FLAGSHIP
ASSET MANAGEMENT

Quarterly Telescope Q1 2024

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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.

02

We manage global portfolios in three distinct strategies

Global Equity | Global Flexible | Global Fund of Funds

We believe in a focused approach to fund management.

Our longest running Funds have track records spanning over two decades.

03

We are long term investors who manage diversified portfolios

We use a dynamic investment strategy and active risk management to build robust and diversified equity portfolios.

Our unconstrained approach allows us to navigate diverse market conditions and identify opportunities wherever they arise.

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The Flagship Global Investment Team

Philip Short BSc (Maths), CFA

Philip is a fund manager of the flexible strategies at Flagship and brings specialist macroeconomic expertise to the global team. Philip has gained 20 years' experience in the industry at JP Morgan, Fairtree Capital and Old Mutual as an analyst and portfolio manager. He completed his Bachelor of Science in Mathematics at the University of Pretoria and is a CFA charter holder.

James Hayward BEng (Civil), CFA

JD is a fund manager of the flexible strategies at Flagship, having joined in 2021 as an equity analyst. At the completion of his degree, JD worked in the engineering and fintech start-up industries while pursuing further studies in investments. JD holds an Engineering degree from Stellenbosch University and is a CFA charter holder.

Kyle Wales CA (SA), CFA

Kyle is a fund manager of the global equity strategies at Flagship and has been investing internationally for over 15 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 qualified chartered accountant and CFA charter holder.

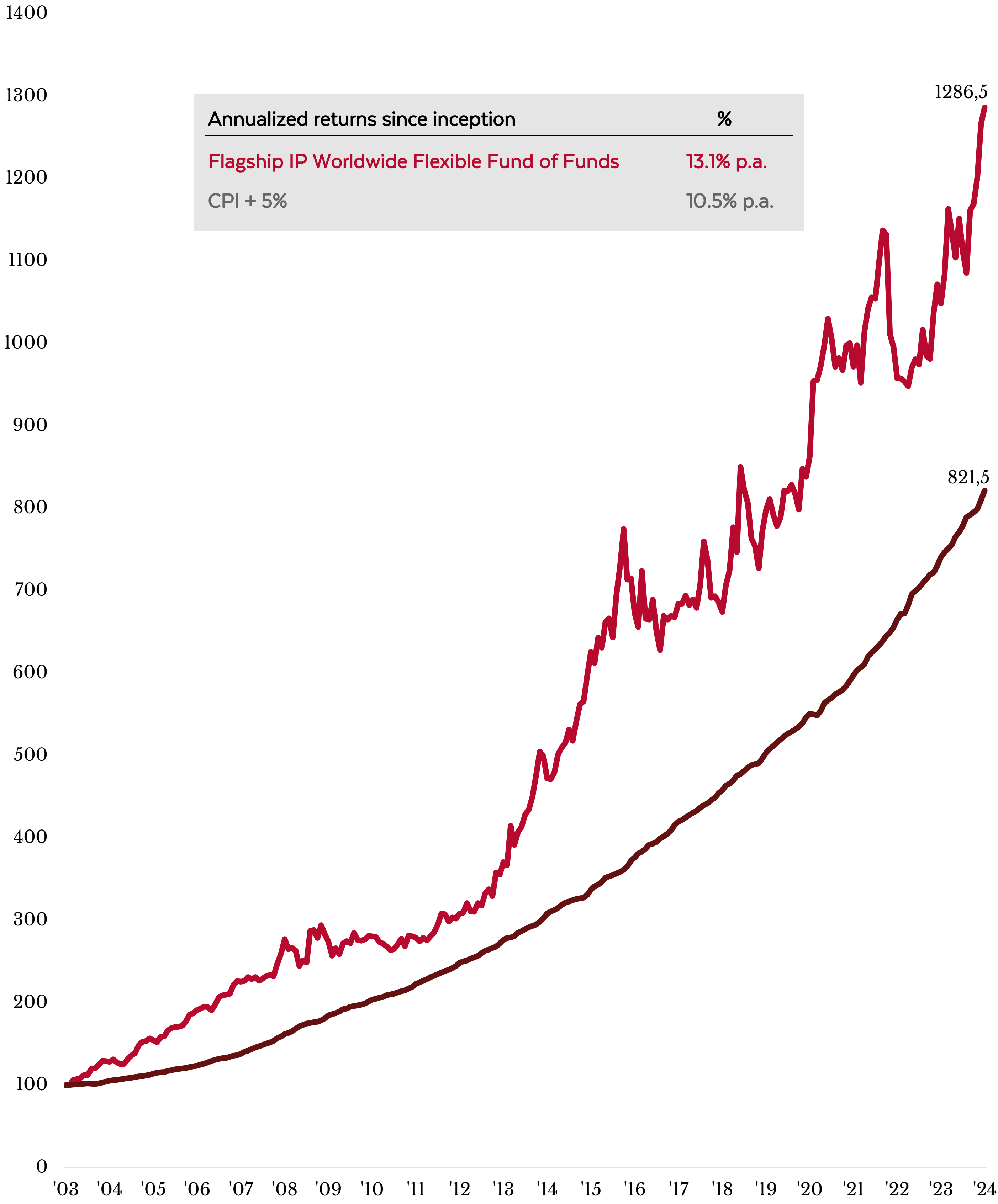
Gerhard Janse van Vuuren BCom (Hons)

Gerhard is an equity analyst for the global team at Flagship, having joined in 2022 via the internship program. Gerhard completed several investment internships while concluding his degree in Investment Management at Stellenbosch University. Gerhard is a CFA Level II candidate and has completed his Honours degree in Finance at the University of Cape Town.

The Power of Long-term Compounding

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

from 3 April 2003 to 31 March 2024 (21 years)

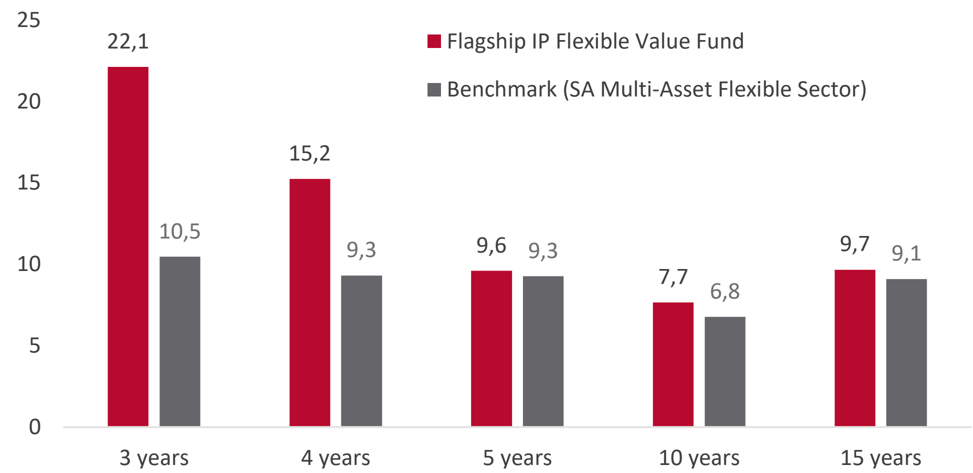


Niall Brown's Hat-trick

The Flagship IP Flexible Value Fund, one of Flagship's longest running domestic specialist funds, was awarded its third Raging Bull award at this year's ceremony in March. The fund, which was launched just shy of 19 years ago, has been run by veteran portfolio manager Niall Brown since inception.

Over the 3 years to the end of December 2023, the Flagship IP Flexible Value Fund returned an annualized 22%, compared to its benchmark of 11%, representing an exceptional 10.5% annual outperformance. The fund has been awarded the 'best performing South African multi-asset flexible fund' in 2018, 2022 and 2023.

Chart 1: Annualised Returns (%) from December 2008 to December 2023



The focus of the Flagship IP Flexible Value Fund reflects Citywire A-rated Niall Brown's investment preferences. The advantage of a flexible portfolio is that the manager has the freedom to look at a range of potential sources of return. Those managers who identify the best opportunities most consistently will thrive.

Niall describes himself as a value investor, who uses standard value measures like price-to-earnings and price-to-cashflow ratios in making his investment decisions. "I'm a contrarian investor who looks to capitalise on investors emotions; particularly where fear and greed drive prices to extremes. Prices can also be driven too low by sheer neglect, rather than panic selling, as is currently the case with many good quality, smaller companies."

Most of the time, I'm searching for seriously undervalued businesses.

The fund's central theme has been buying small and mid-cap undervalued domestic, primarily industrial companies. "Nothing in the property sector. Minimal exposure to financial companies. No banks or insurers. Within that theme, I like to buy companies where management behave like owners. No massive salaries or share awards. I also have a fairly long-term bearish view of the rand, so the rand hedge theme is there too. Most of the time, I'm searching for seriously undervalued businesses," Niall says. The fund's offshore exposure is gained almost entirely through the Contrarius Global Equity Fund, run by the highly regarded value manager Stephen Mildenhall, former CIO of Allan Gray.

Niall has over 40 years' experience in investments. He was a director and head of research at HSBC Securities and subsequently served as Chief Investment Officer of HSBC Asset Management, where he also managed the small cap Nedbank Entrepreneur Fund. After an 18-year career at HSBC, where he worked alongside Ninety One's John Biccard, Niall left in December 2000 to form Osborne Capital, a niche fund management business, which ultimately merged with Flagship in 2011.

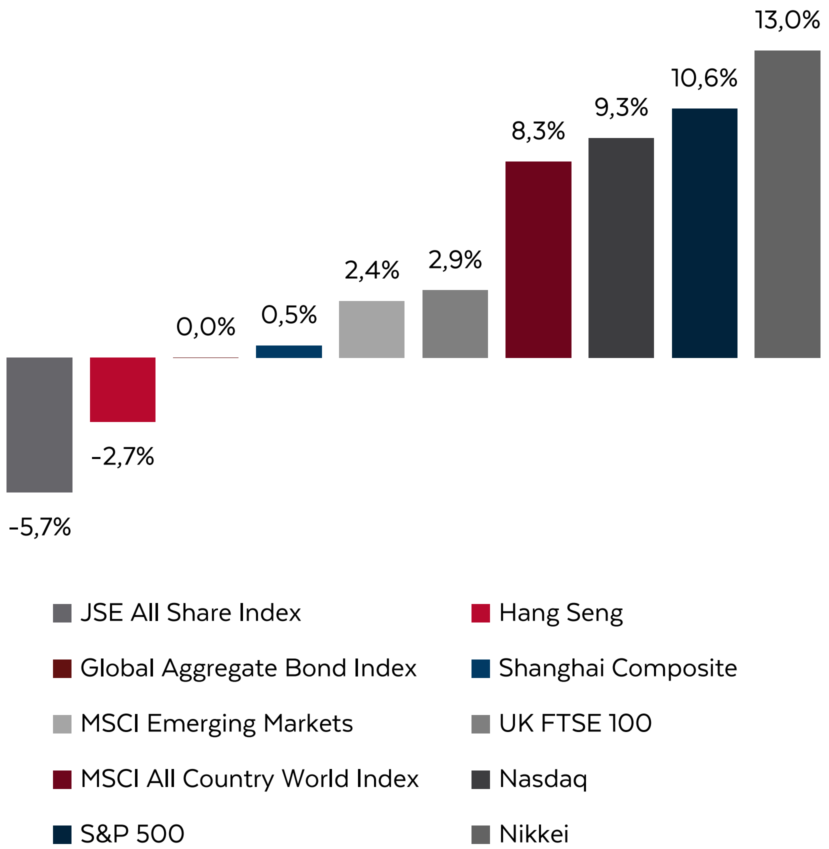
Follow the Money

"Do what you will, this world's a fiction and is made up of contradiction"

- William Blake

Notably, Q1 2024 was the first time the US market delivered consecutive double-digit quarters in more than a decade.

Chart 2: Global Index returns in USD (Dec 31, 2023 to Mar 31, 2024)



Most global equity markets carried over their strength from 2023 into the start of 2024. This was especially true in the US and Japan, where both the benchmark S&P 500 and Nikkei 225 delivered double digit returns for the quarter. Notably, it was the first time the US market delivered consecutive double-digit quarters in more than a decade. The Nikkei, which rose more than 20% if measured in the local Yen, had its best first quarter since the global financial crisis. This surge led to the index surpassing its previous record high which was set in 1989. The strong US performance also helped the MSCI All Country World Index gain 8.3% during the quarter.

Returns on other major exchanges were much more muted, with London's FTSE 100 and the MSCI Emerging Markets index returning 2.4% and 2.9% respectively. Notable poor performers were the JSE All Share Index and Hong Kong's Hang Seng Index. While the Hang Seng lost 2.7% during the quarter, it still fared much better than the All Share, which lost 5.7% during the first quarter of the year.

US markets were strong despite inflation starting to creep back up, as the Federal Reserve signalled they were nearing the required level of confidence to start looking at rate cuts, potentially as soon as the second quarter. China stands in stark contrast to the US. Despite low inflation and ample room to stimulate the economy, erratic policy decisions resulted in equities continuing to move lower.

Monetary policy versus fiscal policy

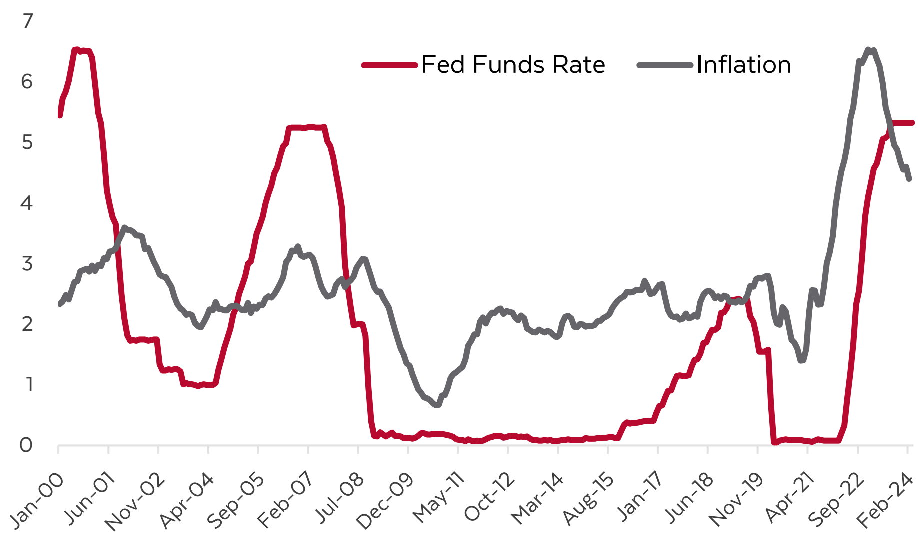
Monetary policy is the policy adopted by a country's central bank which has a general mandate to control inflation and, to a degree, employment. A central bank's dominant tool to achieving its objective is through the setting of interest rates. Monetary policy is referred to as being either expansionary (when interest rates are moving lower and hence stimulating the economy) or contractionary (when interest rates are moving higher and moderating economic activity). In the case of the US, the central bank is the Federal Reserve (the Fed) and its president is Jerome Powell.

Fiscal policy sits within the government's realm of power and is directed through the Treasury which determines taxes (income) and government spending. When the government spends more than it earns through taxes, it goes into deficit, which is generally funded by issuing debt. When the government is running a deficit, this is also considered expansionary as it is moving more money into the economy. Conversely, when a country runs a surplus (taxes are greater than expenditure in a given year), the fiscal policy is considered contractionary. In the US, the fiscal policy mandate sits within the Treasury and its overlord is the Secretary of the Treasury, Janet Yellen.

The more challenging environment is when monetary and fiscal policies are moving in opposite directions.

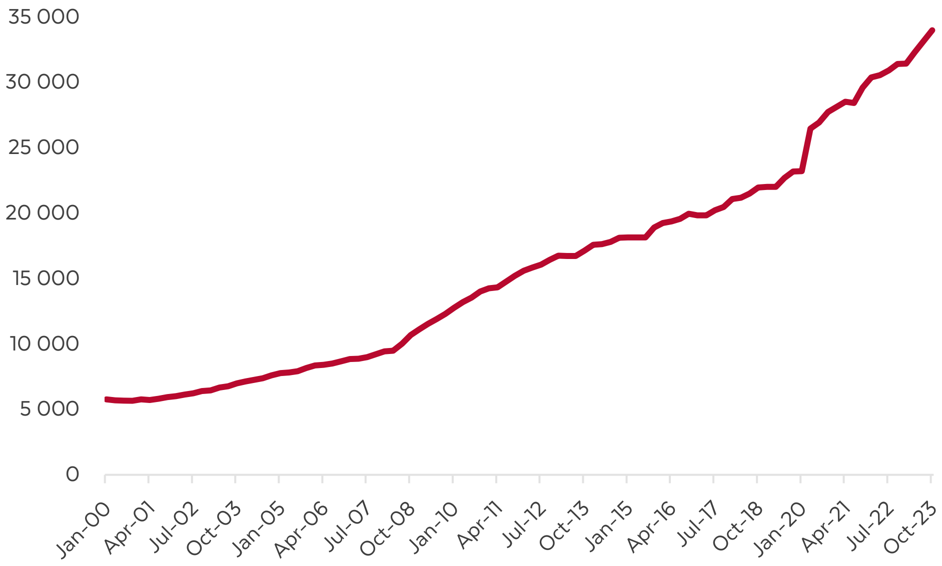
A general rule of thumb is that when monetary and fiscal policies are simultaneously expansionary, markets will do well, as credit is loosened and governments are spending. The more challenging environment is when they are moving in opposite directions, which brings us to the present period, from April 2022 to today.

Chart 3: US Fed Funds Rate & Inflation (%) from Jan 2000 to Mar 2024



We can see from the chart on the previous page that the Fed started raising rates in early 2022, in an effort to curb growing inflation. Countering this, in the chart below, is the Treasury's response in issuing a significant amount of debt, now sitting at nearly US$35 trillion.

Chart 4: US Government Debt (USD bn) from Jan 2000 to Oct 2023



Why is the Treasury issuing so much debt when the economy is strong and unemployment is at very low levels?

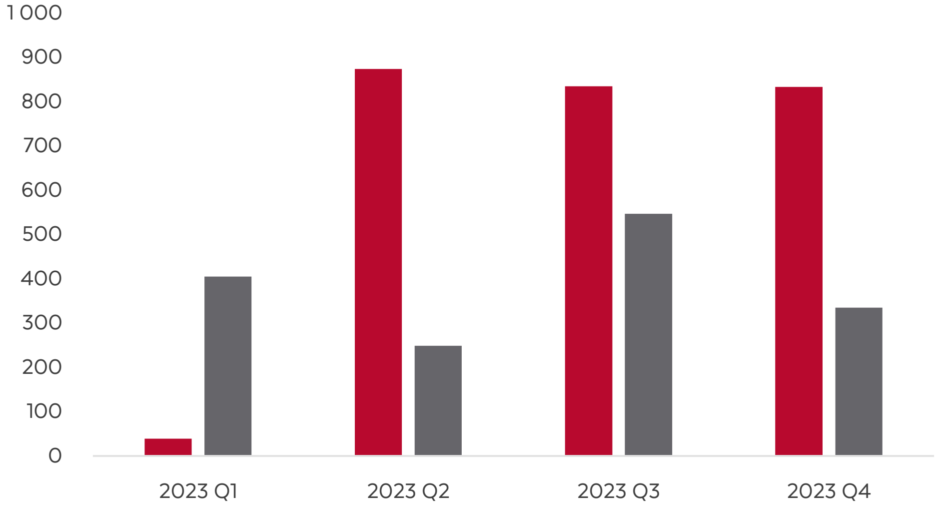
This begs the question, why? Why is the Treasury issuing so much debt when the economy is strong (quarters 3 and 4 of 2023 GDP growing 4.9% and 3.0% respectively) and unemployment is at very low levels? This should be a time to save, run a surplus and pay off debt.

Chart 5: US Unemployment rate (%) from Jan 2000 to Feb 2024

Many believe that, this being an election year in the US, the US Treasury is keeping the economy running hot, unemployment very low and the populace generally happy, in a bid to get the current administration re-elected.

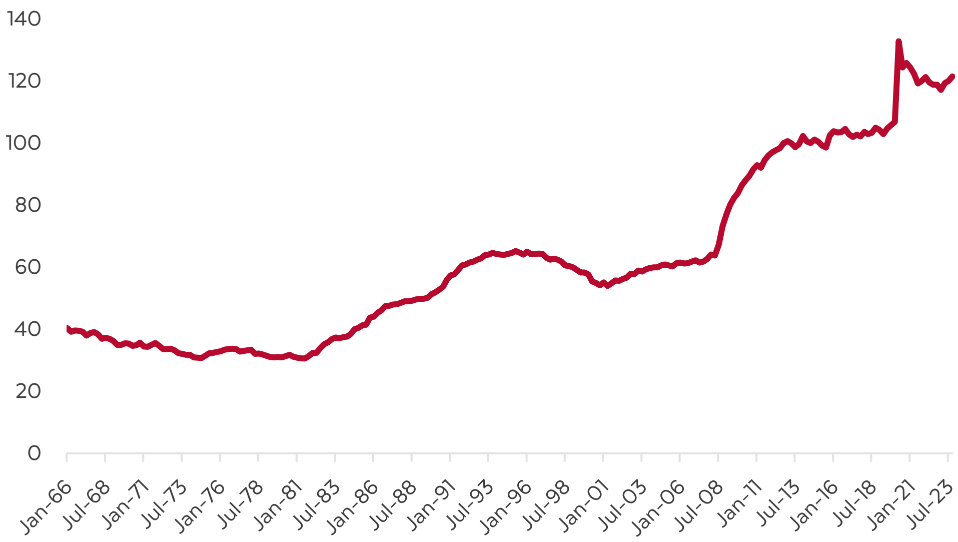
If you look at the chart below, you can see that the Treasury ramped up debt issuance in 2023, issuing over $2.5 trillion debt in that year alone. For a country that receives $6 trillion a year in total tax receipts, that's a very big number.

Chart 6: Change in US government debt (red) and nominal GDP (grey)



Worryingly, that $2.5 trillion in debt only translated to $1.5 trillion in GDP. Historically, the GDP multiplier from debt is 1 to 3 times, meaning that every US$1 of debt raised by the US government should translate into US$1-3 in GDP. In this case, the multiplier is a fraction at 0.6x, implying a weaker private sector. One can argue that there is a time lag from borrowing to generate GDP, but the increasing debt to GDP (shown below) illustrates that debt is outgrowing GDP over the long term as well.

Chart 7: US Debt to GDP (%) from Jan 1966 to Oct 2023



The fact that the US debt to GDP ratio is over 120% is a cause for concern, and that it is projected to hit 200% in 30 years' time, is a red flag.

When thinking about a country issuing debt in relation to GDP, it helps me to think of the country as if it was a business: if a business owner borrows $100,000 from a bank to invest in their business, they would expect that investment to generate a return, at the very least of $100,000 plus the interest on the borrowing, to pay back to the bank. Same with a country: the GDP will translate into tax revenue which will be used to pay back the debt. The fact that GDP cannot keep up with debt issuance is something to watch. The fact that the US debt to GDP ratio is over 120% is a cause for concern, and that it is projected to hit 200% in 30 years' time, is a red flag, something we will discuss in our next Telescope.

The problem that markets are currently trying to decipher is: which way does the balance of financial thrust, monetary or fiscal, take us going forward? Powell is trying hard to limit inflation and cool the economy by hiking interest rates. Yellen is trying to stimulate the economy by pumping money into it, increasing spending on things like infrastructure and employment. This spend from Yellen is one of the reasons inflation stopped dropping in Q1 of 2024, and is causing concern for inflation looking forward.

Chart 8: US 1-year breakeven inflation rate (%) from Apr 2019 to Apr 2024

The problem that markets are currently trying to decipher is: which way does the balance of financial thrust, monetary or fiscal, take us going forward?

The breakeven inflation rate, shown above, is the spread between the treasury yield and the yield on inflation-protected Treasury bonds (TIPS), i.e. it is what the bond market is currently pricing or expecting inflation to be in one year's time. You can see that in early 2024 inflation expectations were around 2%. Three months later that has now jumped to 4%, a sharp and meaningful incline. The Fed's inflation target is 2%. Now there are some sectors of the underlying economy that are struggling from higher interest rates, even with the flash spending by the Treasury. The dilemma is that the Fed cannot cut interest rates too soon or it will reignite inflation. If actual inflation does begin to reaccelerate, the consequences will be dire.

Monetary versus fiscal. Powell versus Yellen. Inflation and Debt. These are the important topics we are currently working on at Flagship and which will have a meaningful effect on markets going forward.

Strategy Performance

The performance of the Flagship Strategies, net of fees, over the quarter and 1 year to 31 March 2024 are shown below.

Fund of Funds Strategy	Q1 '24	%Δ 1YR
Flagship IP Worldwide Flexible Fund of Funds (ZAR)	10.0%	22.7%
Flexible Strategy	**Q1 '24**	**%Δ 1YR**
Flagship International Flexible Fund (USD)	4.3%	9.2%
Flagship IP Worldwide Flexible Fund (ZAR)	10.2%	18.5%
Global Equity Strategy	**Q1 '24**	**%Δ 1YR**
Flagship Global Icon Fund (USD)	7.3%	11.1%
Flagship IP Global Icon Feeder Fund (ZAR)	10.9%	17.8%

All three of Flagship's global strategies delivered strong performance during the first quarter of 2024.

The Fund of Funds strategy had another strong quarter, returning 10%, compared to its CPI + 5% benchmark, which returned 2.3%. The best performer during the quarter was GQG Partners Global Equity Fund, which returned 22%, while the biggest detractor was the Satrix SA Bond Portfolio, which had a slight negative return during the quarter.

All three of Flagship's global strategies delivered strong performance during the first quarter of 2024.

Regarding our flexible strategy, the Flagship IP Worldwide Flexible Fund, delivered an excellent performance during the first quarter, returning 10.2%, comfortably outperforming its composite benchmark, which returned 3.3%.

There were several standout performers, with Meta, Rolls-Royce, and Rheinmetall all gaining north of 40%. Top of the list was Hensoldt, which rose 79% during the quarter. The main detractors were Pinduoduo holdings, Alpha Metallurgical Resources and Goldfields. Together, these positions detracted about 1% from total performance.

After a slow start to the year, our improved global equity strategy clicked into gear during March, outperforming its MSCI All Country World Index benchmark by 3% during the month. This aided overall performance and led to the strategy being within touching distance of its benchmark after the first quarter. The main drivers of performance were the same for our equity and flexible strategies, however Rakuten and Tapestry also contributed to the equity strategy, as both rose by more than 25%. The biggest detractors from our equity strategy were Goldfields, Concentrix, Petrobras and Alpha Metallurgical Resources, together costing about 1.8% in performance.

During the quarter, there were several changes to the global equity and flexible strategies. Not all of these will be discussed in depth, but we would like to share the key changes.

UnitedHealth Group into Novo Nordisk and Eli Lilly

Healthcare stocks generally provide a stabilizing element to portfolios during times of market turbulence. When budgets are under pressure, it is much easier to stop incremental spend on discretionary luxuries than to stop using life-saving medicine, for example. Our decision to switch our holding from UnitedHealth Group into Novo Nordisk and Eli Lilly was two-factored:

- The first concern was surrounding the total medical service costs for UnitedHealth Group and its peers. For the first time in two years, the reported expense ratio was higher than Wall Street estimates. While UnitedHealth initially indicated that they believed this higher cost ratio to be temporary, similar reports by other healthcare providers suggested that there might be a structural shift to a higher service cost ratio. This would be detrimental to UnitedHealth's margins in the long run.
- The second reason was the tremendous growth potential for both Novo Nordisk and Eli Lilly, brought about by GLP-1s. While these were initially developed as diabetes drugs, a whole plethora of potential benefits have since been discovered, the most notable of which is weight loss. Clinical trials are currently underway and early results seem positive, for everything from lowering the risk for heart disease and strokes, to anti-addiction purposes such as aiding smokers attempting to quit.

In Q1, we switched UnitedHealth into Novo Nordisk and Eli Lilly. We sold Becle & Heineken. We bought Rolls-Royce & Rheinmetall.

In the short term, this proved to be a prescient switch, as UnitedHealth's share price has declined by 20% this year, while both Novo Nordisk and Eli Lilly have appreciated by 20%.

Becle & Heineken (sell)

Another big change to our portfolios was exiting our position in Becle, the Mexican tequila titan, as well as closing our position in Dutch beer brewer, Heineken. Theoretically, both of these stocks should have somewhat defensive profiles. This is especially true given their presence across the quality and price spectrum. The act of consumers downtrading within the tequila or beer sector should therefore not be too detrimental to either brand. Despite these theoretical defensive properties, and despite stocks like Heineken trading at a discount to its own history, the entire alcoholic beverage sector has been performing poorly, with most brands reporting volume declines across several sectors and geographies.

Rolls-Royce & Rheinmetall (buy)

We opted to replace our alcoholic beverage sector holdings, while retaining the defensive attributes they were meant to provide. We believe defence stocks, such as Rheinmetall, Hensoldt, and to a lesser extent, Rolls-Royce, will provide us with the required characteristics, while also benefitting from structural tailwinds.

In the following segments of the Telescope, we discuss our investment in the defence sector in more detail.

Defence Battle Lines Drawn Across Europe

By JD Hayward

⇒ Geopolitical tensions are on the rise across the globe. Aside from the current armed conflict in Ukraine, Israel's operation against Hamas and various other internal or regional conflicts, tensions are also on the rise in the East, as China expands its claims over the disputed South China Sea, as well as its increasingly aggressive rhetoric towards Taiwan.

⇒ Multiple countries, especially those forming part of NATO, are revisiting their outlook on national security and subsequently their defence budgets. Despite prior commitments, only 60% of members are actually reaching their spending goals.

⇒ We take a closer look at the current state of affairs across the EU, focusing on the most pressing investment drivers.

> Today, however, much of the developed world is again facing the prospect of war.

Writing about peace and war can be a delicate subject. While the last couple of decades have been relatively peaceful across most of the developed world, many developing countries have not enjoyed a similar era of calm. The Middle East and Africa have been particularly hard hit, with both experiencing bouts of conflict over a prolonged period.

Today, however, much of the developed world is again facing the prospect of war. A little over 2 years ago, on the 24th of February 2022, armed conflict returned to continental Europe as nearly 200 000 Russian soldiers crossed the border from Russia and neighbouring Belarus into Ukraine. They thought it would be a swift march to victory in Kyiv, but 2 years later, the battle drags on and hope of a resolution is distant.

While the battle for Ukraine is by far the most dangerous in terms of the risk of spilling over into a much larger conflict, it is by no means an isolated incident. According to the Geneva Academy of International Law and Human Rights, there are currently more than 100 instances of armed conflict, both internal and cross-border, worldwide.

Aside from actual conflicts, there are also several situations where tensions are simmering below the surface. Front and centre would be Beijing and its increasingly aggressive rhetoric towards Taiwan, together with its disputed claims over the South China Sea. While most of these conflicts are unlikely to spill over into large scale warfare, there is no looking past the fact that, today, the world is again facing the prospect of confrontation between nuclear-armed superpowers, with Russian President Vladimir Putin warning, as recently as 2 weeks ago, that its nuclear forces are in “full readiness”.

Structural Underinvestment

Since the end of the cold war, the West has experienced an era referred to as the “Long Peace”. There are several reasons for this. Increased globalization in terms of trade and mutual commercial goals is a primary factor. There is also the relatively strong deterrent of nuclear war and mutually assured destruction, which has helped ensure peace over the past 8 decades. After all, mutual destruction does not sound like a lot of fun.

This might have instilled a false sense of security in many countries, swiftly exposed when regional powers had to start delivering aid to Ukraine. The thought of a large-scale ground war had become so distant that many members of NATO realized that they were not that well equipped to fight one.

The thought of a large-scale ground war had become so distant that many members of NATO realized that they were not that well equipped to fight one.

To ensure it is sufficiently armed to come to the defence of members when required, NATO put spending guidelines in place nearly two decades ago: 2% of each country’s respective GDP. The rationale makes sense. Countries with stronger economies would contribute a larger nominal amount, but proportionally the contributions would be fair. The problem with this guideline is that it was not being met. Not even close. In 2014, only 3 members met the contribution requirement, despite NATO Defence Ministers pledging more contributions as far back as 2006.

The year 2014 proved to be a pivotal year in NATO’s history, as the “Long Peace” came to an abrupt halt when Russia illegally annexed the Crimean Peninsula. Understandably, this served as a wake-up call. Two years later there came another wake-up call, with the name of Donald Trump.

US Elections

After the 2016 election of Donald Trump as the US President, and thus Commander-in-Chief of NATO’s most powerful member, those countries falling shy of the spending guidelines were given a thorough dressing down by Trump. This included some of the world’s most powerful countries, and given the outsized role of the US in NATO operations, it was not as simple as brushing his criticisms aside.

“Whatever the hell they want”, was reportedly Trump’s answer when posed the question of what he would allow Russia to do to members of NATO who were not footing their share of the bill. The United States, by far the most powerful of all the NATO allies, was carrying the bulk of NATO’s funding burden. This did not make “the Donald” very happy.

This is all relevant as it is now clear that the 2024 US Presidential Election will be a Biden-Trump rematch. Given the very reasonable concerns about Joe Biden’s seeming cognitive decline, there is doubt around his ability to complete another campaign, even from the Democrat’s own supporters. If Trump is re-elected, there is likely to be increased pressure on NATO members that are not yet paying their dues.

This especially given the fact that Russia's invasion came during a time when Trump was not president, something he is more than likely to make explicitly clear.

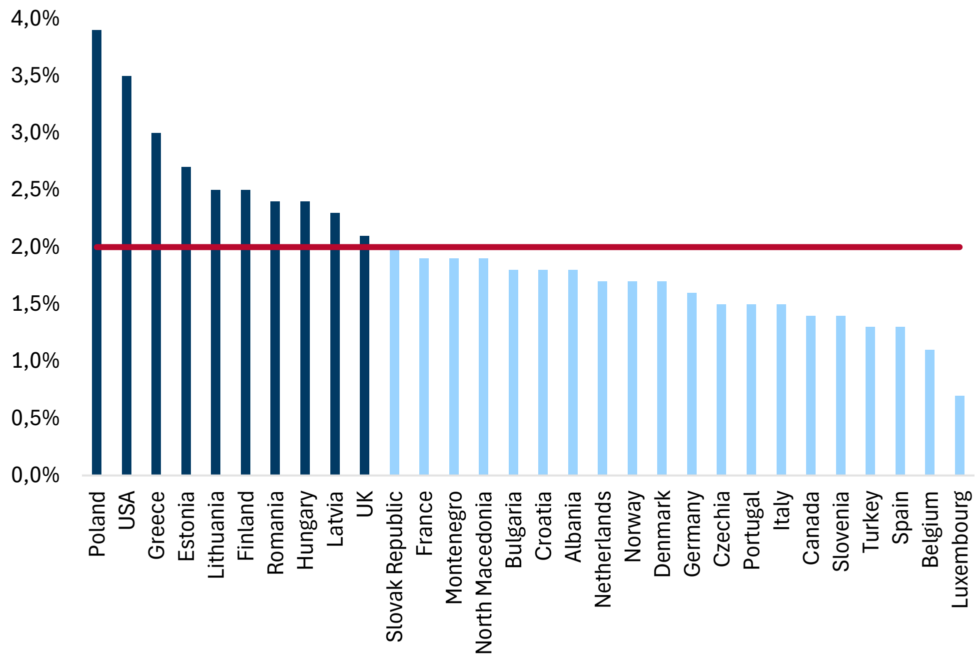
Increased Defence Spend

The results of Russia's invasion, combined with Trump's hardline stance, have been noteworthy. While only 3 NATO members reached the target spend level in 2014, this increased six-fold to an expected 18 countries in 2024.

While this is an improvement, a lot of investment still needs to be made. After the ascension of Finland in 2023 and Sweden last month to become fully fledged members, NATO now has 32 member states, more than 40% of which will not have met their spending targets.

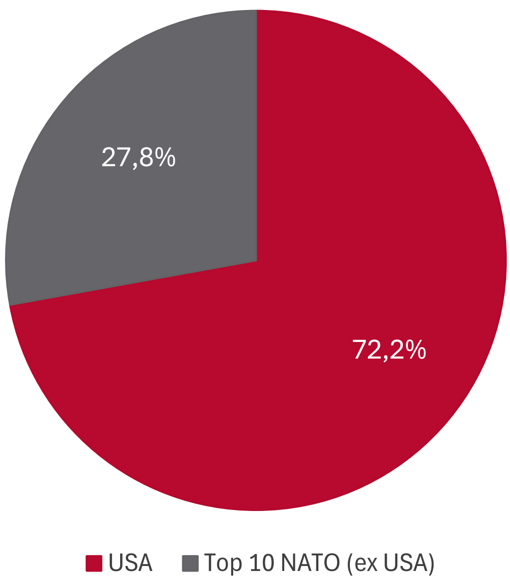
A lot of investment still needs to be made in order to reach target defence expenditure.

Chart 9: Actual vs Target defence expenditure in 2023 (% of GDP)



While the accompanying bar chart gives the impression that the US is not that far ahead of peers in terms of military expenditure, the pie chart below provides a different perspective.

Chart 10: Total defence expenditure in 2023 (in US$)



As grim as the prospect of war is, and as much as military and defence investments are traditionally viewed in a poor light from an ESG perspective, they remain relevant and necessary.

Investment Implications

As grim as the prospect of war is, and as much as military and defence investments are traditionally viewed in a poor light from an ESG perspective, they remain relevant and necessary. Developments in recent years have cast a new light on investments in military and defence stocks. So much so, that some ESG investors have even started viewing these stocks more favourably, choosing not to exclude them based on ESG sentiment alone anymore, as they do play a role in protecting the very fabric of society.

Exposure to the structural growth story behind this theme can come in several different forms. One can either invest in traditional arms manufacturers, or take a more subtle approach by investing in companies that provide auxiliary services, such as radar and electronic systems. There is also the option to invest in companies that have segmental exposure to the industry, without being dependent on it.

Examples of the more traditional arms manufacturers would be German manufacturer Rheinmetall and British based BAE Systems. Both manufacture traditional warfare weapons like tanks and munitions. In the auxiliary services segment, investors can consider German-based Hensoldt, or French-based Thales. Both provide “senses” to military platforms like tanks, helicopters, airplanes, and other fighting vehicles. They specialize in optics systems, radars, and other surveillance equipment. Investors can also consider companies like Airbus or Rolls-Royce. Both are familiar names in the commercial aerospace industry, but also have significant defence segments. All of these companies have experienced, and should continue to experience, increased military spending supported by a world simmering in geopolitical tension.

The past year has delivered stellar returns for global equities and 2024 has, thus far, continued to provide some blockbuster returns. Once markets inevitably cool down, and the effect of high borrowing costs starts to bite, investors will have to look outside of the well-trodden IT sector for opportunities. This becomes easier when considering investment opportunities outside of South Africa, which are set to benefit from structural tailwinds, even in times of geopolitical tensions and uncertainty.

Investment Case: Rheinmetall

RHEINMETALL
GROUP

By JD Hayward

- ⇒ Rheinmetall is predominantly a German defence manufacturer, developing and producing traditional weapons and munitions, as well several high-tech military vehicles and auxiliary defence equipment.
- ⇒ The defence sector will benefit from structural drivers, predominantly a decades-long underinvestment in defence by multiple European NATO members.
- ⇒ Even though the Rheinmetall share price has rallied tremendously since the Russian invasion of Ukraine, now trading on 24x blended forward PE, it is still trading on a PEG ratio of less than 1x, hardly expensive given the growth potential.
- ⇒ Since being added to Flagship's portfolios early in 2024, Rheinmetall has been a strong performer, gaining more than 40%.

Since being added to Flagship's portfolios early in 2024, Rheinmetall has been a strong performer, gaining more than 40%.

"You may not be interested in war, but war is interested in you."

- Leon Trotsky, Russian revolutionary & Founder of the Red Army

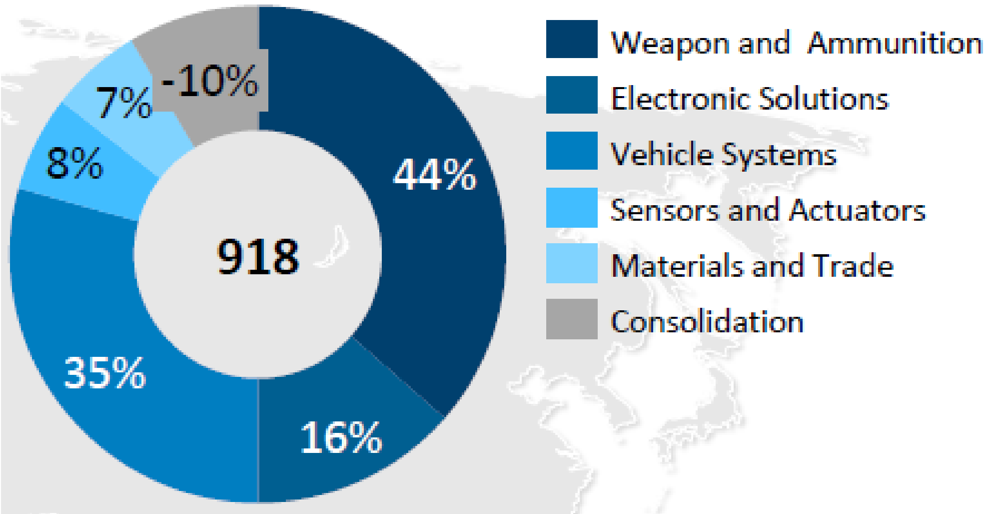
Rheinmetall Skyguard Air Defence system

Rheinmetall is a Dusseldorf-based defence company. It has a 130+ year history since being founded in 1889 and has been publicly traded since 1894. It has been a staple of the MDAX (midcap DAX Index) since its inception, and was recently also included in the standard DAX index, based on its market cap reaching the qualifying criteria.

Rheinmetall develops, produces, and sells components and complete systems within the security and defence ecosystem, where it caters primarily to the German government, but also to other EU and NATO members.

Aside from the defensive applications, they also have small operations in the automotive industry (certain high-tech parts for EV and ICE propulsion systems). This, however, is a small part of overall operations. As can be seen in the pie chart below, defence linked equipment, vehicles and systems account for more than 75% of profits.

Chart 11: Rheinmetall's operating results by segment for 2023 (EUR mn)



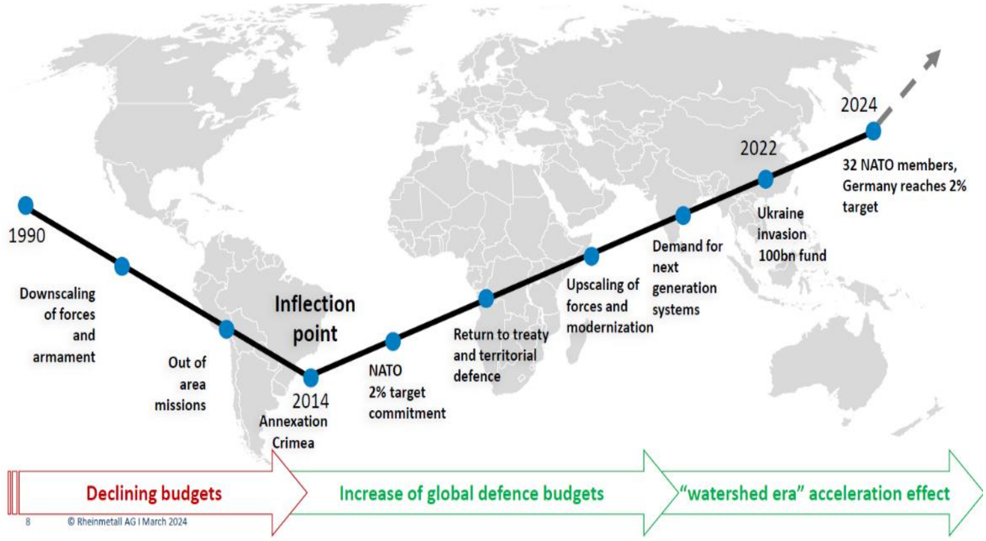
Rheinmetall develops, produces, and sells components and complete systems within the security and defence

While defence is normally linked to steady, GDP-type growth, there have been other drivers and factors at play behind Rheinmetall's performance in recent years.

1) **Cause…**

As has been discussed in greater detail in the previous article, there has been structural underinvestment in the European defence sector for several decades.

Chart 12: Illustration of the defence cycle for NATO countries



After Russia's annexation of Crimea in 2014, alarm bells started going off within Europe. Although this had led to annual defence spending targets being introduced for NATO members, targets were still not being met. Fast forward to a speech by German Chancellor Olaf Scholz three days after the 2022 Russian invasion of Ukraine. In this speech, Scholz refers to a "Zeitenwende", or a watershed moment in modern German history.

2) … and effect

The ripple effect of this can perhaps best be explained at the hand of several recent quotes:

"If you want peace, you have to successfully deter potential aggressors." … "This is the only way to achieve our goal of making the Bundeswehr one of the most capable conventional armed forces in Europe once again"

- Olaf Scholz, German Chancellor

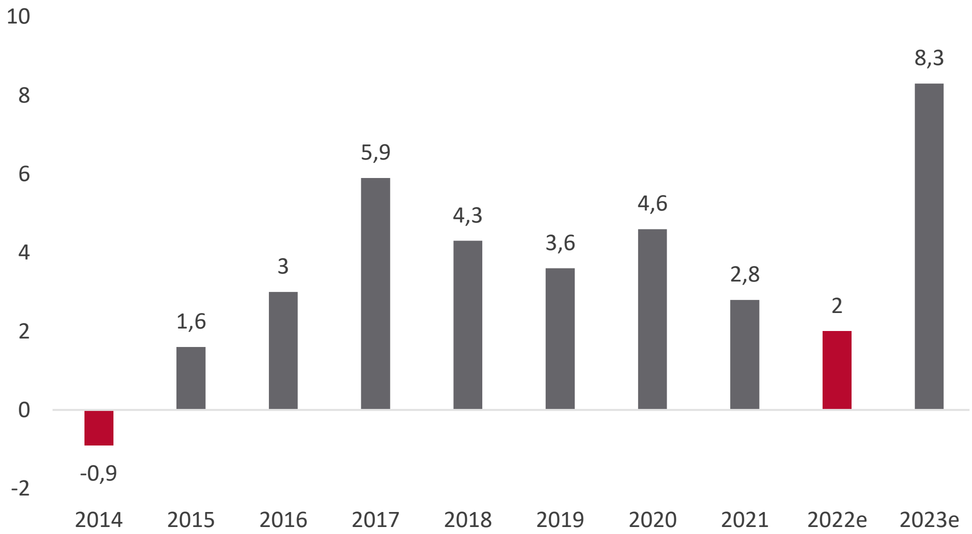
"A new decade of security policy has begun. In this situation, we at Rheinmetall are grateful to be able to make a decisive contribution to restoring our country's ability to defend itself. We are sparing no effort in order to fulfill this task of national importance. We are investing massively, building new plants and significantly increasing our personnel."

- Armin Papperger, Rheinmetall CEO

In 2024, Germany will spend close to €75 billion on defence, the largest annual expenditure in the history of the Bundeswehr.

This change in mentality is not only true for Germany, but to some extent for the entire EU. This is evident from the graph below, which indicates that real defence spend growth by NATO members, post Crimea-annexation, has been noteworthy. This is especially evident in the years after Russian military aggression, which are indicated by red bars.

Chart 13: NATO countries ex US annual real change in defence expenditure (%)



In 2024, Germany will spend close to €75 billion on defence. This is the largest annual expenditure in the history of the Bundeswehr, and for the first time in modern history, Germany will spend more than 2% of its annual GDP on defence. Despite the increased defence spend in recent years, Germany is actually ill equipped to defend themself, as much of its ammunition and equipment have been sent to Ukraine as part of the Western response to Russia's invasion of Ukraine. The same is true for allied countries.

The result is that growth drivers are now three-pronged:

1) Stockpiles and ammunition first need to be replenished.
2) Ukraine requires continued support as long as Russia's invasion continues.
3) Only then can NATO members really focus on expanding their own capabilities and stockpiles.

Given the capital outlay required from manufacturers for new production sites and model development, they are understandably reluctant to embark on such expansions without certain guarantees in place. This too, is well explained by the following quotes:

"Industry needs to know it has buyers – say a five or 10-year plan with guaranteed offtake"

- Marie Agnes Strack-Zimmerman, Chair of Bundestag Defence Committee

"a reliable, sustainable, and yes, rising budget"

- Boris Pistorius, German Defence Minister

More telling though, was the growth in Rheinmetall's orderbook: a year ago this was sitting at €15 billion, but this year it has ballooned to more than €38 billion.

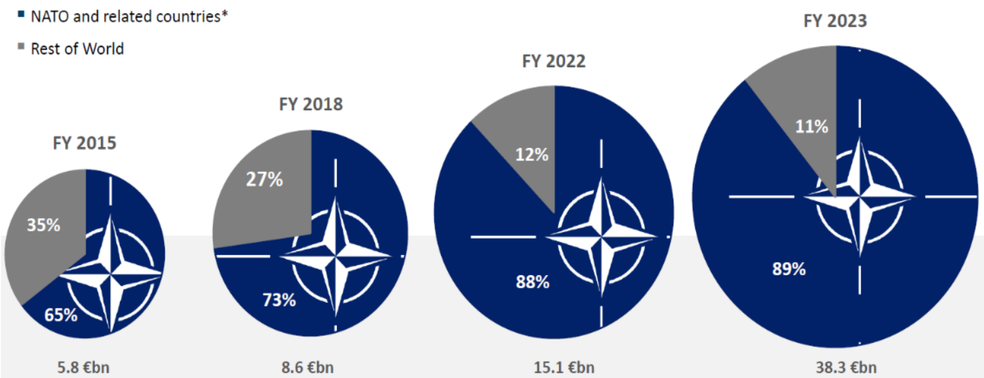
What this means for manufacturers like Rheinmetall is long term contracts and ballooning order books.

Results in the numbers

In its most recent earnings report, Rheinmetall reported very strong growth. While revenue for the year grew by 12%, operating profit grew by 19%, and EPS by 34%.

More telling though, was the growth in their orderbook. A year ago this was sitting at €15 billion, but this year it has ballooned to more than €38 billion. While this is a very large increase, it is not a once off, as can be seen in the growth of Rheinmetall's orderbook post the annexation of Crimea.

Chart 14: Rheinmetall's order book from 2015 to 2023



Rheinmetall has already benefitted tremendously from the need of sovereign nations to be better equipped to defend themselves. This has led to the share trading on a blended forward PE of 24x, well above its historical average. However, considering the expected growth in coming years, it is still trading on a PEG ratio of less than 1 - not particularly expensive for a company with a 130-year history, strong growth drivers, and a position of strategic national importance within Europe's largest economy.

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 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,

The Flagship Global Team

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