sasfin Wealth

Sasfin Global Equity Model (SGEM)

Quarterly Review – Q3 2023:
1 July 2023 – 30 September 2023

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PERFORMANCE

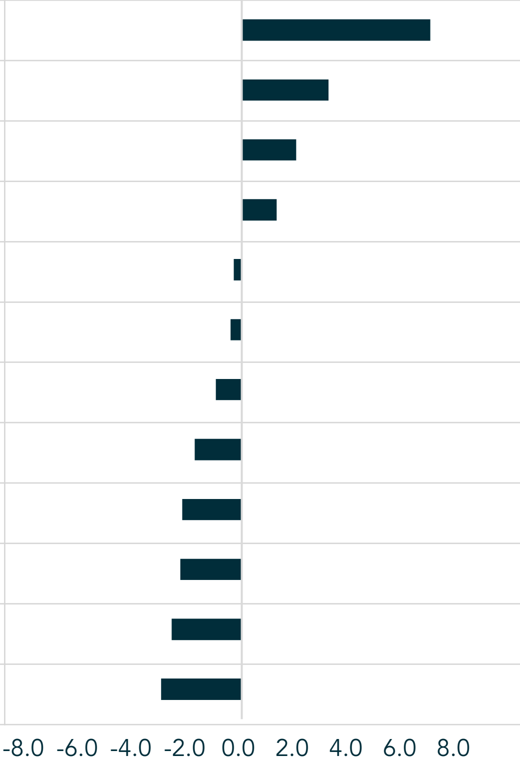
Total Return (%) - Period ended 30 September 2023

	Quarter	YTD	1 Year	3 Years[1]	5 Years[1]	Since Inception[1, 2]
SGEM	(6.0)	9.2	21.2	4.7	5.8	8.5
MSCI ACWI[3]	(3.4)	10.1	20.8	6.9	6.5	7.3

Source: Morningstar
Note:
1 – Annualised
2 – Inception date: 31 December 2014
3 – MSCI All Country World Index

Portfolio Positioning (% Weight)

Sector	SGEM	MSCI ACWI	Under/Over (%)
Cash	7.0	-	
Consumer Discretionary	14.4	11.2	
Consumer Staples	9.1	7.1	
Health Care	13.2	11.9	
Financials	15.4	15.7	
Materials	4.1	4.5	
Communication Services	6.6	7.6	
Energy	3.5	5.2	
Information Technology	19.3	21.5	
Real Estate	-	2.3	
Utilities	-	2.6	
Industrials	7.4	10.4	



Source: FactSet

MARKET COMMENTARY

Interest rates are going to stay higher for longer. That is the view of global equity markets and accounts for the broad-based weakness in stock prices, the declines of which resulted in the MSCI ACWI falling 3.4% during the third quarter of 2023.

As a rule of thumb, stock prices and interest rates tend to move in opposite directions. It therefore follows that if interest rates are not expected to come down, at least not at the rate that the market expects, stocks will reprice, in this case fall, to adjust to the new set of expectations.

For months now, the market had eagerly anticipated that central banks would announce an end to the trend of hiking interest rates. In particular, many were hopeful that the US Federal Reserve ("Fed") would announce, at worst, one final rate hike followed by a series of interest rate cuts during the course of 2024. This was not to be the case. While inflation has come down significantly since the commencement of the rate hiking cycle, it still remains elevated. The "stickiness" proved apparent in the August read of CPI which increased slightly to 3.7%, still well above the Fed's target rate of 2.0%.

This likely reinforced the view of the Fed to maintain a higher level of interest rates. The Fed may have opted to hold interest rates constant following the FOMC meeting in September, but Fed chair Jay Powell noted that the majority of Fed officials favoured an additional rate hike later this year. Perhaps the most disappointing piece of news emanating from the meeting was the consensus among participants that interest rate cuts might only start taking place at the back-end of 2024, somewhat later than what the market may have been pinning its hopes upon.

Movements in bond yields certainly echoed the view of "higher for longer". The yield on the benchmark 10-year US Treasury rose nearly 20 basis points during the quarter to end the period slightly above 5.0%. Perhaps more impactful, especially for longer duration equities has been the rise in the "real" rate of interest (see discussion further below for more detail). The 10-year US Real yield (US Treasury constant maturity or "TIPS") rose more than 60 basis points during the quarter, closing out the period at 2.2%.

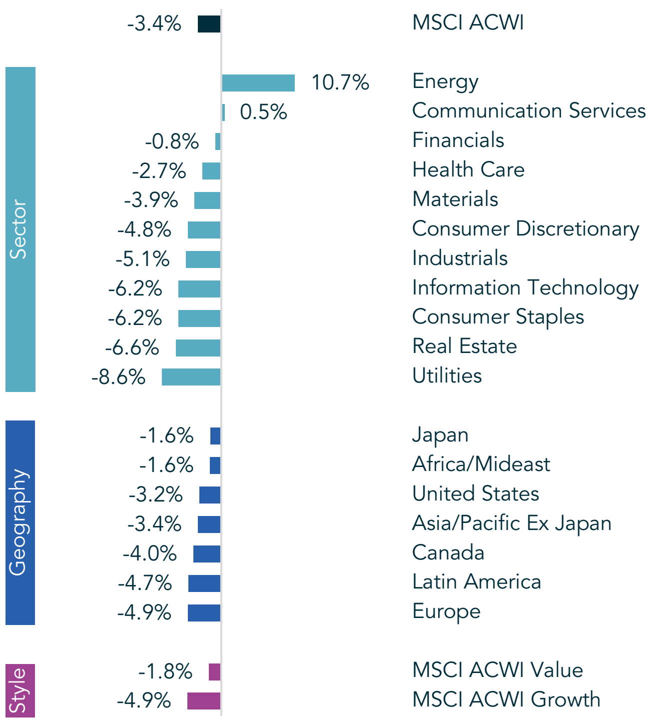
Higher interest rates were not the only detractor during the quarter. The post-covid recovery, or lack thereof, in China remains a burden on Chinese equities as well as those companies with relatively larger exposures to the region. Concerns over slowing economic growth and the highly indebted property sector, continue to weigh on investors' minds as Western assets poured out of the region.

The downturn during the quarter was generally broad-based, be it sectoral or regional. There was however one notable exception, the Energy sector. The price of oil rose nearly 30% over the past three months, leading many oil companies, be they upstream or downstream to double-digit price gains during the period. Production cuts by Saudi Arabia and Russia drove the price of Brent Crude as high as $95 a barrel. Some speculators have even suggested that it may rise above $100. At this level, inflation may prove even stickier than it is already proving to be. Could we move to an environment of higher for *even* longer?

On the flipside, with interest rates now back at levels last seen during the Global Financial Crisis ("GFC") of 2007/8, the question will be asked, how long can these levels be sustained before something breaks? US consumers appear to have used up much of their pandemic savings and are increasingly resorting to using their credit cards. Credit card delinquencies have in turn begun to rise, rising to 2019 levels, but still well below what was experienced during the GFC. Delinquencies is other areas such as the auto market have also been on the rise.

Regardless, the US dollar is benefitting from expectations around "higher for longer". The US Dollar Index, a measure of the of the US Dollar against a basket of other currencies gained over 3.0% during the quarter. In contrast, gold, which does not typically enjoy an environment of higher interest rates owing to higher holding costs, dropped below $1,900/ozt to end the period at $1,871/ozt.

MSCI Index performance (USD %)



Source: FactSet

PERFORMANCE AND ATTRIBUTION

Following three consecutive quarters of relative outperformance, the conclusion of the third quarter brought an end to our positive streak. The SGEM declined 6.0% during the period, underperforming its benchmark (MSCI ACWI), which registered a decline of 3.4%.

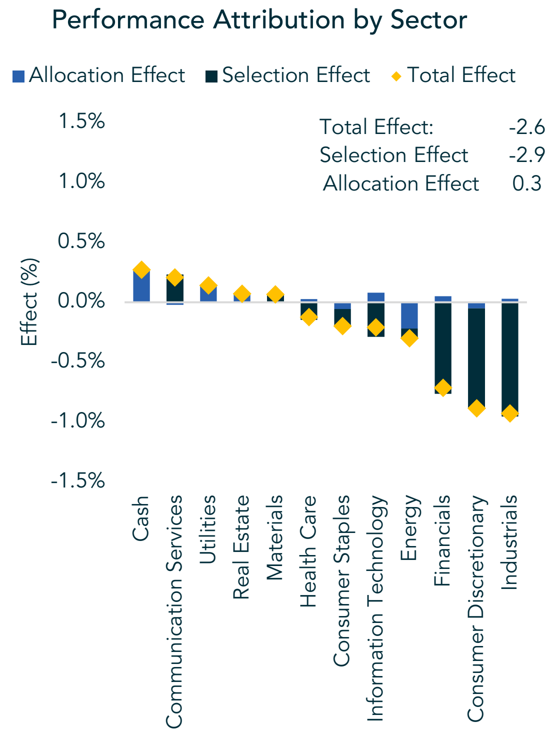
The relative underperformance can broadly be ascribed to the rise in longer term real yields. As a rule of thumb, as interest rates rise, so stock prices fall. The "DNA" of the SGEM is such that it is composed mostly of quality stocks, the majority of which have a growth tilt. The bulk of future earnings for "quality growth" stocks lie further out into the future as both growth rates as well as returns on capital are expected to remain above-average for extended periods of time.

This stands in contrast to companies that are more cyclical in nature as their future profits tend to be weighted more towards the near-term. As the majority of the future profits or "value" of quality growth stocks lie further out into the future, they are considered longer duration in nature which is another way of saying that they are more sensitive to changes in yields. It therefore follows that the rise in longer term rates has been relatively more impactful for the quality growth stocks leading to larger prices falls compared to the broader market.

Beyond rising interest rates, there were also stock specific issues that negatively impacted a number of our holdings during the quarter. This is well highlighted by the relatively larger negative contribution from the Selection Effect. The Selection Effect reflects the impact of holding specific stocks and their weightings relative to the benchmark. In this particular quarter, the negative Selection Effect can be ascribed to having a relatively larger weighting in specific stocks that underperformed the benchmark.

Perhaps the most notable issue, insofar as the impact it has had on some of our holdings, is the Chinese economy and the related headwinds that it currently faces (refer discussion above). As a result, our most directly exposed position located in the Financials sector, insurance giant **AIA**, fell sharply during the quarter.

Within the Consumer Discretionary sector, our holdings in **LVMH** and **Nike** were also negatively impacted by the prospect of a weaker Chinese consumer and the ensuing "softer" demand for discretionary items.



Source: Morningstar

The challenges facing the Chinese economy are pervasive in nature, meaning not just consumers but enterprises as well, are exposed. In particular, one of our holdings in the Industrials sector, specifically **Siemens**, has begun to feel the impact of waning Chinese demand. Orders within its digital industries segment, which assists manufacturers in the digitisation and automation of their facilities, have fallen quite steeply on the back of Chinese customers reducing order numbers. Softer demand is forecast to persist, at least in the short-term, and the German industrial conglomerate's stock price has begun to reflect such an environment, declining sharply during the quarter

While it may not have been exposed to Chinese headwinds, a second SGEM holding within the Industrials sector endured a challenging third quarter. At their most recent quarterly update, **RTX** (formerly Raytheon) management highlighted a manufacturing issue that has arisen regarding jet engines made by its subsidiary Pratt & Whitney. The issue, which is said to impact hundreds of engines on Airbus planes, will require RTX to remove and inspect the affected engines before determining the extent of repairs required. The RTX CEO noted that the repairs are going to be "expensive", and while they have estimated that the damage will be in the billions of dollars, the final figure still remains somewhat open-ended.

In general, the third quarter was particularly challenging for stocks within the Information Technology sector and for the most part our holdings within the sector were no exception. The largest underperformer within this cohort was semiconductor equipment manufacturer **ASML**. A slowdown in general semiconductor demand has led manufacturers that use tools made by ASML, such as TSMC, to push out capex spend to later years. In addition, concerns around export controls regarding shipments to China continue to linger in the background.

One area where demand for semiconductors remains healthy is those chips that are used for artificial intelligence ("AI") purposes, specifically those designed by **Nvidia**. The recent demand for Nvidia's AI computing stack has been nothing short of incredible and their recent quarterly results showed just how much demand surrounds their product offering with revenue surging over 100% and profits increasing four-fold. As the idea of AI continues to grow in momentum, demand for Nvidia's products is expected to remain robust though many are asking, quite rightly, how long can it last?

Besides the positive contribution from Nvidia during the quarter, there were two other bright spots worth mentioning. Rising oil prices benefited our holding in **Shell**. Despite concerns surrounding health care reform as we draw closer to the next election year, managed care organisation, **UnitedHealth**, delivered a strong gain during the quarter.

Somewhat surprisingly, the best performing holding within the SGEM portfolio during the quarter was **Alphabet**. The parent company of Google reported a strong set of results during the quarter, especially within its cloud computing division as it continues to build out its AI capabilities.

Both Alphabet and rival **Amazon** are facing antitrust lawsuits in the US, alleging that the two run effective monopolies in their respective fields of search and e-commerce. A sizable amount of political will exists to reduce the power that the two Big Tech giants wield but successfully suing the two may prove quite a challenge given the archaic rules surrounding antitrust and how they pertain to a digital era.

TOP PERFORMING STOCKS			BOTTOM PERFORMING STOCKS		
COMPANY	GICS SECTOR	CONTRIBUTION (USD %)	COMPANY	GICS SECTOR	CONTRIBUTION (USD %)
Alphabet	Communication Services	0.5	LVMH	Consumer Discretionary	(1.1)
Shell	Energy	0.2	ASML	Information Technology	(0.8)
Nvidia	Information Technology	0.2	AIA	Financials	(0.6)
UnitedHealth	Health Care	0.2	Siemens	Industrials	(0.6)
Berkshire	Financials	0.1	Diageo	Consumer Discretionary	(0.4)

Source: Morningstar

CHANGES IN HOLDINGS

During the quarter we exited our positions in Bank of America and RTX and we added a new holding to the portfolio, namely Constellation Software.

As part of our investment process, we are increasingly focusing on companies that we consider to be "quality-growth". There are a number of factors that we use to characterise a quality growth business such as high returns on capital, attractive growth opportunities, whether they possess a competitive advantage, the quality of management and financial stability.

CHANGES IN HOLDINGS (continued)

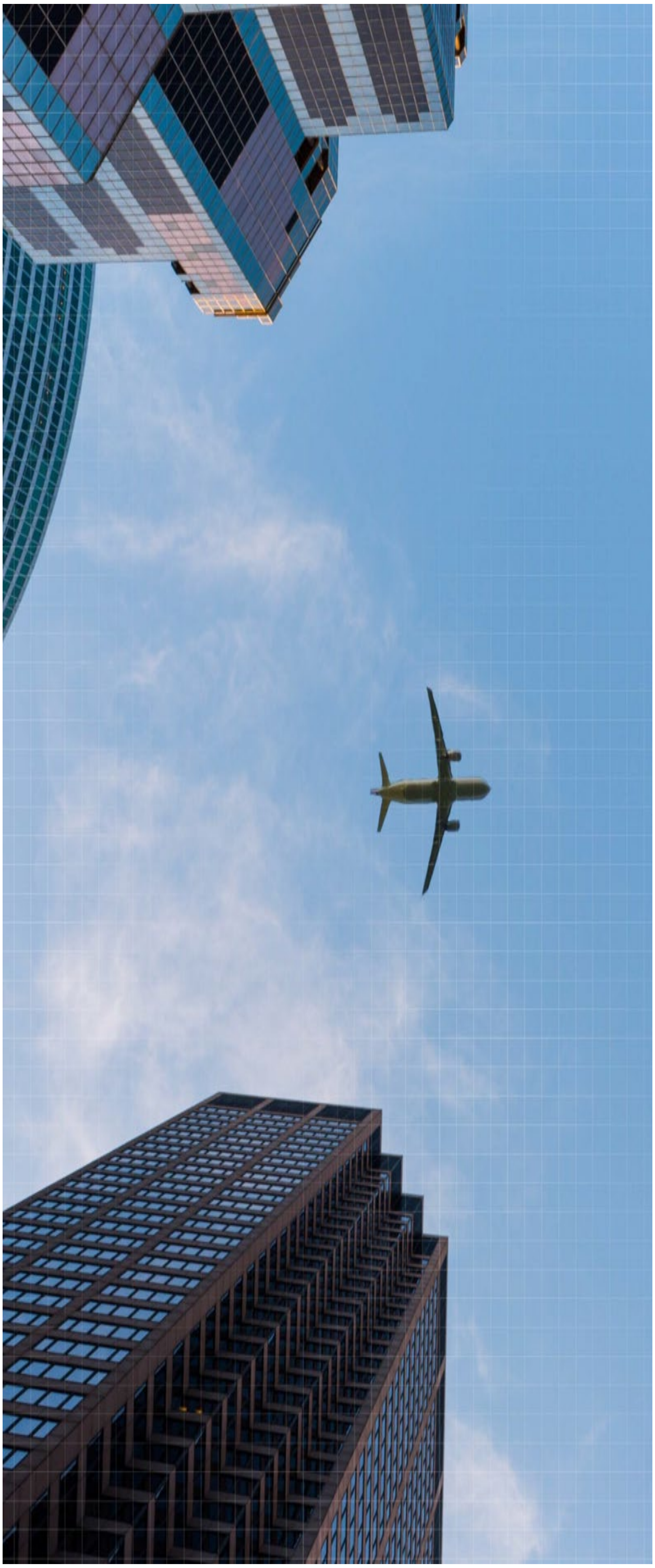
In terms of financial stability, we prefer to invest in companies that have minimal debt on their balance sheet. Put differently, we prefer companies that are not highly leveraged. This is of particular relevance to banks, and therefore Bank of America, as the typical banking model is predicated on leverage, something we would prefer to avoid. The recent banking failures of SVB and First Republic highlight the relevance of this concern.

n addition to high leverage, the ever-increasing opaqueness of banking group balance sheets, especially those of large investment banks such as Bank of America, hinders our ability to better understand the size and nature of assets and liabilities that they hold. Systemic events that lead to a spike in interest rates or credit spreads, to name but a few, could materially impact these entities and without a clear understanding of their "true" exposure, we believe it would be more prudent to avoid taking on such risks.

Following the disappointing news from RTX (see above for more detail), we have opted to exit our position in the company. We maintain the view that the company is likely to benefit from an uptick in defence spend as nations upgrade their military capabilities on the back of the Russia-Ukraine conflict. However, the issue surrounding their jet engines and the rather open-ended nature of the related liability has left us feeling uneasy, so much so that we would prefer not to be exposed. As a result, we have opted to completely exit our position in the company.

Constellation Software is a Canadian-based global software company that specialises in acquiring and managing vertical market software businesses. Vertical market software refers to software that fills a need for and is tailored to companies within a specific market or vertical, rather than being applicable across a range of industries such as Microsoft Office.

Constellation Software is a good example of what we would refer to as a quality growth business. It has a long track record of above-market growth, it generates high returns from the capital that it reinvests back into the business, it has a strong management team with a long-term focus, many of the businesses that it owns possess competitive advantages, and the company has a strong balance sheet with minimal debt.



OUTLOOK AND WAY FORWARD

Market consensus seems to suggest that interest rates have just about peaked, though the Fed has indicated that the door remains open for one more interest rate increase later this year. The Fed has also suggested that interest rates will remain at elevated levels for a period that may stretch further out than previously expected, much to the market's disappointment.

An extended period of higher interest rates is likely to be supported by a phenomenon that is less spoken about but nonetheless impactful for the level of interest rates as well as equity markets. Central banks may be close to drawing a line under the rate hiking cycle but are still likely to continue with quantitative tightening (QT), the reverse of quantitative easing (QE). Without going into technical details, QE is a form of monetary policy whereby central banks purchase securities, such as government bonds, in the open market with the impact of reducing interest rates. QT has the opposite effect and leads to higher interest rates.

Whether an extended period of higher interest rates will be sufficient to push inflation back down to the Fed's targeted level of 2% remains to be seen. With the price of oil continuing to push higher towards the $100 level, some voices have even suggested that interest rates may need to go even higher.

Regardless of whether interest rates go higher, the data is beginning to show that the consumers and businesses are beginning to feel the pinch of higher rates. The savings that consumers accumulated during the COVID period, specifically from government payouts, has slowly dwindled away and credit card debt has steadily crept higher. Businesses are not immune either with the rate of corporate defaults beginning to accelerate. Perhaps the real trigger for interest rates to fall will be when something "breaks", be it business, the consumer or even the plumbing of the financial system.

Before we go too far down the macro "what-if" rabbit hole, we should pause and remind ourselves that we are long-term investors. Determining the trajectory of interest rates over the long-term, let alone the timing of changes thereto, is difficult at best and we believe borders on a "fool's errand".

We do however need to be cognisant of the current interest rate environment and even don our "fools" cap in taking a view on what the longer-term rate of interest might be.

This is particularly relevant when we attempt to determine what we believe to be the intrinsic value of companies through the discounting of future profits or cash flows at an appropriate rate – which of course has a rate of interest embedded therein.

History has shown that over the long-term, the best determinant of a company's stock price is the growth in earnings by the company. Two considerations are worth highlighting from this statement.

Firstly, it is our preference to invest in companies that we believe are able to consistently grow their earnings over the long-term. To our mind, the type of companies that best encompass this philosophy are quality growth businesses. As a reminder, these businesses are able to consistently generate high returns on capital and reinvest excess profits back into attractive growth opportunities.

The second consideration worth mentioning is that instead of obsessing over, and basing our investment decisions on macro variables such as interest rate changes, we will instead focus on factors that impact a company's earnings over the long-term. These factors can range from broad analysis such as the competitive forces impacting the economic profitability of an industry down to more company-specific factors such as how management is deploying capital, be it R&D or shareholder distributions.

We highlight these considerations to provide some perspective. The recent performance by equity markets as well as the macro-outlook can easily lead one to adopt a bearish outlook expecting further disappoint down the road.

It is completely within the realms of possibility for markets to continue to disappoint, be it for the remainder of the year or perhaps longer. We would however again highlight that our focus lies further out into the future and the long-term performance of our holdings.

This said, we humbly acknowledge that while we cannot predict what will happen in the future, our outlook remains sanguine, cautiously optimistic if you will. The in-depth analysis that we have performed on the businesses that we have invested in provides us with a level of comfort that despite the near-term headwinds, the companies will continue to grow their earnings at above-average rates of growth. We maintain the view that as their earnings grow, their stock prices will follow, though the pattern may be somewhat asynchronous.

PORTFOLIO CHARACTERISTICS					
	SGEM	MSCI ACWI		SGEM	MSCI ACWI
Quality[3]			Valuation[3]		
ROE	35.5%	15.6%	P/Earnings	22.5x	15.4x
ROIC	21.2%	8.0%	P/Book	8.0x	2.4x
EBIT	23.4%	13.4%	P/Sales	5.1x	1.8x
Gross Profit	49.0%	34.4%	FCF Yield	4.8%	5.1%
Growth[3]			Risk/Volatility[2]		
Sales growth[1]	11.4%	7.2%	Beta	0.9	0.9
Earnings growth[1]	15.1%	8.6%	Std Deviation	14.5	15.2
Size[3]			Sharpe Ratio	0.5	0.4
Market cap	USD595bn	USD408bn	Sortino Ratio	0.8	0.7

Source: FactSet, Morningstar
Notes:
1 – Trailing twelve months 3-yr annualised growth rate
2 – Risk statistics calculated since SGEM inception (31 December 2014)
3 – SGEM Quality, Valuation and Size characteristics calculated using weighted averages, SGEM Growth characteristics reflect median values

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