing?**

Since 2012, real US household income has been on a steady upward trend after a decade of declines starting in the early 2000's. Wealth levels in 2000 were only reached again in 2016. Today, median income is close to all-time highs, but is again facing downward pressure due to COVID. Going forward, there seems to be a number of conflicting indicators when assessing the state of the US consumer and the factors influencing it. An inversion of the yield curve has historically been an accurate leading indicator of coming recessions. While this is not yet the case, we are close to it.

As of March 2022, there is almost a 2:1 ratio of job openings to unemployed workers. Predictably, this is leading to higher bargaining power on the side of the employee, resulting in an increase in wages, as well as adding to inflationary pressures in the market. This is illustrated in the graph on the next page.

Graphic 1: US wage tracking at the highest rate in 15 years



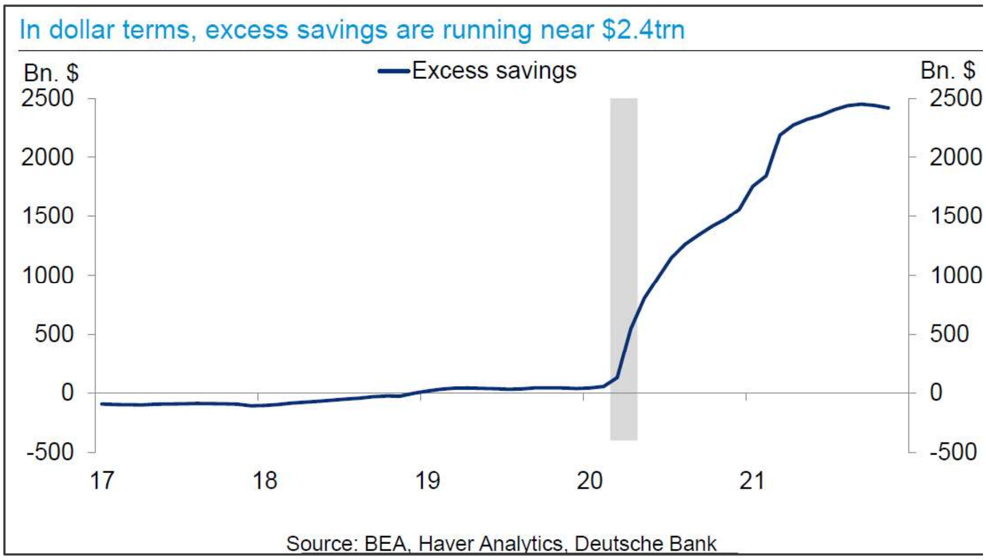

The flipside of this coin is that the coming rate hike cycle will apply the brakes on the economy, which could quickly lower the ratio of openings to unemployed.

Ample job opportunities have led to a sharp recovery in consumer confidence from the depths of the pandemic, with unemployment rates remaining low. Over 19 million of the 22 million jobs lost during COVID have been regained. However, after the fast recovery, confidence levels took a knock again due to the Russian invasion.

There has been a large build-up of excess savings due to consumer spending plummeting, as well as the stimulus cheques provided to millions of US consumers. These excess savings can clearly be seen on the graphic from Deutsche Bank below. Based on this sudden excess of ≈$2.4 trillion (about 13% of total GDP), one could easily conclude that the US consumer has to be flush with cash.

Based on this sudden excess of ≈$2.4 trillion (about 13% of total GDP), one could easily conclude that the US consumer has to be flush with cash.

Graphic 2: Excess Savings (Source: Deutsche Bank)

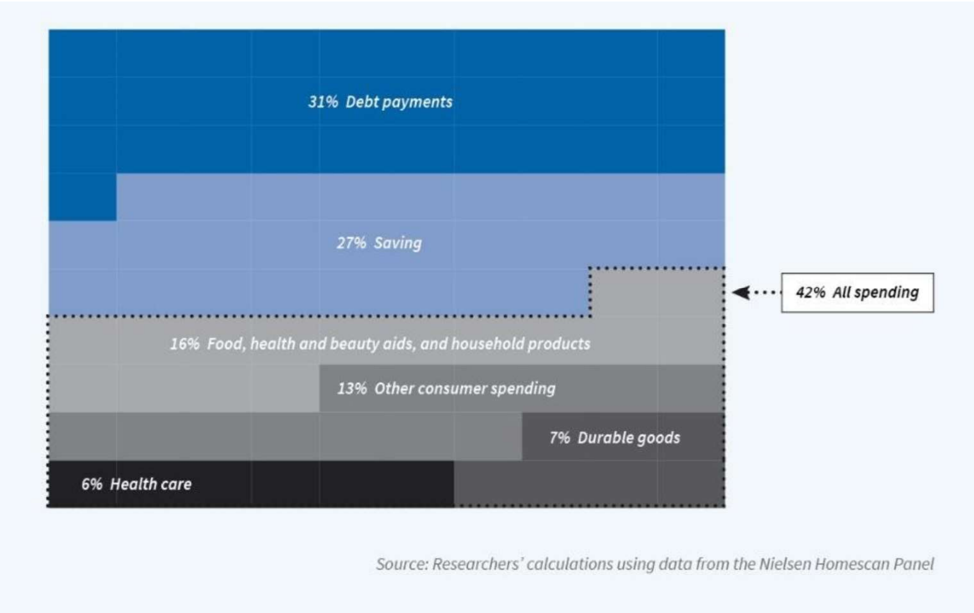


Moody's estimates the excess will be reduced by about $50 billion per month through to the end of 2023, meaning that only about $1 trillion will be spent, and most of this by low- and middle-income households where there is a much higher Marginal Propensity to Consume (MPC).

This is consistent with economic theory which indicates that foregone consumption is more likely to be treated as wealth, providing little impetus for future spending - the MPC of income is much higher than the MPC of wealth. TD Economics calculates that the total portion of excess that is attributable to foregone consumption is about 50% - meaning that this portion has a low MPC attached to it and is unlikely to act as a stimulus to the US economy in the near future.

This is more or less in line with research from the National Bureau of Economic Research, which indicates that almost 60% of stimulus payments were diverted to savings and debt reduction. These tendencies are also consistent with patterns seen in 2001 and 2008, periods where the Fed also provided direct payments to consumers.

**Graphic 3: Recipients reported Use of the the CARES Act Stimulus Payments**




**Conclusion**

The average US consumer has recovered their COVID losses and is in a better position than they have been in the last 5 years after reducing debt and increasing savings. However, rising inflation, lower confidence and increasing interest rates seem to be weighing on consumers' minds, causing them to hold onto excess savings for longer.

In this environment we believe the consumer environment will favour companies with the strongest brands and offerings. In Dicks Sporting Goods we believe we have found an investment that meets this criterion, and where many of the recessionary risks are priced in.

# Investment Case: Dick's Sporting Goods

By Pieter Hundersmarck

- ⇒ Dick's Sporting Goods (DSG) is America's largest sporting goods retailer. It was founded in 1948 by Dick Stack, and is today chaired by his son Ed Stack. It has 854 stores across the US, and Lauren Hobart has served as CEO since February 2021.
- ⇒ DSG is a very successful operator in the sporting goods retail space. Their key advantages are scale (buying power, better assortment and inventory management), a good management team, a good online offering and a large offline presence of 864 stores (for brand awareness as well as omnichannel capabilities).
- ⇒ We see DSG as a powerful business model encompassing a fleet of efficient bricks and mortar stores coupled with a strong omni-channel capability where their store fleet is used as distribution and pick-up centers. The Company saw very slow progress in its omni-channel roll-out since 2016, but the pandemic pushed this into the next gear.
- ⇒ If DSG can show they are consistently growing in the mid to high single digits, along with leveraging their store base to generate GP margins in the 32-34% range (as opposed to 29%-30% range of the past) then this can flow through to EBIT margins of 10-11% (versus the past 5.5%).
- ⇒ The share trades on 7.9x earnings (versus its 5 yr average of 12.3x) and a 1.98% dividend yield.

**Watch the video here (click on the photo)**

There are a number of key questions that need answering prior to an investment into Dicks. The first is what does the business model look like, and can we fathom its resonance with consumers?


The business model is a ‘speciality retailer’ with an assortment of sporting and lifestyle products that allows for (roughly) a 30% GP margin, and Selling, Genereal and Administrative expenses of between 20-25% of sales. Traditionally this has left little room for operating profit (5% roughly). The advent of a robust omni-channel is changing this.

> *“The omnichannel customer…tends to be more profitable, generate higher sales and higher ticket than just an online customer”*
>
> Lauren Hobart (CEO)

**Omni-Channel is changing the growth and margin profile of DSG**

DSG’s e-commerce-enabled sales constitute 30% of sales in 2020 (16% in 2019). This year it is expected to fall back to the low-20% of sales due to the ‘rush’ of reopening and associated store traffic.

DSG’s omni-channel strategy is to utilise the store fleet as their warehouses. They are seeing strong demand through both digital and physical selling channels. Management noted during the firm's latest earnings call that "(its) stores enabled over 90% of our total sales and we fulfilled more than 70% of (its) online sales, either through ship-from-store, in-store pickup or curbside." This played a key role in supporting the retailer's margin performance in the last fiscal quarter as the company can play a larger role in meeting end-customer demand instead of relying heavily on third parties.

**Delivery Costs per unit (stylized)**


The chart above shows how using stores as warehouses allows them to generate sales without the associated cost that they typically would incur via long delivery distances from warehouses or “DCs” far from the consumer (as traditional e-commerce players do). Most of DSG’s sales are fulfilled via click and collect and shipping from store.

**What is the macro background in the US re: sporting goods /enthusiast equipment?**

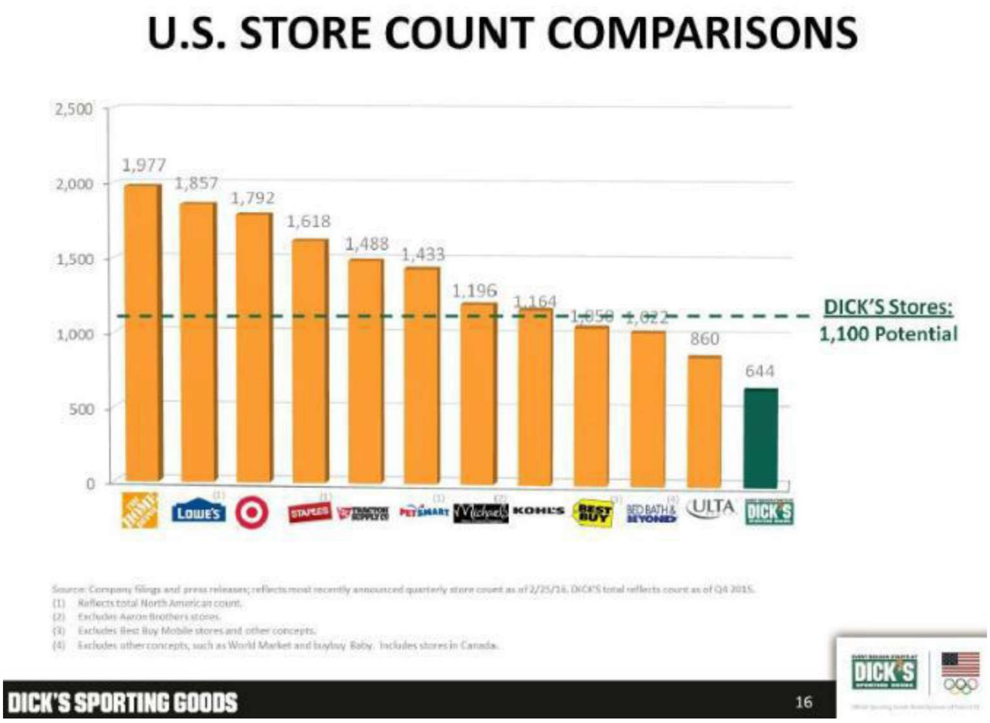
An investment into Dicks is a bet on America, and a bet on sports remaining integral to that nation. It's a bet that US consumers will continue to spend on sporting goods, and Dicks will continue to garner the lion's share of spend in that category.

There are 2 risks here. The first is the macro environment of the US consumer. Much has been said about the US debt burden and low interest rates. Naturally, when rates move higher, we will see lower spend on consumer discretionary items like sporting goods, as more money is used to pay down debt.

Secondly, the competition in the space is fierce. Academy (a peer) has a great offering, and other general retailers, like Walmart, also offering a compelling value proposition for potential Dicks consumers. We are cautiously optimistic that Dicks will be able to weather these storms, provided the interest rate hikes are gradual and the competition remains rational.

Omnichannel investments have reduced the number of physical stores that Dicks requires, and this in turn will reduce occupancy costs and raise GP margins.

Given the above, what are the prospects for growth in same store stores for Dicks? In a 2016 presentation, management noted the following:




The number of Dicks stores is still not at this potential (864 today vs 1,100 possible identified in 2016), and it's possible that a growing e-commerce business has curtailed that target potential.

Whether Dick's follows through on its physical store build out will largely depend on how they drive internet sales. Our view is that store openings will be limited, and most growth will come from leveraging their existing physical footprint, as well as digitally enabled sales.

### Market perception

There is no doubt that DSG ceded market share for many years to the e-commerce players. Growth was mediocre and profitability was low. The result of this was a low PE multiple applied to the stock since 2010. The chart below shows how the forward PE multiple contracted over the past 10 years from c. 17x post the GFC to 9x by the end of December 2021 (and 7.9x today). We believe this negative perception about DSG's prospects will reverse as the company continues to execute on its omni-channel plan.

**DSG's forward PE multiple from 2002 – December 2021**


### Conclusion

The omni-channel strategy that the Company is following is positive in our view, and will lead to higher sales growth and higher profitability than the past.

The market conditions for Dick's are neutral in our view. We see the US consumer as healthy, although we accept that rising rates will curtail discretionary spend, and move it to the businesses that offer the best value.

The market perception of Dick's is too negative, and at the current price to earnings ratio of 7.9x, we see the risk reward profile as skewed in our favour.

# 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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