

Melville Douglas

Global Equity Fund

A Bumpy Ride

Navigating global stock markets this year has been akin to skiing down a Winter Olympics moguls slope. There have been bumps with every twist and turn. Namely, a growth-to-value investment style rotation, stagflation worries, and a European war.

Investors abhor all this uncertainty and duly marked down share prices. At its worst point the MSCI All Country World index fell over -13% by early March from its early January peak.

The outlier amidst the sell-off has been energy. For equity investors the sector is feast or famine, and little in between. The MSCI All Country Energy sector index (which includes the oil majors, drillers and oil service companies) surged over +20% during the quarter as oil prices broke through \$120 per barrel. Brent crude was trading below \$20 per barrel two years ago.

Oil companies periodically have their moments in the sun (and in purgatory), but they are price takers in a capital-intensive industry that is in terminal decline as fossil fuels are phased out. As the selling price of their products is highly volatile, the oil industry typically deploys capital investment near the top of the cycle when they are cash-flush, there is belief "it's different this time" and marginal projects look attractive. This sows the seeds for the next downturn.

As the resource industry has a poor track record of generating consistent returns above the cost capital and pinpointing cyclical tops and bottoms is not our forte, we have little direct exposure to commodity producers. The tortoise-and-the-hare benefit of owning steady compounders will outweigh near-term FOMO.

Another macroeconomic headwind is the cost of living squeeze that will reduce demand for products and services as consumers tighten their purse-strings. In addition, higher interest rates lower the present value of cash flows in future years. Because quality-growth stocks tend to trade on higher price-to-earnings ratios than the broader market, they were disproportionately sold off when the Federal Reserve became more hawkish. As these are also the type of companies the fund seeks to invest in, performance has lagged benchmark indices during the quarter.

Quarterly Commentary as at 31 March 2022



What's Our Game Plan?

The silver-lining is that the recent sell-off has provided compelling new money entry points for selected high-quality investments. For example, Nike's share price is down -20% year-to-date but the business continues to report robust sales momentum and pricing power. This well-managed, innovative business is boosting profit margins by skipping the middle-man and increasingly selling products that consumers want via direct digital channels.

Another example is Microsoft. The software giant reported +20% year-on-year sales growth last quarter, driven by robust demand for its cloud computing services where it is a Big Three player alongside Amazon and Google. Cloud computing penetration sits at only 27%, providing a long runway for growth. The share price sell-off has lowered Microsoft's valuation back to pre-pandemic levels even though its business mix has structurally shifted to a sustainably higher plain of profitability and growth. It justifies its place as one of the largest holdings in the portfolio.

During these bouts of volatility our tried-and-tested investment philosophy provides objectivity. Rather than seeking to catch every macroeconomic and geopolitical wind-shift in the macro environment we have constructed a diversified portfolio of quality compounders that can deliver competitive inflation-plus returns without undue risk. Our mantra is to identify great business models operating in sustainably better than average growth markets, monitor their economic moat, avoid excess valuations and hold one's nerve through periodic bouts of investor nervousness. It is a long game.

Quarterly Commentary as at 31 March 2022

From our Fund Manager's Desk

Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund to demonstrate what we find compelling. This time round we have chosen Anthem (soon to be renamed Elevance Health).

US Healthcare - A Blessing and a Curse

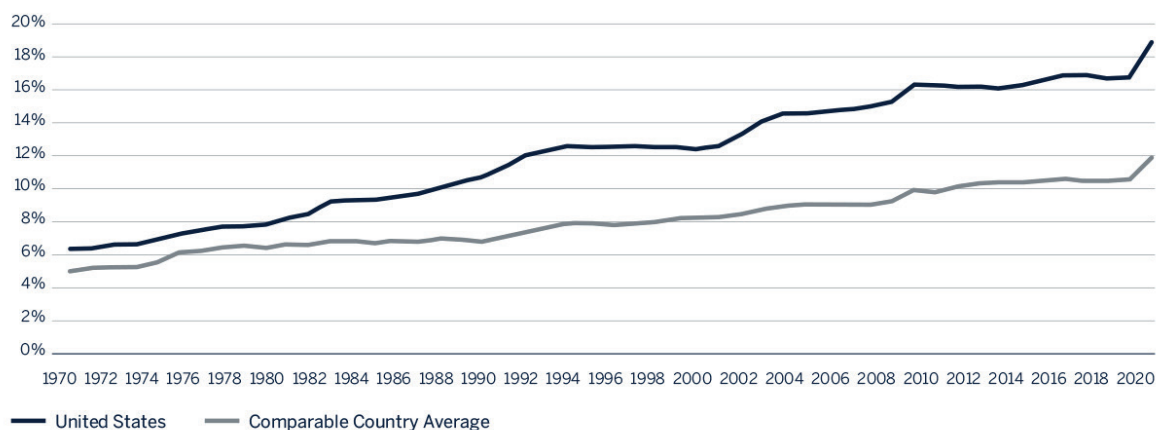
US healthcare is widely regarded as world beating in terms of cutting-edge advancements, treatment, and care. There are large drawbacks though; it is not universal, and its byzantine and incentive structure is unsustainably costly. As a result, even though the country spends more of its GDP on healthcare than other wealthy nations, it often languishes near the bottom of peer healthcare outcome rankings such as infant mortality and life expectancy.

US healthcare is unique amongst the G7 countries in that it does not have a government health service that is available to the entire population, regardless of age and income. To access its leading-edge healthcare, most of the US population is required to sign up to private insurance or government health insurance programs, with roughly 10% of the population being uninsured.

US healthcare costs are onerous relative to comparable countries as the fee-for-service payment model and threat of legal action incentivizes healthcare practitioners to spend rather than optimize. US health consumption expenditure is 19% of GDP, which is 50% higher than similar countries. The concern lies in that US healthcare costs will rise further to an unsustainable proportion of GDP as a result of an ageing population, increasing occurrence of chronic conditions and costly medical advances.

Rocketing US health spending will become a problematic burden on society if left unchecked

HEALTH CONSUMPTION EXPENDITURE AS A PERCENT OF GDP (1970-2020)



Source: KFF

Quarterly Commentary as at 31 March 2022



A conduit for change

There is a solution – MCO efficiencies

Managed care organisations (MCOs) provide and administer health insurance and healthcare services to individuals in the US. They primarily serve individuals through employers as well as government programs. Unlike drug companies, MCOs are not subject to patent cliffs and the ongoing pressure to innovate, resulting in a more consistent profit generating business model. What we find attractive about the managed care sector, is that it plays a pivotal role in lowering US healthcare spending growth. There has been increased focus on driving efficiencies in how healthcare providers are reimbursed by MCOs. Shifting payments models from a fee-for-service basis to value-based care would ultimately lower the elevated healthcare costs by changing healthcare providers incentives from excessive utilisation of resources toward less costly treatments whilst delivering quality based care.

Anthem is one of the largest MCOs in the US and a core holding, along with its peer United Healthcare, in the Melville Douglas Global Equity fund. The company has a great track record over the years of not only adding value to the US healthcare system, but also to its shareholders.

Taking a Greater Share From an Expanding Pie

Anthem's health insurance business represents the largest proportion of its revenue. Profit is earned when premiums received from customers exceed customer claims and operating expenses. As a result, the business is incentivised to optimise healthcare and other costs to remain profitable. Profitability in the health plan business is regulated as the business is required to spend between 80% and 85% of premiums received on medical costs. If this does not occur, the business is required to return the unspent portion, which was required to be spent, to members.

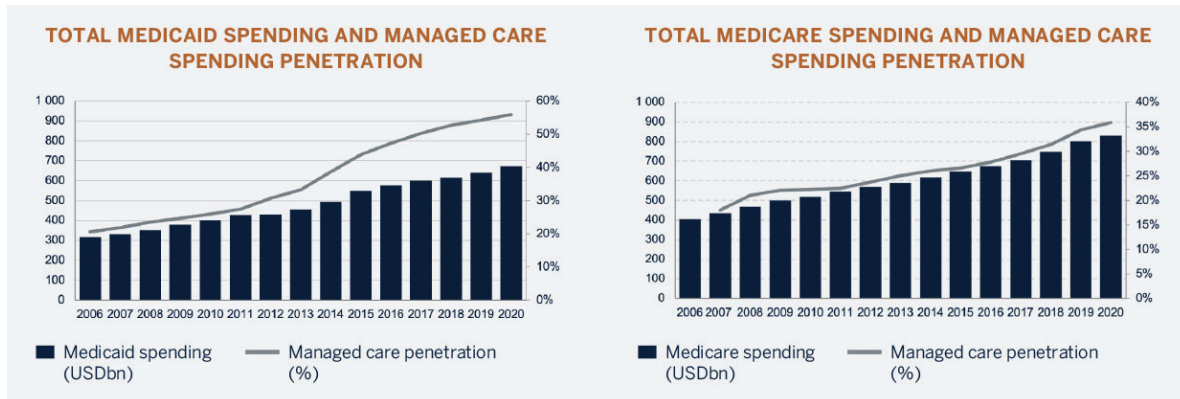
Anthem is one of the largest commercial insurers in the US, where insurance is offered through employers. This segment drives a significant proportion of group earnings due to its high profit margins. We expect steady, albeit moderate growth from this mature part of the market which is already dominated by the large MCOs. Growth is likely to be driven by jobs growth and the general rise in health spending per capita.

The big opportunity is garnering more market share of the government and state programs. Health insurance is offered through Medicare, a program for the elderly, and Medicaid, a program for low-income individuals. We expect the MCOs to play a larger role in government and state programs as they currently control less healthcare spending within this market.

As MCOs partake in a larger portion of the healthcare cost ecosystem, their ability to control where healthcare spending takes place increases. This helps to lower healthcare cost growth while providing the MCOs with an extended customer base.

Quarterly Commentary as at 31 March 2022

Anthem and its managed care peers continue to take share of US government programs



Source: Centers for Medicaid and Medicare services, Medicaid, BAML, Statistica

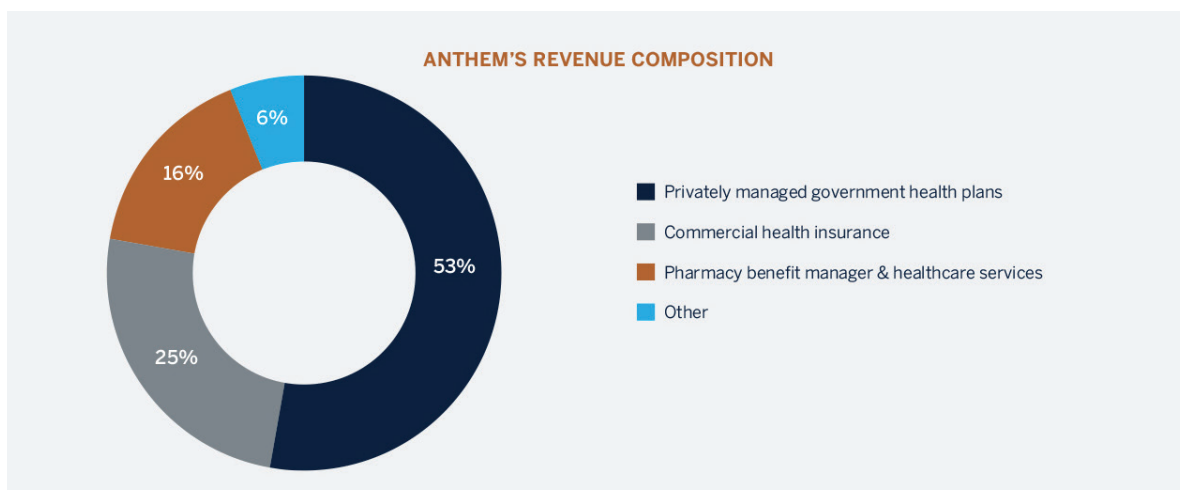
Diversification to Unregulated Earnings Drives Higher Profitability

In addition to its health insurance business, Anthem is increasingly building out its healthcare services, which is still in a nascent stage. This includes IngenioRx, a pharmacy benefit management service (PBM), which manages drug spending on behalf of health plans. PBM services manage drug coverage, rate negotiation with manufacturers and delivering medication to customers. Integrating PBMs with the health plans has been a key theme as MCOs move toward vertical integration.

Anthem's health services business (Diversified Business Group) focuses on reducing the cost and enhancing the quality of healthcare. Its healthcare services include behavioural health solutions for mental health conditions, advanced patient care and management of chronic diseases beyond primary care through care centres and home-based care.

This business has the advantage of penetrating within Anthem's customer base as well as externally. The healthcare services diversify Anthem's portfolio and contributes to reducing healthcare costs. The benefit of these services is that its growth and margin profile is stronger than the base business. We view this as a compelling strategy, as the earnings related to this business are unregulated, allowing for higher profitability than the health plan business.

Anthem and its managed care peers continue to take share of US government programs



Source: FY21 company financials

Politics and Economics - A Reliable Source of Near-Term Sturm and Drang

Healthcare is a political hot potato. Hence, US presidential election campaigns tend to create uncertainty over the direction of future healthcare policy. As the risk of lower spending could lower premiums received by the MCOs, the share price performance of the MCO sector has historically underperformed leading up to elections due to healthcare policy concerns. Once there is clarity on the direction of healthcare policy, the share price performance of the MCO sector tends to recover on easing concerns.

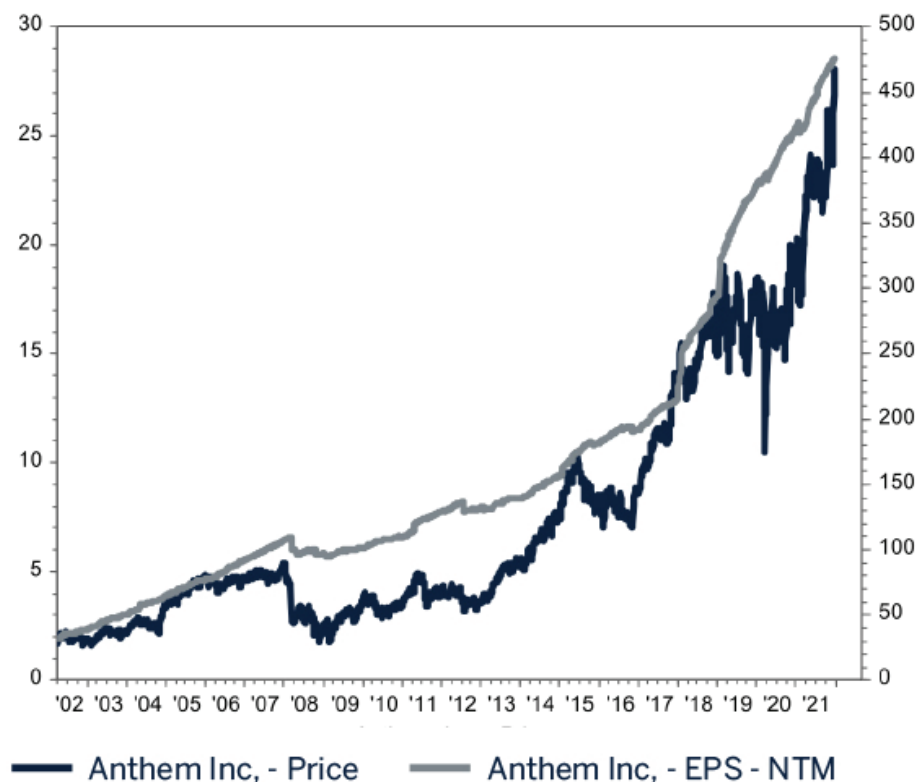
For Anthem, which has a sizable commercial exposure, economic downturns can result in job losses and individuals having to forgo their health insurance. While this results in slower commercial growth for the business, this can be offset by stronger Medicaid growth as individuals apply for health insurance through government programs.

An Effective Way to Profitably Capture the Inexorable Rise in Healthcare Spending

An investment in Anthem is a route to tap into both potential growth of healthcare spending (i.e. ageing demographics and increasing treatment demands by patients) and governments budget pressure to get more bang for a buck. In doing so, Anthem is likely to grow its profits in the low to mid-teens.

The combination of a strong track record of delivery in a stable growing addressable market, marks Anthem as a “Melville Douglas stock”.

Anthem's profits have driven its solid share price performance over time



Quarterly Commentary as at 31 March 2022

Market Review and Outlook

“There are decades when nothing happens; and there are weeks where decades happen”

Vladimir Ilyich Lenin

A grim time for the world. First and foremost, our thoughts are with the 44m Ukrainians impacted by the Russian invasion. Whilst it is crass to assess investment implications whilst lives are tragically being lost, it is also incumbent on us to review the risks and remain objective.

The cliché is to “buy to the sound of cannons, sell to the sound of trumpets”, i.e. markets panic at the outbreak of wars and then become complacent again when they end. The quote was first uttered by financier Nathan Rothschild during the Napoleonic Wars but sadly man's inhumanity to man and investor greed & fear are hard-wired in the human-psyche.

As shown in the table below, selloffs associated with major geopolitical events tend to be short-lived and often a buying opportunity when a recession is not around the corner. Although tail risks have increased, our base case is that we will not be a global recession within the next 12 months. Of course, each situation had their own specifics, but history suggests there is wisdom in pausing for reflection rather than automatically rushing for the exit.

How Do Stocks Do After Major Events?

S&P 500 Index Performance After Geopolitical and Major Historical Events

Market Shock Events	Event Date	S&P 500 Index Returns				Near a Recession?
		1 Month	3 Months	6 Months	12 Months	
Germany Invades France	5/10/1940	(19.9%)	(12.7%)	(4.5%)	(18.7%)	No
Pearl Harbor Attack	12/7/1941	(1.0%)	(11.0%)	(6.5%)	4.3%	No
N. Korean Invades S. Korea	6/25/1950	(10.0%)	1.6%	4.1%	11.7%	No
Hungarian Uprising	10/23/1956	(2.1%)	(2.8%)	(1.3%)	(11.7%)	Yes
Suez Crisis	10/29/1956	(4.4%)	(3.6%)	(0.0%)	(11.6%)	Yes
Cuban Missile Crisis	10/16/1962	5.1%	14.1%	20.7%	27.8%	No
Kennedy Assassination	11/22/1963	6.8%	11.9%	15.5%	23.2%	No
Gulf of Tonkin Incident	8/2/1964	(1.6%)	1.9%	5.3%	2.7%	No
Six-Day War	6/5/1967	3.3%	5.9%	7.5%	13.5%	No
Tet Offensive	1/30/1968	(3.8%)	5.1%	5.2%	10.2%	No
Penn Central Bankruptcy	6/21/1970	(0.1%)	7.2%	16.8%	28.6%	Yes
Munich Olympics	9/5/1972	(1.0%)	5.7%	2.3%	(5.8%)	No
Yom Kippur War	10/6/1973	(3.9%)	(10.7%)	(15.3%)	(43.2%)	Yes
Oil Embargo	10/16/1973	(7.0%)	(13.2%)	(14.4%)	(35.2%)	Yes
Nixon Resigns	8/9/1974	(14.4%)	(7.0%)	(2.8%)	6.4%	Yes
Reagan Shooting	3/30/1981	(0.9%)	(1.8%)	(14.0%)	(16.4%)	Yes
Continental Illinois Bailout	5/9/1984	(3.1%)	1.0%	6.4%	12.8%	No
1987 Stock Market Crash	10/19/1987	8.1%	10.9%	14.7%	22.9%	No
Iraq's Invasion of Kuwait	8/2/1990	(8.2%)	(13.5%)	(2.1%)	10.1%	Yes
Soros Breaks Bank of England	9/16/1992	(2.5%)	3.0%	6.8%	9.9%	No
First World Trade Center Bombing	2/26/1993	1.7%	2.0%	4.0%	4.7%	No
Asian Financial Crisis	10/8/1997	(3.7%)	(1.8%)	14.1%	(1.5%)	No
U.S.S. Cole Yemen Bombing	10/12/2000	2.7%	(0.9%)	(11.3%)	(19.6%)	Yes
U.S. Terrorist Attacks	9/11/2001	(0.2%)	2.5%	6.7%	(18.4%)	Yes
Iraq war started	3/20/2003	1.9%	13.6%	18.7%	26.7%	No
Madrid Bombing	3/11/2004	3.5%	2.7%	1.5%	8.4%	No
London Subway Bombing	7/5/2005	3.3%	1.8%	5.3%	5.5%	No
Bear Stearns Collapses	3/14/2008	3.6%	5.6%	(2.8%)	(41.5%)	Yes
Lehman Brothers Collapses	9/15/2008	(16.3%)	(26.2%)	(34.8%)	(11.7%)	Yes
Boston Marathon Bombing	4/15/2013	6.3%	8.4%	9.7%	17.9%	No
Russia annexed Crimea	2/20/2014	1.5%	2.6%	8.0%	14.7%	No
BREXIT	6/24/2016	6.5%	6.2%	11.0%	19.7%	No
Bombing of Syria	4/7/2017	1.8%	3.1%	7.6%	12.8%	No
North Korea Missile Crisis	7/28/2017	(1.1%)	3.6%	14.8%	13.4%	No
Saudi Aramco Drone Strike	9/14/2019	(1.4%)	5.4%	(8.8%)	12.5%	No
Iranian General Killed In Airstrike	1/3/2020	1.9%	(23.1%)	(4.2%)	14.4%	Yes
U.S. Pulls Out of Afghanistan	8/30/2021	(3.7%)	2.8%	?	?	?
Average if no recession		0.0%	3.7%	7.1%	10.8%	
Average if recession		(3.8%)	(6.7%)	(6.1%)	(11.5%)	

Source: LPL Research, S&P Dow Jones Indices, CFRA, Strategas 02/22/2022

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

Source: LPL Research

Quarterly Commentary as at 31 March 2022

Wars have negative ripple effect in today's globalised economy. There are direct and indirect impacts. From a direct exposure perspective, Russia and Ukraine are relative minnows regarding trade – contributing only 0.6% to European exports. Nonetheless, sanctions still pose a risk to businesses operating in these countries. For example, European banks Société Générale and UniCredit have branch networks in Russia.

We had re-reviewed the Russia and Ukraine exposures across all the companies held in the portfolio. As a percentage of revenues, most of the holdings have zero or very limited exposure (i.e. 1% to 2% of revenues). The most exposed is PepsiCo, which derives 6% of sales from Russia and 0.6% from Ukraine. These operations have locally sourced manufacturing and ingredients, and they are low profit margin markets for PepsiCo (i.e. the profit hit will be a lot less than the revenue exposure).

The more pertinent tail risk is the indirect impact on commodity prices and inflation expectation. You will note in the table above that a notable exception to “buy when there is blood on the streets” was the 1973 Yom Kippur War and the devastating oil supply shock. There are some parallels today with the oil price trading above \$100 per barrel. Russia is the world's second largest gas producer and third largest oil and gas producer with pipelines feeding much of Europe. Higher oil and gas prices will crimp demand as it raises the cost of living and will delay the peak in inflation. In addition, the cost of certain foods will rise as Russia and Ukraine are leading suppliers of grains, accounting for just under a third of the world's wheat exports. Russia is an important source of metals used in manufacturing such as nickel, titanium, palladium and aluminium.

A mitigating factor is that higher commodity prices would not exert the shock to the system experienced in the 1970s because they are a much lower proportion of the household budget. Over 20% of US consumer spending was on food & energy in the 1970s. It is about half that level today. Wage inflation has been increasing but long-term inflation expectations, as indicated by the swaps market, are only back to 10-year historic averages. On balance, central banks are expected to raise rates, but they do not want to jeopardise growth after all the extraordinary measures during the pandemic to keep economies on track. They will likely temper monetary tightening if there is a meaningful slowdown. An additional positive is that developed world consumers are supported by ample excess savings and the confidence instilled by low levels of unemployment.

Growth remains the key to our strategic view on the equity asset class. The below chart of the MSCI All Country World index since the late 1980s shows markets tend to go up outside the periods around recessions (the grey shaded areas are US recessions). Our base case is that there is no recession around the corner, particularly with COVID-vaccinated economies reopening for business. The monetary policy punchbowl is being withdrawn but it is still accommodative even with seven US rate hikes this year.

Quarterly Commentary as at 31 March 2022

Stay on board outside recessions



Source: Melville Douglas

As equity market prices are volatile, there are always reasons to worry and avoid being invested. Today's risks include persistent supply-chain constraints, sustained high inflation, COVID outbreaks, Federal Reserve tightening and Russia-Ukraine conflict escalation. In this fluid situation, there will also be unforeseen surprises along the way. To mitigate these risks, the portfolio is diversified across geographic regions and a broad range of industry sectors.

Beyond the here-and-now, the long-term case for owning equities to preserve and grow the real value of your wealth remains compelling. The fund's investments in companies with superior businesses models, wide economic moats, and large and growing addressable markets will drive compound earnings growth for many years to come. When calm is restored this ongoing increase in intrinsic value will be recognised in their share prices.

Melville Douglas

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