Quarterly Report

Counterpoint SCI Preference Share Fund

Quarter ending 31 December 2021

This Fund is suitable for investors seeking an above-average after-tax yield in the form of dividends. This will be achieved by diversifying the portfolio's holdings across various preference shares and dividend yielding assets. A minimum 80% will be invested in preference shares.

Performance Table

Annualised Performance	Fund	Benchmark
3 Months	16.0%	0.9%
1 Year	44.0%	3.5%
3 Years	15.0%	4.9%
5 Years	11.5%	5.6%
Since Inception (January 2008)	8.4%	6.2%

Fund Details	
Benchmark	*STeFI Call Deposit Rate*
ASISA Category	*South African Equity Unclassified*
Portfolio Manager	*Andrew Dowse*

Performance Review

Global markets marched higher during the last quarter of 2021. The MSCI All Country World Index rose 6.7%, taking the annual return for 2021 to 18.5% in US dollars. Strong gains in select technology stocks like Apple, Microsoft and Nvidia and Tesla in the consumer discretionary sector did the heavy lifting, but gains were also seen across the market in other sectors like healthcare where Pfizer and Unitedhealth Group rose sharply. Although a small sector contributing to the overall market in the United States, real estate also saw strong gains of around 17.6% during the 4th quarter. However, it was not simply a smooth ride up. Strong gains in October and the first half of November unravelled somewhat towards the end of November on news of a new variant of Covid-19, named Omicron by the World Health Organisation, having been identified in South Africa. Furthermore, persistently high inflation numbers in developed markets were wearing down central bank governors who had up until then dismissed inflationary pressures as temporary and transitive. The release of the Federal Reserve Committee's minutes on 24 November revealed that members of the Committee were growing increasingly anxious and resolved to taper monetary stimulus and raise interest rates earlier than had been guided in prior minutes and announcements from the Committee. Nevertheless, the market shrugged off these concerns somewhat in December as a late Christmas rally ensued at the end of the year.

Energy markets in Europe continued to be impacted by supply constraints with natural gas prices remaining elevated, albeit moderately lower off the extreme highs as supply bottlenecks ease. Oil held previous quarter gains and base metals drifted sideways to slightly lower. The shock to energy supplies as northern hemisphere countries head into their winter, has prompted a re-think about how aggressively "green" energy alternatives can displace traditional hydrocarbon energy base supply. Coal and oil have proved a point through this crisis, but that does not take away from the fact that the climate crisis needs to be addressed in a hurry.

The rand depreciated a further 5.8% against the US dollar during the quarter, following the 5.5% decline in the prior quarter, as South Africa was labelled as the origin of the Omicron variant outbreak. The United Kingdom and a host of other countries wasted no time in banning travel to or from South Africa. In time, it was shown that the origin could be traced to countries in Europe, but it was first detected in South Africa. Furthermore, South African scientists led the world in understanding that although infections of Omicron were more aggressive than other

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Top 10 Holdings (%)	
ABSA Preference Share	13.6
Firstrand Limited Preference Share	12.4
Investec Non Redeemable Preference Share	12.1
Standard Bank Group Preference Share	12.0
Discovery Holdings Preference Share	7.5
Steinhoff Investments Preference Share	7.5
Coronation Fund Managers	5.4
Grindrod Limited Preference Share	3.2
Network Healthcare Preference Share	3.2
Invicta Preference Share	2.7
Total	**79.6**

Asset Allocation (%)	
SA Preference Share	74.2
SA Cash	18.3
SA Equity	7.5
Total	**100.0**

variants, it was less dangerous, and the number of hospital admissions are notably lower than during previous waves of other variants. During December many of the countries that placed travel bans on SA removed these bans after the SA government employing them to not exacerbate the economic impacts of lockdowns and travel bans. The Reserve Bank raised the benchmark repo interest rate in November by 25 basis points, bringing the prime interest rate up to 7.25% and commencing a tightening cycle. Concerns of rising inflation globally, driven by higher commodity prices and supply disruptions, is prompting most central banks to change to a hawkish tone. Developing economies have been quick to get ahead of the curve by hiking earlier. Higher interest rates are being priced in by the market at a faster pace as this rhetoric grows.

The Fund rose 16.0% in the fourth quarter, exceeding its STeFI Call Deposit benchmark which rose 0.9%. On a stock level, the main positive contributors for the fund were Absa, Standard Bank, Investec (INLP & INPR) and Discovery. No holdings contributed negative returns during the quarter. On a relative basis, the Fund slightly underperformed the FTSE/JSE Preference Share Index (+17.3%) due to an underweight allocation to banks which performed extremely well following Investec Bank's announcement that they too intended to buy back their non-redeemable preference shares and cancel the securities. Other banks rose again in anticipation of similar announcements following the Nedbank announcement in the third quarter. This follows on from the buy-backs of Sasfin and PSG in the second quarter as issuers are looking to reallocate capital while they have cash on their balance sheets at their disposal. There is still between 10% and 20% upside for the other banks' shares to trade close to their par values and given the proximity to par that Nedbank and Investec bought back at, there could still be some room for the market to lift higher from these levels. Furthermore, prospects of rising short-term rates are lifting the market higher as income becomes more important to investors.

Portfolio Actions

After the buy-backs by Nedbank and Investec Bank (INLP) the Fund received a substantial amount of cash. The Investec corporate action occurred right at the end of the year so had practically no opportunity to deploy that cash, but the proceeds from Nedbank were used to acquire non-bank preference shares like Discovery, Steinhoff, Grindrod and Netcare where the relative valuation had become slightly more attractive. The Fund also established holdings in Coronation and British American Tobacco. While these stocks are not preference shares but rather ordinary equity shares, the dividend income yield had become materially more attractive than preference share yields. Furthermore, the characteristics of these businesses and specifically their cash flows exhibit very similar metrics to how preference shares return income. That satisfied our assessment sufficiently to believe that these would be an appropriate fit for investors using this Fund. While the position sizes are relatively small to start with, they may grow in time depending on opportunities elsewhere. The Fund is also looking for the right opportunity to add some debt exposure through additional tier 1 (AT1) bonds, which are instruments issued by banks and intended to replace preference shares in their capital structure. For the time being we see the pricing as a little bit expensive and therefore have not added any exposure as yet.

Portfolio Strategy

The objective of the Fund is to generate a high amount of income in the form of dividends. That income aims to exceed the returns generated from other short-term cash yields (like STeFI call deposits or money market funds). For tax sensitive investors, the high level of dividend income represents an attractive opportunity to improve income generation on an after tax basis that similar traditional assets cannot match.

In order to achieve its objective, the Fund does subject itself to higher degrees of volatility as the capital price can move up and down driven by expectations for long-term interest rates and actual moves in short-term prime interest rates. However, by owning a diversified allocation of stocks and analysing the underlying fundamentals of these securities, we aim to mitigate credit default risk of specific companies and improve price volatility driven by sentiment towards any individual company.

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Currently the Fund does not hold any fixed income instruments due to the tax leakage compared to preference shares, However, if prevailing yields in the market do not compensate investors sufficiently, we may consider an allocation of up to 20% in bonds or other related fixed income assets. Similarly, if the credit risk rises to unacceptable levels, fixed income instruments may be used to protect capital when that need overwhelms the need for income generation. Cash is another asset class available to seek the outcomes discussed above, but generally the Fund will hold only small levels of cash to facilitate flows into or out of the Fund as well as when seeking an opportunity to buy an asset, but only at the right price. Lastly, the Fund seeks to actively manage liquidity risk by owning sufficient assets that can be liquidated at relatively short notice without putting the Fund's allocations at risk.

The Fund is positioned to benefit from rising short-term interest rates, as we find ourselves at historic lows and expect prime interest rates to begin rising in the near to medium term. The Fund could also benefit from long bond yields declining if there is a realisation in South Africa that short rates will have to remain low for longer due to little inflation risk, other major markets like the US, UK, Europe and Japan remaining accommodative and stagnant economic growth. Naturally there is a risk that the premium required to commit long-term capital to South Africa could rise, which could see capital prices fall, although we think this premium is already sufficiently large given the macro-economic backdrop. We expect the sovereign bond yield curve to flatten in the next year or two which will support returns for preference shares that already have attractive starting forward gross yields of around 6.67% which, after fees and tax, represents a forward yield of 4.59%. We expect this income to still meet or exceed the after tax returns on cash and bonds in the medium term.

Andrew Dowse
Portfolio Manager

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