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PARTNERS

Rozendal Partners year end letter 2018

Dear friends and fellow investors,

Rozendal's performance vs. benchmark

Period	Fund*	Benchmark**
Since inception***	4.9%	(8.6%)
Six months to 31 December 2018	5.5%	(6.9%)

*Rozendal Worldwide Flexible Prescient Qualified Investor Hedge Fund. Returns shown for the B unit class, which is the earliest unit class in existence. Return numbers for other unit classes may differ slightly. Returns shown assume income is reinvested gross of tax.

**FTSE/JSE All Share Total Return Index

***1 February 2018

Introduction

This letter marks the conclusion of the first calendar year of operation of the Rozendal Worldwide Flexible Prescient Qualified Investor Hedge Fund ('the fund' or 'the QIHF')[1]. Disappointingly, the process of getting the Rozendal global fund up and running is still beset with regulatory delays. Hence this letter will again deal primarily with the QIHF. While the fund's operations only commenced on 1 February 2018, and the period covered in this letter does therefore not represent a full twelve months, we will ignore this for the sake of convenience and materiality. One month is truly immaterial both in the context of the timelines on which we invest, and in the context of the time we expect to be co-invested in the fund with our fellow investors.

Unfortunately, we have not yet reached a stage of having completed an investment cycle in any of the fund's investee companies, so our comments in this letter will be short on specifics and long on generalities. Please bear with us – we do expect to conclude the investment cycle of at least one of the investments in the fund during the next six months (due to corporate action and/or the nature of the investment, not because we are forecasting a material share price increase prompting us to sell!).

Investment Returns

The fund's return since inception has been modest in absolute terms, but strong in relative terms. 'Strong' on both counts would have been more satisfactory, but we are not displeased with the outcome to date.

Holding a meaningful amount of cash (both South African Rands as well as foreign currencies) proved to be beneficial in a year where many asset classes (notably also the fund's benchmark) suffered negative returns. Our cash holdings are a residual of the opportunity set we have at hand: a limited opportunity set will result in substantial cash holdings. A plethora of attractively priced opportunities will result in low cash holdings. We do not target a specific allocation to

[1] Note that the financial year end of the fund is 31 March.

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cash – and will prefer an environment where we are so overwhelmed with attractive investment opportunities that we hold no cash at all.

When it comes to stock specifics, on the positive front, Anglo American Platinum ('Amplats') has been the top contributor to returns during the year. 2018 turned out to be only the third year in the past ten during which the FTSE/JSE Platinum & Precious Metals index delivered better returns than the overall market (the other two being 2009 and 2016). Solid demand for the non-platinum components of the basket of metals mined by the platinum miners was accompanied by muted production growth, resulting in production deficits in the palladium and rhodium markets. This boosted prices quite impressively (refer to Chart 1 below). Combined with a weaker rand dollar exchange rate and reasonably stable operating conditions, profitability at Amplats is recovering strongly – which the share price is reflecting.

Chart 1: Platinum, palladium and rhodium prices (rebased to 100)

Source: Thomson Reuters Datastream, Rozendal Partners

Impala Platinum's announcement during the year that it is materially curtailing its longer-term volume production expectations is the type of action which one does associate with industry cycle bottoms. There have been a number of such signals in the platinum industry in recent years, and many of them have been 'false starts', so we would not be so bold as to call Impala's announcement the bell that rang at the turning point for the industry. But it is certainly a positive signal from a capital cycle perspective.

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When Chris Griffith joined Amplats as Chief Executive Officer in 2012, he made it quite clear to investors that he would be managing Amplats for a 'lower for longer' platinum price environment. At the time, we were inclined to think that this was perhaps too conservative: such a strategy inevitably involves giving up profits when the cycle turns. More than six years later his decision has proven to be inspired. Amplats has dramatically outperformed the rest of the industry both on the ground and on the stock market since Mr Griffith's appointment.

Grand Parade Investments has been another strong contributor to returns. We joined like-minded investors in bringing shareholder action to effect positive governance changes at this hugely discounted investment holding company. While some aspects of the shareholder action process have been frustrating, we are satisfied that things are moving in the right direction in the company, to the benefit of all shareholders. The share price tells a story of the market agreeing with our assessment. Come the time, we will present a more detailed retrospective about our experiences with Grand Parade Investments.

On the negative side, share prices of some of the 'SA Inc.' companies held in the fund suffered during 2018. The share prices of companies like HCI, Invicta and AECI all reflected the gradual dissipation of hope that the South African market experienced during 2018. The optimism around the change of president in South Africa early in 2018 made way for the harsh reality of an economy in recession, a government incapacitated by years of egregious corruption, and little prospect of a rapid improvement in fortunes. We don't hold any meaningfully variant view about the South African economy (macro forecasting is not our forte) but are comfortable that the price of the 'SA Inc.' investments in the fund reflect an unduly dire long-term view of the respective companies' prospects. In several instances, the companies themselves are also able to effect meaningfully positive change to their own fortunes without being overly reliant on purely a broad recovery in the South African economy.

Investment Observations

2018 appears to have been the year where the global equity market party finally started to fizzle out – specifically in the US. The S&P 500 index delivered its first negative calendar year return since the Global Financial Crisis ten years ago. And interestingly, most asset classes suffered negative returns in 2018, even if the numbers were comparatively modest. There was a distinct return to greater volatility in equity markets during the latter half of 2018. This uptick prompted some alarm from market commentators. But in the longer-term context, it has really been nothing exceptional.

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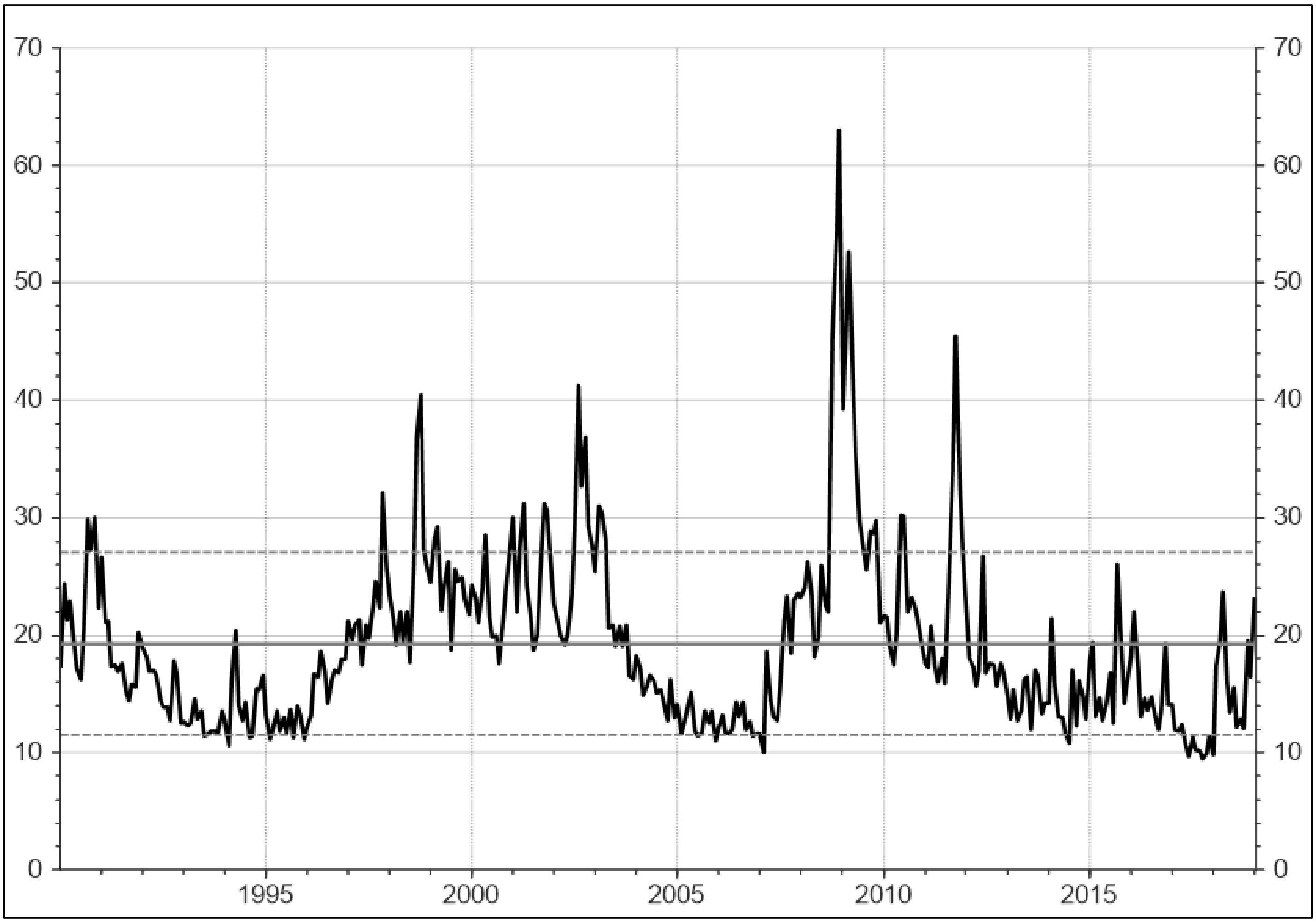
Chart 2: CBOE Volatility Index



Source: Thomson Reuters Datastream, Rozendal Partners

The chorus of voices in times of volatility usually have either a tone of panic (typically media commentators looking to drum up sensation where really there is none) or of composure (typically financial professionals looking to keep their clients from decamping). Do not expect us to join either chorus in such times: while price fluctuations can be unsettling to those with a short-term focus, we strive to find opportunity in short term volatility rather than dwelling thereon.

1. Popularity

Finance luminary Roger Ibbotson and associates published a very interesting work on popularity and its role in asset prices and investment returns late in 2018[2]. The overall conclusion is that any characteristic which is popular amongst investors results in the price of assets displaying that characteristic being bid up. This inevitably results in low prospective returns being earned by investors in such assets. This finding hardly sounds earth-shattering, and certainly conforms to our world view when it comes to investments. But Ibbotson et al. manage to lay out the merits of the case with proper

[2] https://www.cfainstitute.org/en/research/foundation/2018/popularity-bridge-between-classical-and-behavioral-finance

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academic rigour. In the process they also provide a very useful and concise summary of the most important academic findings to date in the field of asset pricing, risk factors and investment anomalies – highly recommended reading.

(Un)Popularity exhibit 1: The United Kingdom

For us the obvious corollary from reading Ibbotson et al.'s work is a renewed search for the unpopular in investment markets. And amongst the major stock markets of the world, one currently stands out: The United Kingdom.

The political chaos around Brexit has been the stuff of editorial dreams. Ever since the 'Leave' vote prevailed almost three years ago, there has been a constant flow of news highlighting the uncertainty of the impact Brexit will have on the United Kingdom. The cover of The Economist of 17 January 2019 is a case in point:

To the extent that there is any certainty on the matter, it appears to be that Brexit will have a negative impact on the economy of the UK. Uncertainty shrouded in negativity is exactly the kind of characteristic that markets hate.

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Unsurprisingly, this has resulted in the pound selling off to historically very cheap levels on a real effective exchange rate basis.

Chart 3: British pound real effective exchange rate

Source: Thomson Reuters Datastream, Rozendal Partners

And as Chart 4 below shows, the UK stock market's relative rating also reflects this revulsion.

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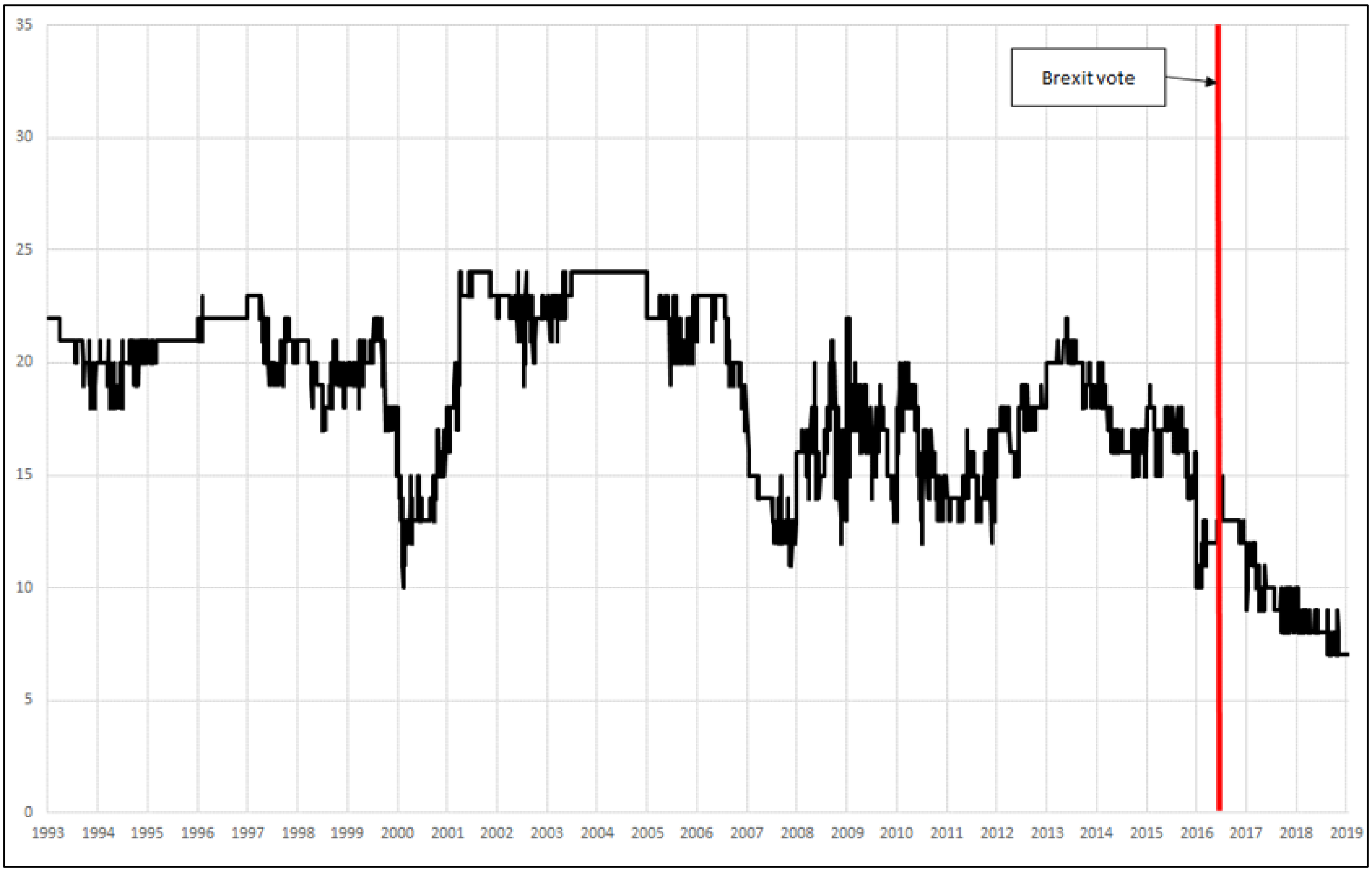
Chart 4: UK market price to book ranking relative to developed markets



Source: Thosmon Reuters Datastream, Rozendal Partners

In this chart, a lower value means a more attractive (i.e. lower) price to book value compared to other developed markets. The UK market is the cheapest it has been relative to other developed markets in 25 years on a price to book basis. Of the 25 developed markets in the data set, the UK was historically on the more expensive side, ranking on average 18th out of 25. Currently it ranks 7th. Incidentally, Ireland and (perennially 'cheap') Korea ranks cheapest, while Denmark and the (perennially 'expensive') US ranks most expensive. While the merits of price to book as a valuation measure has been the subject of much debate, our work shows that on the level of country indices it has been a better predictor of long term (five to ten years) relative returns across markets than other widely used valuation metrics (price to earnings, dividend yield or price to ten-year average earnings). While the fund does have capital committed to the UK already, it is certainly a market we are scrutinising closely for more opportunities.

(Un)Popularity exhibit 2: Coal

Global warming and man's impact on the environment have been increasingly topical and contentious issues in recent years. It is not for us to cast judgements in these matters. But the controversy around coal – the most polluting of energy sources – and the financing of coal production has resulted in some interesting developments in financial markets. The following paragraph from a piece of research published by a leading equity research firm encapsulates developments beautifully:

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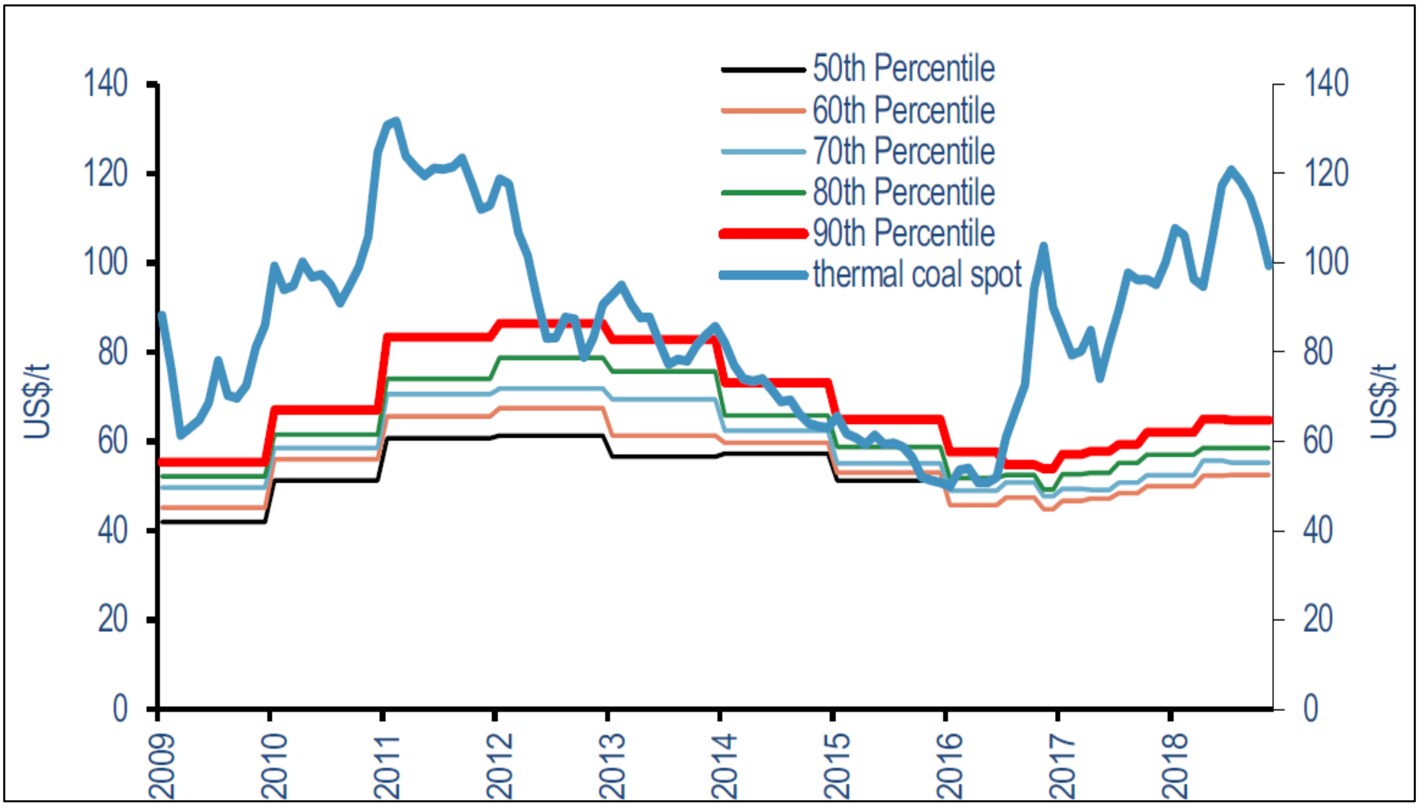
'The lack of investment in new supply is a key issue in thermal coal – in previous cycles, the price peak was the point for investments in thermal coal projects. This time, not only are a lack of financing and difficulty obtaining mining licences a hurdle, but also the fear of demand falling away quicker than anticipated is making miners hesitant. As for met coal, we therefore apply a 15% IRR in our thermal coal incentive price analysis.'[3]

Whereas the analyst quoted here uses a 10% required rate of return on mining projects to calculate the commodity price at which it is economically feasible to develop a new mine, for coal projects he uses 15%. On this basis, a substantially higher commodity price relative to production cost is required to trigger the development of new coal mines than for other minerals.

Coal mining has historically been the ultimate zero barrier to entry industry. Coal resources are plentiful globally. Licenses and capital have always been required to establish a new coal mine, but these are typically hardly insurmountable impediments. However, the difficulty of financing large scale coal mines in the current environment is creating a capital constraint on the industry. Where capital is scarce, returns on capital tend to be high. Chart 5 below shows how high globally traded thermal coal prices have been relative to production costs in recent years. Let there be no doubt: excess returns have been earned.

Chart 5: Thermal coal prices relative to production costs



Source: Wood Mackenzie, Morgan Stanley Research

[3] Morgan Stanley metal&ROCK: Long-term prices – stimulating supply, 12 December 2018
https://ny.matrix.ms.com/eqr/article/webapp/7f9c01bc-f159-11e8-b042-be2b9f38d232?ch=rpext&sch=sr&sr=5

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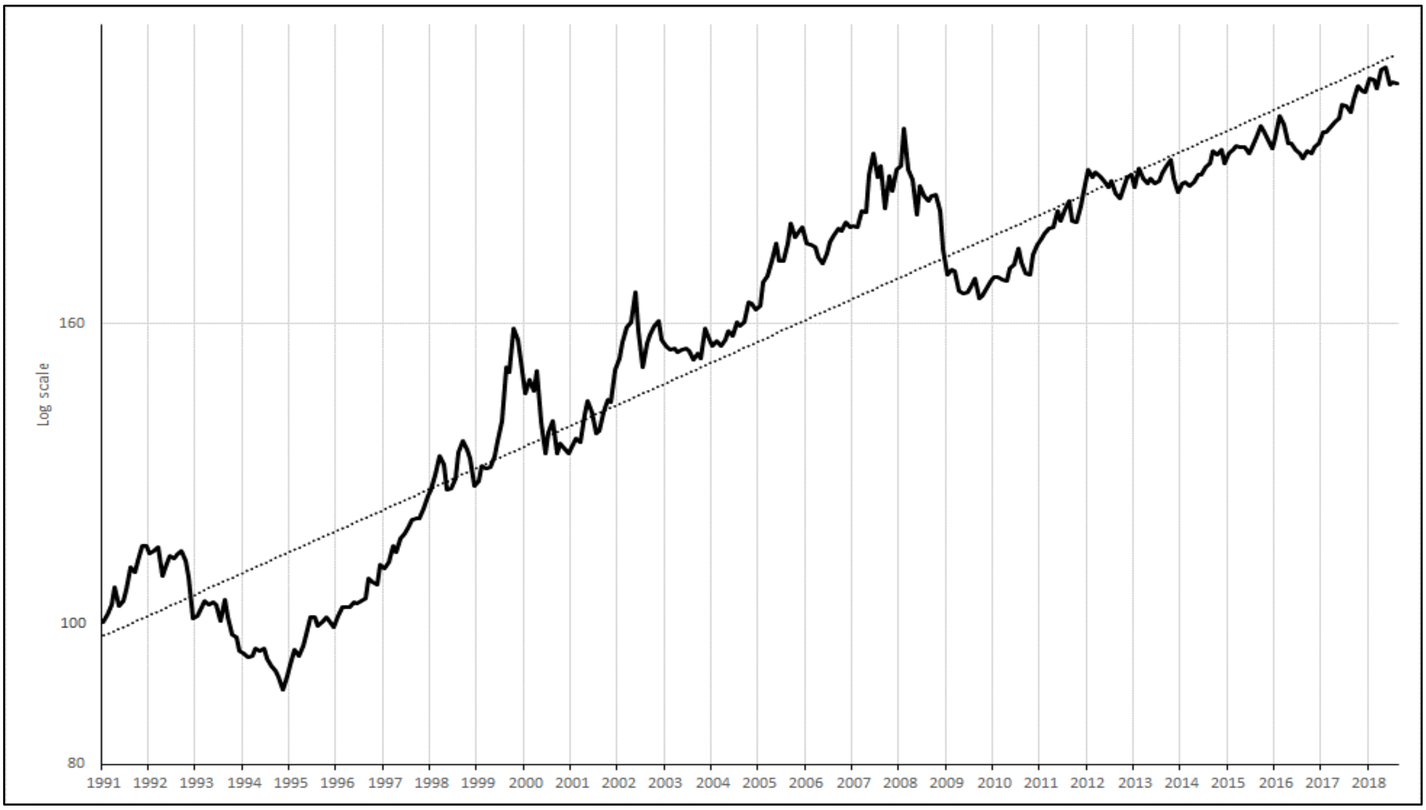
Normally, one would expect such excess profits to trigger a flood of new supply in a no barrier to entry industry, and for prices to mean revert closer to costs quickly. But the lack of capital available for developing new coal mines may well mean that these high prices persist for longer than one may historically have expected.

The fund currently has negligible exposure to coal mining – we are generally cautious in our approach to commodity markets where profit margins are as elevated relative to history as we have seen of late in many areas of the diversified mining industry. But the dire unpopularity of coal as an industry for new capital investment is certainly a factor that features prominently in our thinking when we look at mining companies with exposure to this most hated of minerals.

2. Value investing and momentum

Historically, simple value investing[4] has worked – at least over very long timeframes. The inverse of value investing – growth investing – has failed dismally. But momentum investing – the practice of buying stocks which have performed best over the past six to twelve months – has been a very robust strategy. Chart 6 below illustrates the relative return delivered by the MSCI All Country World Momentum index compared to the standard MSCI All Country World index since 1991.

Chart 6: MSCI ACWI Momentum vs. MSCI All Country World: USD total return



Source: Thomson Reuters Datastream, Rozendal Partners

[4] By 'simple value investing' we refer to a quantitative process of buying the stocks with the most attractive valuation measure (such as enterprise value to sales, price to earnings, price to book value or dividend yield) in the market, paying no attention to prospects of the businesses underlying said stocks.

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On average (as depicted by the dotted trend line in the chart), momentum has beaten the broad market by about 3.4% per year. Yes, momentum does 'crash' on occasion, at least in relative terms (refer to the early 1990's, and both the years 2000 and 2009), but despite this the strategy has historically delivered very good risk adjusted returns over long periods of time. Momentum investing is the legitimised manifestation of the old 'cut your losses, run your profits' market aphorism.

From a value investor's point of view, momentum investing is somewhat counterintuitive. Cutting losses and running profits means that one is selling assets that have declined in price and buying (or holding on to) assets that have increased in price. In a strict valuation-based investment framework this makes little sense: assuming one's assessment of intrinsic value of an asset is accurate, then it makes sense to have more capital invested in an asset that has a greater discount to intrinsic value. Short term price declines will typically result in greater discounts to intrinsic value, and vice versa for short term price increases. Hence a value investor should logically be buying when prices fall and selling when they rise. But this results in exactly the opposite behaviour to what one would engage in if following a momentum investing framework. One is effectively 'shorting' momentum by buying the dips and selling the (price) pops as a value investor. History suggests that one categorically does not want to be short momentum – at least not for extended periods of time.

As value investors first and foremost, how do we deal with this dichotomy? To us the most practical way of ensuring we are not persistently betting against momentum is to be more cognisant of momentum in our portfolio construction than we may have been if following a purely valuation-based portfolio construction process. We view a dramatic share price fall with a degree of circumspection rather than just blind enthusiasm, we build positions in 'recently cheap' shares in a measured fashion, and we pay attention to catalysts, corporate actions and/or other cues of emergent value rather than just focusing on discount to fair value. And of course, if momentum is on our side when we buy a stock, so much the better!

Rozendal Partners update

The eagle-eyed amongst our readers will have noticed that the word 'Worldwide' has snuck into the fund's name - as if it was not long enough already. Once again (refer to our commentary about the fund's name in our previous letter to investors), this is a regulatory imperative which we have had to heed. The fact that the fund has the flexibility to invest all its assets outside of South Africa following a recent investor ballot necessitated insertion of the 'Worldwide' tag into the name. This has changed nothing to how we manage the fund though.

And in a very exciting development during the past six months, we were delighted to welcome Madeleine Kymdell to the Rozendal Partners team. As the first (and at this stage only) female member of the team, her appointment has increased our diversity score by an infinite percentage. Madeleine will mainly be responsible for some operational matters as well as general support of the team in our quest to deliver the results for investors that we set out to do.

Yours sincerely,

Wilhelm Paul Jan

30 January 2019

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