FOREWORD

DID YOU KNOW? HAIRCUT

In the world of finance, a 'haircut' isn't about trimming your locks. It refers to the reduction in the value of debt that creditors agree to accept when there's a default. When a sovereign debt haircut is implemented, bondholders and other creditors agree to accept a lower repayment amount than the face value of the debt. This reduction can be expressed as a percentage, for example a 20% 'haircut'.

Sovereign debt haircuts are often employed as part of debt restructuring or debt relief programmes. They are typically negotiated between the debtor country and its creditors, including international financial institutions, other governments, or private investors. The objective is to make the debt load more sustainable and affordable for the debtor nation.

A sovereign debt haircut can be voluntary or involuntary, depending on the circumstances. In a voluntary haircut, bondholders or creditors agree to the reduction willingly through negotiations. In contrast, an involuntary or forced haircut may be imposed by the government or as part of a legal process, potentially through legislation or a court ruling.

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ARE THERE OPPORTUNITIES IN SA INC. STOCKS?

As fund managers, we are always on the lookout for opportunities that can generate good returns. This is true even — or perhaps especially — when sentiment is at its worst. An area of the local market that has received a lot of attention lately for its historical cheapness are 'SA Inc.' stocks. Portfolio manager NANCY HOSSACK takes a closer look at prospects for this segment.

SA Inc. stocks are companies whose earnings are predominantly linked to the South African economy, such as banks, insurers, retailers, construction companies and SA-focused industrials. This categorisation excludes companies with significant offshore earnings, as well as resources companies. Of course, resources companies may be impacted by SA-specific factors like power outages or wage inflation if they have mining operations in the country. However, their earnings are more influenced by exogenous factors such as the whipsaw of international commodity prices and exchange rates.

SA Inc. stocks are currently trading at very low valuations compared to their history. The FTSE/JSE Mid Cap Index (which is predominantly SA Inc shares) is trading on an eight times price earnings multiple, the lowest in its 20-year history, although we did briefly touch that level in 2008 during the Global Financial Crisis. There are several reasons why these stocks are so cheap. Firstly, there has been fifteen years of economic stagnation, brought on by underinvestment in fixed capital. Secondly, investors are using high discount rates to assess the present value of future earnings of SA Inc. stocks. This is because the country risk rating is understandably very high compared to history. Finally, investors are naturally worried about the outcome of the 2024 national government elections and are not paying a premium for stocks that might be most affected.

As a result, the market has heavily marked down almost all SA Inc. stocks. This offers fertile ground for long-term stock pickers. We believe there is opportunity in companies that can expand market share despite the tough economic environment, and in those that deal in staples as opposed to discretionary goods. Additionally, industries where competition has dwindled could offer opportunities for the remaining players. Finally, companies with the ability to pass on inflation costs, especially in an inflationary environment, or those capable of keeping costs lower than competitors, are also worth considering.

However, we should guard against 'betting the farm' on the sector just because it is cheap. Concerns for the political and policy making environment after the 2024 national elections are genuine. And South Africa's fiscal issues are undeniably escalating — which may worsen the prospects of SA Inc. companies. As always, diversification of correlated risks is critical.

At the time of writing, the Foord Equity Fund has about 40% of its portfolio in SA Inc. stocks. With a high cash weighting at 14% of the fund and a small exposure to gold to protect against local and foreign risks. About 45% of the portfolio is invested in companies that earn a significant portion of total earnings in offshore markets. Potential for a sovereign debt crisis and adverse outcomes in 2024 cannot be ignored and we will aim to protect capital in that event.

Despite the gathering storm clouds, astute investors should always look for inflection points. Change is the only constant and South Africans have a long history of looking over the precipice and saying, "not today". If the JSE can adjust its trajectory, it will create a lot of wealth for investors. So, while we are in protection mode currently, we remain cognisant of the possibility of outsized gains and open minded in our positioning.

FOORD'S HIGH CONVICTION CALL ON THE GLOBAL ENERGY TRANSITION

ISHRETH HASSEN
Portfolio Manager

The global energy transition presents a compelling opportunity for the astute investor. Its implications extend far beyond a simplistic switch from fossil fuels to renewable energy. Instead, it invites a nuanced understanding of the complex interplay between economics, technology, geopolitics, and societal aspirations that underpin the global energy system. In this comprehensive review, Foord Singapore portfolio manager ISHRETH HASSEN unpacks these dynamics to identify the potential winners and losers of this momentous shift.

The catalyst of the global energy transition lies in the struggle against climate change. Sparked by the clarion call of the 2015 Paris Agreement, the race is on to temper the earth's thermostat and limit temperature rises to 1.5 degrees Celsius above pre-industrial levels. Consequently, the investment world has spurned oil and gas, particularly in the aftermath of Russia's aggression in Ukraine. In contrast, renewable energy sources such as solar, wind, hydrogen, and electric technologies have captured imaginations and markets alike.

As investors with a commitment to sustainable practices, we were captivated by the opportunities arising from this energy transition. However, to make informed investment decisions we needed a comprehensive understanding of this complex transition. In reaching our investment conclusions, we credit the global energy needs analysis conducted by Dr Scott Tinker, Professor of Geosciences at the University of Texas at Austin and the team at his nonprofit, Switch Energy Alliance. Our conclusions are intriguing.

The concept of energy density is pivotal to the global energy transition. Hydrocarbons such as coal, oil and natural gas are packed very densely with energy. Simply put, energy density is a measure of the amount of energy stored in a given system or region of space. The energy density of hydrocarbons is far higher than that of renewables (wind and solar). This means that larger volumes of materials are needed to harness the same amount of energy from renewables compared to hydrocarbons.

The global demand for energy is intrinsically linked to rising prosperity. As countries become more affluent, they consume more energy. No primary energy source has decreased in consumption since 1965 — not even coal. Indeed, the world still consumes more coal and oil today than all the other energy sources combined. With continued population and economic growth, energy needs are poised to rise.

Wind and solar energy production is undoubtedly growing exponentially. However, context is vital. Wind and solar have been able to provide only 10% of new global energy demand in the past ten years. This is not total demand, but just the growth in energy demand. Staggeringly, this means hydrocarbons fulfilled 90% of new energy demand in the last decade.

The future trajectory of energy demand reveals stark regional disparities. Energy demand in North America and Europe has plateaued for almost four decades. However, the energy appetite in Asia and the rest of the world is burgeoning. Home to three-quarters of the world's population, these regions are experiencing rapid economic growth and increased prosperity. The energy consumption in Asia already eclipses that of Europe and North America combined.

Emerging economies are embracing coal for industrialisation, much like the developed world did in the past. Coal, being the densest and most economical source of energy, is an attractive option for rapidly developing nations such as China and India. With the largest populations globally, these two nations' coal consumption outstrips all other energy sources combined.

India now has a larger population but consumes just a quarter of the energy that China does — India's per capita energy consumption is where China was back in 1995. It is inconceivable to us to think that India could rely on green energy alone to follow China's path to industrialisation.

Natural gas consumption is also surging. This energy source is denser than renewables but produces fewer emissions than coal and oil. This positions natural gas as a viable transition fuel on the path to a more sustainable future.

Energy security is another critical factor in the global energy transition. Large energy importers like Europe, China and India are embracing renewables and electric vehicles in a bid to reduce their dependence on imported energy. Projections suggest that 700 million electric vehicles may be on the roads by 2040, each wielding 5,000 battery cells. That amounts to a staggering 3.5 trillion batteries needing replacement every seven years. This raises questions about the environmental impact of battery disposal and the skyrocketing costs of key materials like lithium.

Research shows that producing an electric vehicle requires eight times more metals and materials than an internal combustion engine. It takes seven times more copper to produce wind and solar energy than conventional fuels. What happens to costs if there is a shortage of copper, gold or silver — all highly conductive materials needed for 'electrification' of the world? And what about pollution? Internal combustion engines require drilling and produce emissions — but solar, wind and electric vehicles require mining and landfill disposal.

In the global geopolitical context, the energy transition presents strategic investment opportunities. Russia's domination of oil and gas production and China's control over processing supply chains for renewable materials exemplify how energy resources are intertwined with geopolitical power.

What does all this mean for the future energy mix?

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SOUTH AFRICA'S DEBT DILEMMA — RISKS AND OPPORTUNITIES

South Africa's sovereign fundamentals have deteriorated alarmingly over the past decade — so much so that the country now finds itself entangled in a debt crisis. Portfolio manager FARZANA BAYAT looks at the implications of the debt dilemma and the investment strategies Foord employs to protect investor capital while yielding inflation-beating returns.

Poor economic management has burdened the South African economy with seemingly unending challenges: power shortages, transportation bottlenecks, political uncertainty, stagnation in growth, high unemployment rates, under investment, overspending and lack of fiscal consolidation. The result has been escalating debt levels.

South Africa's debt burden has multiplied in recent years. In 2006, the country's total debt was a modest R500 billion. By 2011, this had grown to R1 trillion and escalated to R4.7 trillion by 2022. It is expected to approach a whopping R6 trillion by 2025.

Of course, the economy has also grown — not but proportionately. Relative to the country's Gross Domestic Product (GDP), the debt burden increased from a conservative 30% of GDP to a worrisome 70% of GDP over this period. If not for the statistical rebasing of GDP, we would be closer to 80% now.

Worse though, is that South Africa currently spends 20% of tax revenue on servicing debt. This debt service cost crowds out other much needed expenditure — crippling the government's ability to invest in essential sectors like healthcare and education. Consequently, we find ourselves caught in a debt trap. The only way out is through high growth (unlikely), inflation (probable) or drastic curtailing of government spending (politically unpalatable going into elections).

> *"South Africa currently spends 20% of its tax revenue on servicing debt."*

Globally, there has been a surge in sovereign debt and debt defaults, triggered by excessive borrowing during periods of low interest rates. Now, with the interest rates rising, several countries are struggling to service their debts. Additionally, borrowing in US dollars has become costlier due to the strengthening of the US dollar relative to emerging market currencies.

According to the International Monetary Fund, almost half of African countries are in debt distress as of 2023. South Africa has not been declared in debt distress yet, but, given its debt trajectory, it could soon be headed there.

Analysing South Africa's ability to repay debt by considering factors such as debt and interest cover metrics, and the country risk premium, South Africa ranks 15th among 25 heavily indebted countries. It fares worse than countries like Nigeria, Morocco and Turkey, which are themselves in precarious positions. There is a looming risk of a sovereign debt crisis in South Africa, and investors should be cautious.

There are primarily two methods to navigate oneself out of a debt crisis, depending on the nature of the debt. If a country has mainly offshore debt, restructuring the debt or imposing haircuts (see *DID YOU KNOW?*) are options. However, if the debt is primarily in local currency, as in South Africa's case, then the path of least resistance is to run with higher inflation — money printing causes inflation, which causes nominal GDP to increase, thereby reducing the debt-to-GDP ratio. The drawback to this strategy is a substantially weaker currency, which itself perpetuates inflation.

Given that South Africa's path out of the debt crisis might entail higher inflation, Foord employs an investment strategy that includes exposure to several resilient instruments in its fixed income portfolios:

- **FLOATING RATE NOTES:** As interest rates should to rise to counter inflation, investments in floating rate notes can be beneficial. These instruments reset quarterly based on prevailing rates and offer a term spread.
- **INFLATION-LINKED BONDS (ILBS):** With inflation expected to rise, ILBs are the only instrument to offer full inflation protection and are an attractive investment if real yields remain stable.
- **OFFSHORE ASSETS:** These offer protection against currency depreciation, which is a probable outcome of structurally higher inflation.
- **CONVERTIBLE BONDS:** These are debt instruments that can convert into shares at a future date. Regulations allow their inclusion in fixed income funds, and they tend to rise with rising equity prices.

> *"South Africa's debt crisis is a concern that investors must closely monitor."*

In contrast, fixed rate government bonds can be a poor investment if inflation rises more than expected. In this scenario, rising bond yields will force bond prices down (bond prices move inversely to yields). The result is capital loss — if you don't hold these bonds to maturity.

In the Foord Flex Income Fund, we own a blend of these assets to protect capital and produce inflation-beating returns. The fund is currently yielding 10.5% with a very low level of downside risk. It primarily holds short-dated, high credit-quality assets, and avoids risky credit exposure (the bulk of instruments are rated AAA and AA and over 80% of the portfolio is invested in senior bank and government paper). Given that inflation risks are to the upside, we prefer ILBs over fixed-rate government bonds.

South Africa's debt crisis is a concern that investors must closely monitor. The country's debt has risen alarmingly and its ability to service this debt is deteriorating. Foord's safety-first investment style aims to safeguard capital and take advantage of opportunities only when the risk is warranted. By diversifying investments and understanding the economic landscape, fixed-income investors can still navigate these challenging times with caution and prudence.

MARKETS IN A NUTSHELL

EQUITIES

World: Global equities rose, driven narrowly by a handful of outsized US tech names on AI frenzy — emerging markets were flat, pulled lower by Chinese stocks on concerns for slowing economic growth and rising geopolitical tensions

South Africa: The FTSE/JSE All Share Index was little changed in rands but lower in US dollars on adverse prospects and sentiment — and weighed down by resources stocks which sold off on generally lower commodity prices

BONDS

World: Developed market bond yields rose to multi-decade highs on hawkish central bank responses to sticky 'core' inflation — more US debt issuance is expected after an eleventh-hour debt-ceiling resolution

South Africa: SA bonds sold off sharply on net foreign selling on deteriorating fiscal fundamentals and a low-growth debt trap — compounded by SA's arms-to-Russia fiasco

CURRENCIES

World: The US dollar was slightly weaker against other majors as the market anticipates that US rate hikes will peak first — but the yen was sharply weaker as the Bank of Japan practiced continued abeyance

South Africa: The rand was in freefall, weakening sharply intra-quarter to record-lows against the US dollar — on persistent loadshedding and rising Western worries for SA's perceived Russian friendship

COMMODITIES

Oil and copper were sharply lower as markets fretted about prospects of a US-led global recession — while precious metals gold and silver fell latterly as a risk-on tech rally gripped markets

ECONOMY

World: Higher inflation and rates haven't dramatically slowed economic growth, especially in the US where fixed-rate mortgages predominate — but signs suggest that small businesses may start to suffer as lending standards tighten

South Africa: The IMF and SA Reserve Bank both forecast anaemic GDP growth for SA in 2023 — the economy has been severely hampered by loadshedding and policy own goals

MONETARY AND FISCAL POLICY

World: Despite a 'hawkish pause', the US Federal Reserve expects two more US rate hikes this year — while central bankers in the UK and Eurozone are also hawkish

South Africa: SARB raised rates by 0.5% to tackle the deteriorating inflation forecast — with little effect on the rand, it suggests we may be beyond the point where rates support the currency

CULTIVATING FINANCIAL LITERACY

While the thought of introducing complex monetary concepts to a young mind may seem overwhelming, studies from institutions like Cambridge University suggest that children as young as three can begin grasping basic financial principles. By providing an early education in finance, we encourage monetary independence and responsible spending in adulthood.

Here are three critical pillars for fostering a future generation of financially savvy individuals:

1. DECODING THE VALUE OF MONEY

A recent global asset management survey noted that 37% of parents avoid money-related conversations with their kids due to a sense of discomfort — however, to inculcate a healthy money mindset, children must understand its worth. For instance, if your child receives a cash birthday present, talk to them about what could be bought with that money — and what cannot. Then introduce the concept of saving and how saved money can grow. Let them experience saving practically by storing their savings in a piggy bank or bank account, depending on their age. For younger children, secretly add an interest component to their piggy bank and show them how their money has grown. For older children, talk about the interest item on their next bank statement.

2. UNDERSTANDING INSTANT GRATIFICATION VERSUS DELAYED REWARD

Parents can use storytelling to illustrate the merits of delayed gratification over instant pleasure. Consider introducing books like Foord's More than Enough and Little by Little, which offer excellent savings metaphors. In the former, a squirrel named Anele, along with her mother, collects acorns not just for the approaching winter, but for the many, many years ahead. In Little by Little, Anele learns the crucial investing principles of patience and the passage of time. By visualising these stories, children begin to understand the consequences of not saving for the future.

Try to motivate your children by setting attainable saving goals. If they set their eyes on a meaningful purchase, co-create a roadmap that sets out the path and duration needed to achieve the objective. Regularly revisit this plan to keep their motivation alive.

3. DEMONSTRATING EFFECTIVE FINANCIAL BEHAVIOUR

Children often mirror their parents' habits, and this holds true for financial behaviours as well. Make sure that your own spending patterns reflect the principles you wish to pass on to your offspring. For older children, consider involving them in family financial discussions. This practice not only demystifies the concept of money but also gives them insights into the rewards of diligent work and planned expenditure.

Remember, if you allow your children to control their own money, also give them the freedom to make money-related mistakes. These mistakes serve as invaluable teaching moments for imparting lessons on future financial prudence.

As we celebrate Savings Month this July, let's commit to raising a generation well versed in managing their finances, making them ready to confidently navigate the economic seas of adulthood.