

Capicraft Newsletter: First Quarter 2023

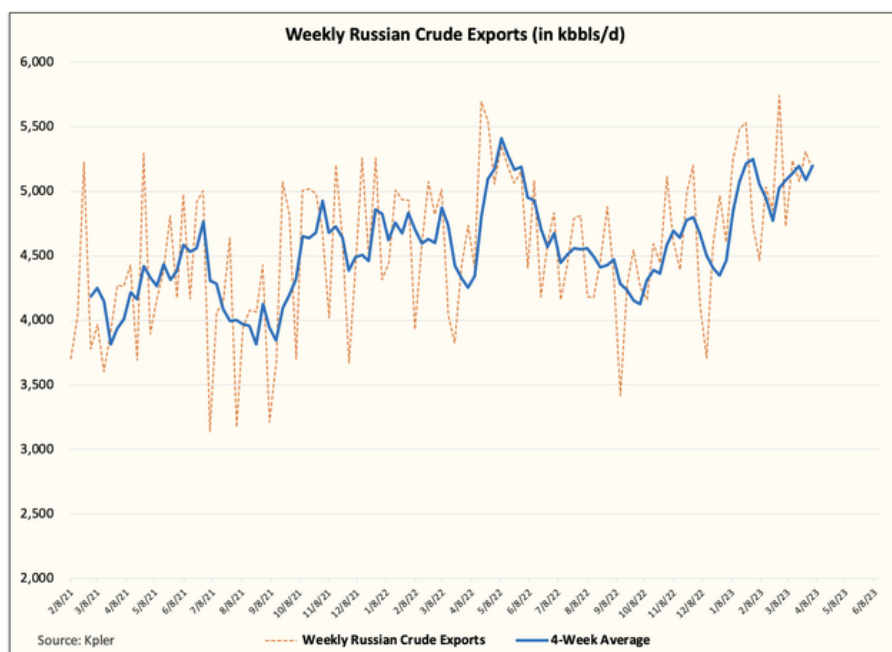
Introduction

Capicraft has mixed feelings about the first quarter of 2023. On the one hand, our portfolios earned good returns: the Capicraft Global Creator is up 4.2% in Dollar terms (up 8.9% in Rand terms) and most of our multi-asset portfolios also grew by high single digits percentages in Rand terms. But on the other hand, during the first quarter of 2023, the MSCI World Index of all shares rose by 7.2% in Dollar terms and the JSE climbed by 5% in Rand terms. Some international markets were even higher, like the tech-heavy Nasdaq which gained 16%. Our local special events portfolio, the Capicraft Compounder, added just 0.4% for the quarter after returning 22% last year. At times it felt as if our portfolios were going to be left behind in the dust of a galloping bull run.

But it's important to compare apples with apples. For example, Capicraft's portfolios carry less risk than general stock markets such as the S&P 500 and especially the Nasdaq (which is still down 25% since the start of 2022). Classified as a flexible multi-asset global fund, the Capicraft Global Creator's 8.9% return in Rand terms compares well relative to industry peers which on average returned 9.1% in Rand terms. Nevertheless, it is not the relative performance we have become accustomed to over the last two years.

Capicraft's investment theses during the First Quarter of 2023

Our major investment thesis did not materialize as we had hoped it would. First, we started the year quite "defensive", warning that we were still shunning tech stocks. In the first quarter of 2023, however, the Nasdaq rose by 16%. If short-term market movements are your only measure of success, then this view of ours was wrong. Second, some opportunities about which we were most excited about have still not materialised, because management is dragging its feet to unlock value for shareholders. Third, persistent load shedding in South Africa added to our frustration (and to everyone's costs). Some of the largest businesses on the JSE are multi-national companies that are less affected (if at all) by load shedding in South Africa. But small and medium-sized South African companies, in which Capicraft is invested, are suffering from a "level-6" type of sentiment. Fourth, China's reopening occurred more slowly than we expected and Chinese demand for energy products disappointed. Despite sanctions, Russia now exports more oil than a year ago (see the table). In addition, the world's largest energy consumer (the USA) may yet experience a recession this year. Unsurprisingly, the Oil and Gas index was down 6.1% during the first quarter of 2023. In the Global Creator, our energy exposure is about 20%. Energy exposure together with other inflation hedges held back our returns during the first quarter.



Capicraft differs from general market participants

The effectiveness of our investment strategy should obviously not be judged based on one quarter's results. At times, conditions in the market will frustrate us. Sometimes this frustration will last longer than one quarter. However, all the noise in the market should not make one short-term oriented. Most market participants follow a different approach. By way of analogy, they play T-20 cricket but we participate in 5-day Test cricket:

1. We don't want to lose wickets.
2. We don't have to hit every ball for a six.
3. If we don't lose wickets, eventually we will hit boundaries.
4. We know there will be a second innings...and another test.
5. Partnerships win matches.

To stick with the analogy, during the first quarter of 2023, some of our best batsmen disappointed, but a partnership kept the innings together, and a defendable total was put on the scoreboard. The partnership was our exposure to gold and silver. In the Global Creator, that exposure comes in various shapes and forms, from junior gold miners to physical gold instruments as well as royalty companies. Together, these positions represent about 12% of the fund.

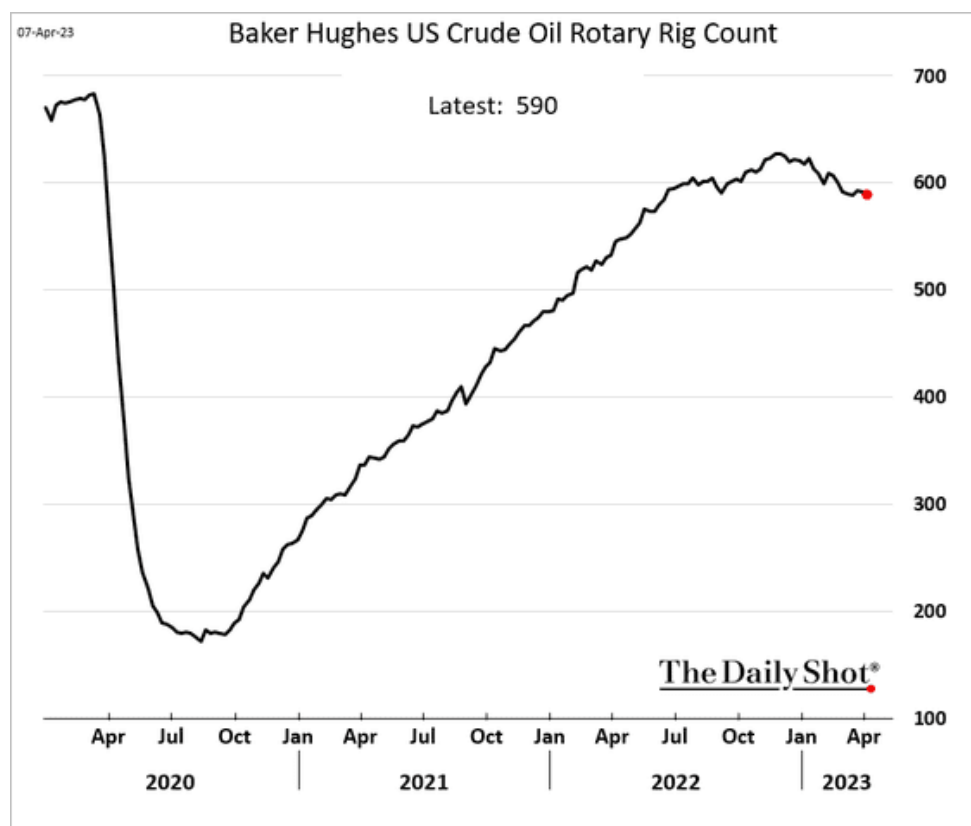
Also, our second largest position, Burford Capital, finally started hitting runs for us. Burford is the world's largest litigation financier, earning an average of 30% in its litigation book. Due to Covid, many court cases were postponed, Burford's debt had to be refinanced urgently, and prominent analysts questioned Burford's business model. But everything changed on 31 March 2023. A long-awaited court ruling was decided in Burford's favour. In terms of this ruling, Argentina owes billions of dollars to (among others) Burford—these amounts may be multiples of Burford's current share price. On 31 March 2023, Burford's share price rose by 54%. Other concerns have also been addressed

and Burford can now finally be valued for what it is: a business that can earn high capital returns without much correlation to the wider financial markets. In April 2023, Burford's share price rose further, but our valuation is still multiples of the current share price.

The Second Quarter

And so, we enter a new quarter, a second innings if you like, with a good batting line-up.

Our opening batsmen are in the energy market. On 2 April 2023, OPEC announced that its oil producers will cut production by around 1.5 million barrels of oil per day. This is a huge amount. The oil price has obviously reacted to this. Meanwhile, oil production in the USA is slowing and the Americans are struggling to surpass production levels of 2019/20.



During the previous decade, the US shale industry was the world's marginal oil producer. Some of the most prominent shale resources are now experiencing declining oil well rates. The competitive advantage is now back in the hands of OPEC, which of course prefers higher oil prices. Moreover, oil inventories are currently at 17-year lows. For energy prices, the path of least resistance is higher. We have analysed how profitable our main oil producers could be if oil trades at \$60 per barrel. Imperial Oil is an integrated Canadian oil producer and our largest oil position. Even if oil trades at \$60 per barrel while Imperial Oil's share price is \$47 per share, a free cash flow yield of 13% can still be achieved. At Capicraft, we look for such asymmetric investment outcomes: limited risk but significant price moves to the upside.

By the way, what can be said about this partnership?



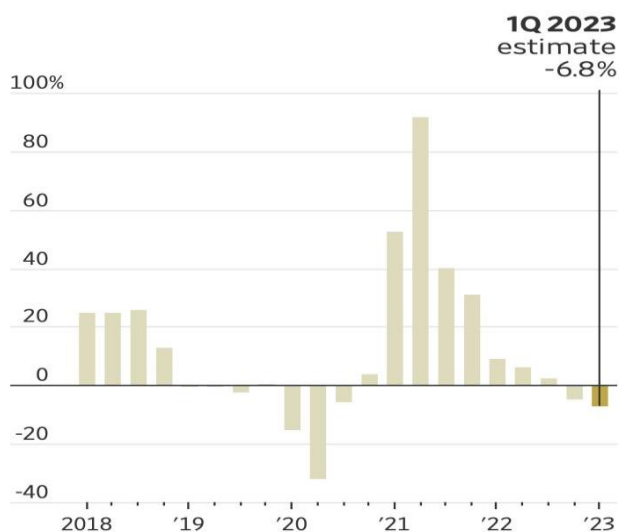
The Bank crisis in the USA

Meanwhile, the cricket pitch is changing rapidly, and it is becoming much more difficult for our batsmen. During the first quarter of 2023, the US experienced one of the largest banking collapses in its history. Silicon Valley Bank (SVB) folded, and two other banks were also in trouble. Authorities in the US reacted quickly to save depositors' cash and to limit the crisis. To understand the root causes of this crisis, please read our third quarter (2022) newsletter. In that newsletter, we stated that government bonds, especially US government bonds, have mistakenly been built into the financial system as a "risk-free" asset that can serve as collateral. When depositors raided SVB, that bank was forced to sell this collateral to make funds available to depositors. The problem is that rising interest rates have made government bonds much less valuable. If SVB (and several other banks) had to mark down its investments in government bonds to market value, then some banks would be insolvent. This is what happened to SVB. Fortunately, most banks in the US don't have this problem. But a potentially bigger problem is a possible "deposit flight". If many depositors at other smaller banks also suddenly claim their deposits, this could force these banks to sell government bonds at losses. With so many sellers in the US government bond market, a liquidity crisis could quickly turn into a sovereign crisis. Authorities in the US did not actually come to the rescue of banks, but rather (primarily) protected the financing capacity of the US Treasury. A crisis has been avoided, at least for now.

The irony is that depositors in the US continue to rapidly move their deposits to "safety"—mainly US government bonds. Recently, this has caused rates on US government bonds to fall significantly; it served as an artificial interest rate reduction for the economy. This is also largely the reason why growth and technology stocks are currently performing despite lower profit expectations (see the table below). Banks' willingness to grant credit is also decreasing (see the table below) and this is usually a good indication that a recession is on the way.

Profit expectations are declining:

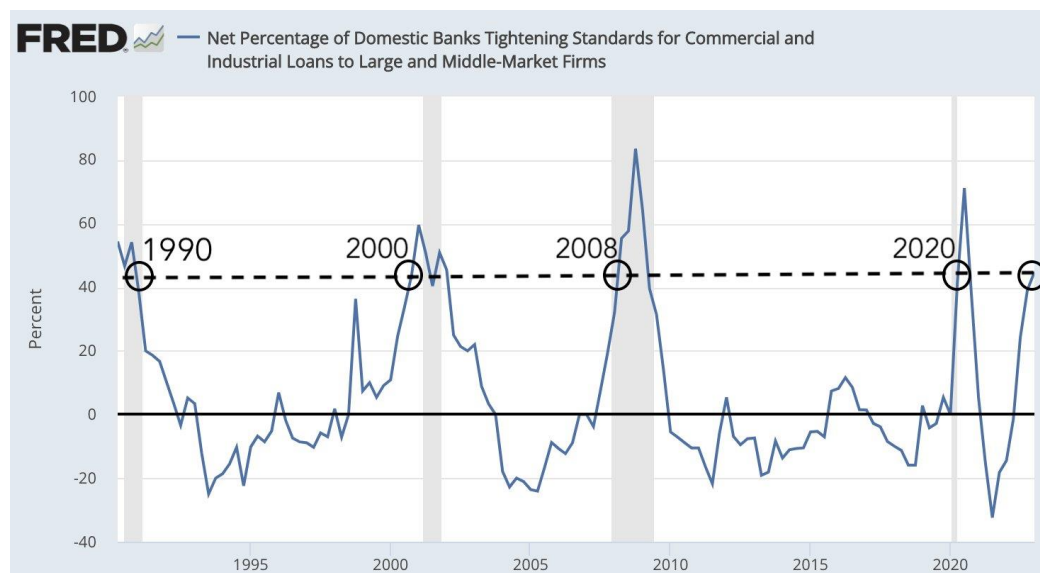
S&P 500 quarterly earnings, change from a year earlier



Note: 1Q 2023 earnings based on estimates. As of April 6.

Source: FactSet

Banks are employing more stringent credit criteria:



No reason for pessimism

China continues to open its economy and the Chinese authorities are supporting the broader economy. Recently one commentator opined tongue-in-cheek that the US has a "Red Bull and Vodka" economy. The depressant is higher

interest rates and inflation, but at the same time the economy is stimulated by various fiscal packages. However, financial markets can handle such a toxic combination only for so long.

That's why we are protecting our wickets. We have large hard-currency cash positions and precious metals exposure. We even started buying some bonds, but mostly in emerging markets in the East. Many emerging markets have already swallowed bitter medicine and appear relatively healthy. We currently give greater weight to defensive companies. But the scoreboard must keep ticking. We stick to our game plan which has been refined on many pitches in numerous tests. We continue to invest in stocks, asset classes and sectors where we find long-term value, regardless of short-term volatility (and, sometimes, frustrations). The boundaries will come, we just need to be patient.

Your Investment Partner,

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