REZCO ASSET MANAGEMENT

QUARTERLY INVESTOR COMMENTARY QUARTER 1 | 2020

PERFORMANCE UPDATE

The 2020 year started off with a bluster for equity markets. Low interest rates prevailed while global economies were strong; US and China entered into a trade deal, and Brexit was becoming clearer under Boris Johnson. Markets hit record highs and the Rezco funds, being close to fully invested, were performing very well.

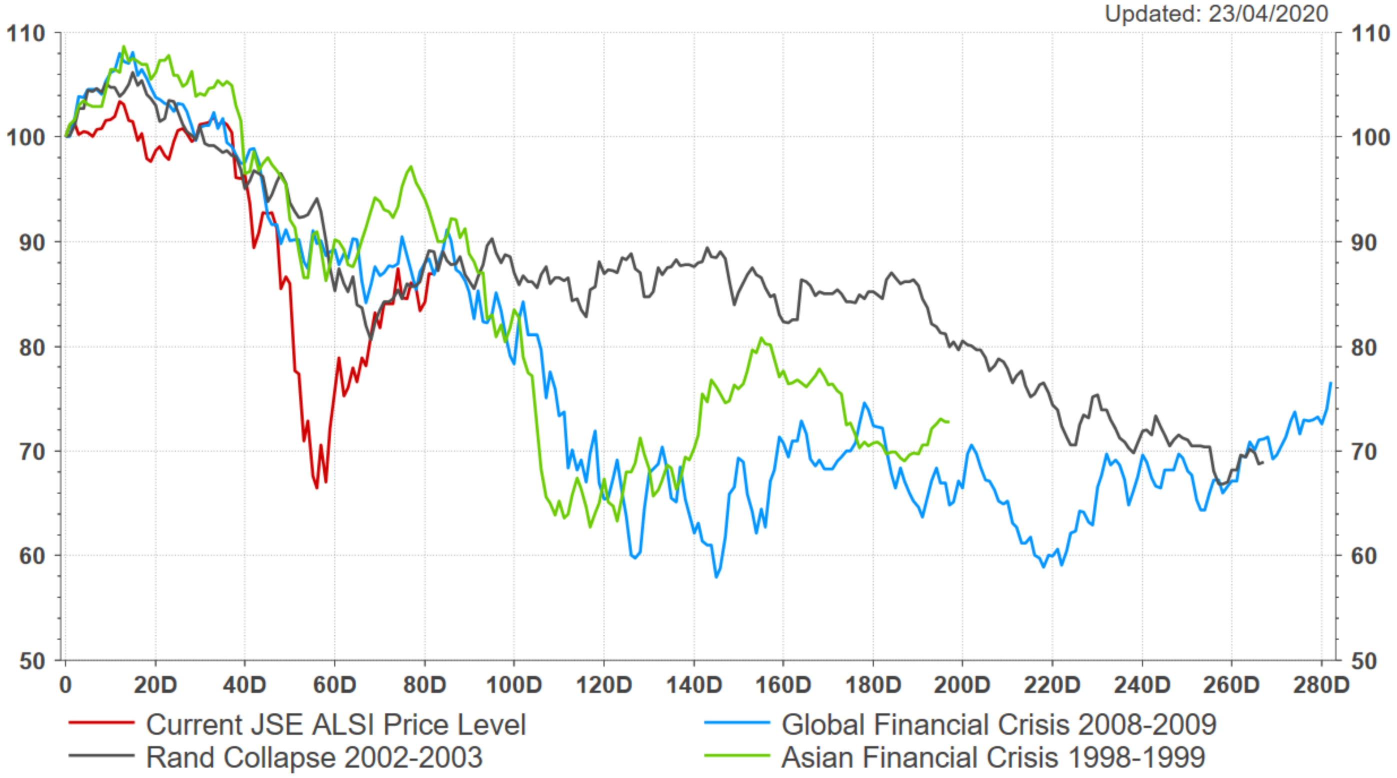
Risks then changed dramatically through the end of January, and on early signs of the potential downside from a spread of novel coronavirus outside Hubei province and into China and the rest of the world, we pivoted quickly to a very cautious asset allocation. We decided it was better to sit on the side lines and wait for more information. We did not see the risk of staying invested as worth it – maybe another 5% upside if we were wrong but 30-40% downside if the risks unfolded. The multi-asset funds sold early and aggressively to reduce risk, with the funds moving into USD Government bonds with moderate duration, SA Government Bonds with low duration, and gold.

Given the ALSI falling 21.4% for the quarter, and the ASISA Multi-Asset High Equity category being down 13.5%, we are pleased to report that the Rezco Value Trend Fund and the Rezco Managed Plus Fund were up 1.9% and 2.4%, respectively, for the quarter. The Rezco Stable Fund was up 5.5% for the quarter compared to the sector average of -7.2%; the combination of avoiding equity risk, utilising the offshore allowance to buy USD, and avoiding high SA Government Bond duration supported this outperformance. The Rezco Equity Fund, given the mandate to stay invested, was down 15.4%. Although we never like losing money, the Fund did outperform the market and peers significantly.

MARKET UPDATE

Markets have rallied off their intra-March lows, but we view this as a normal bear market rally – we are expecting more pain to come as the market finds its lows. The expected recession is most likely worse than the GFC, but markets move in waves of pessimism and optimism. The recent optimism appears based on economies starting to open up, coupled with significant stimulus packages. The below chart maps the current fall in equities against other bear markets – we think the market moves more similarly to the GFC, but in the case of SA shares we are concerned the recovery is not yet as convincing. Simply put, we see global equity markets, SA included, as being 2 months into a bear market that could go on for 6-18 months from here, and we do not think the worst is behind us.

JSE ALSI PRICE LEVEL OVER DIFFERENT BEAR MARKETS (REBASED TO 100)



Source: Refinitiv Datastream / Rezco

REZCO VIEWS THE RECOVERY DIFFERENTLY

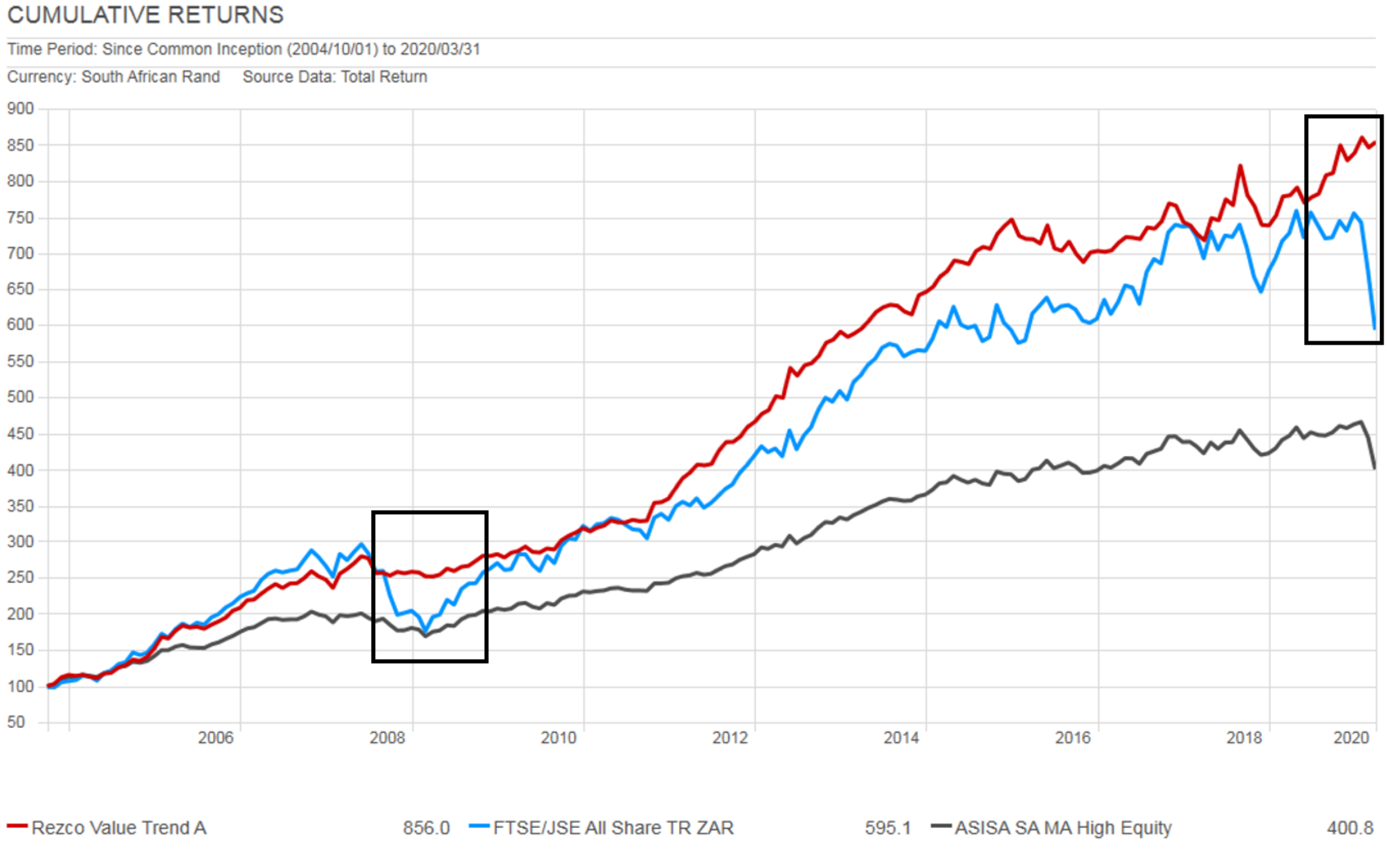
The good news for people's health is that social distancing works; the problem is it is very bad for the economy, and also cannot be maintained for long enough to completely remove any traces of coronavirus. That is why we did not become bullish when confirmed coronavirus cases growth rates started rolling over, as this supports extended social distancing. Coronavirus is not that bad for the economy, but social distancing is. Thus, the main variable to consider in terms of market dynamics is the change in expectations for social distancing. Given the facts, we are concerned that some form of social distancing, coming in waves of more and less, will be rolling through economies for many months ahead. Economies will have some false starts, misfires and some will outright stall. The engine will get going, but we do not see the stimulus packages alone being sufficient to avoid the normal impact and cycles of recessions and bear markets. This supports our view of a more extended bear market, as opposed to the V shaped market over the last two months.

Confidence is a very important element of recoveries. Lack of confidence means consumers spend less and businesses invest less. Confidence takes time to build, as to do businesses and investment proposals. The idea of a temporary pause, or an "off" type switch to an economy may work on a spreadsheet, but real businesses do not work in the same way. This is why there is always a relationship between GDP growth, company earnings, and share prices. This recession is disruptive and large and not easily fixed. The GFC was resolved with liquidity, but the problem was a lack of liquidity and confidence in financial markets. The coronavirus crisis needs a vaccine. Liquidity may not solve this crisis, but it will help dampen the blow.

RISK MANAGEMENT AND THE WAY FORWARD

Risk management is core to our process, and Rezco has built a track record demonstrating a willingness to utilise true active allocation to manage risk through the cycles.

REZCO VALUE TREND FUND



Source: Morningstar

Looking forward there are still significant risks that we are concerned about:

- Coronavirus not being solved. Better treatment and a vaccine in 2021, although our base case, is not guaranteed.
    - Risk of second or third waves do not appear priced in.
    - Another way of saying the above is that government stimulus only plugs the economic hole of the first wave of coronavirus. Will there be capacity to spend 10-20% of GDP more than once in a short period?
    - SA has delayed, and generally done a good job, but it is not guaranteed that a major local health crisis has been avoided – we still have tail risk here.
- The economic disruption and ripple effect are impossible to fully model and understand, and the economic recovery is not a given.
- Major sectors around travel, leisure and service industries may be impacted long after lockdowns end.
- Global trade reduces, which reduces economic growth but also creates inflation risk (the lack of inflation due to globalisation has supported lower interest rates). QE works when there is not any inflation, but what happens should inflation return? Over-indebtedness is an issue, and US markets have long been supported by debt fuelled share buybacks.
- US political risk will increase through the election cycle – will the US be able to keep their corporate tax rate cuts?

So while there are some shares which are cheap, we are not yet buyers. There will be a point to buy, but until expectations are revised downward, especially for the year 2021, we see a risk return skewed to the downside. Therefore, the multi-asset funds are currently positioned very cautiously around the following three key asset allocation decisions:

1. A high allocation to short duration SA Government Bonds (i.e. avoid duration and avoid corporate credit).
2. Negligible equity risk outside gold where there is a high allocation.
3. The funds are utilising their full offshore allowance which is invested in a portfolio of US Government Bonds with a moderate duration.

We remain flexible and focused – on the lookout for good investment opportunities, but at the same time avoiding the temptation to be sucked back into the late stages of a bear market rally. Value will emerge, but so too will value traps, failed business and bankruptcies and probably also more cases of fraud and unexpected distress through industries (such as the recent negative oil price).

REZCO OPERATIONS

Rezco has always placed a high value on technology, and has built world leading systems around cloud, machine learning, big data, and a robust operational infrastructure. Rezco's operations, both administrative and investment, have not been impacted by any changes due to restricted movement; all we have been missing is a team chat around the coffee machine. Furthermore, we have found interacting with our clients via Zoom webinars and quick one-on-one video chats extremely productive and useful over this time. Please get in touch with us should you want to be included on our Webinar invites or if you have any specific questions – in these difficult times we want to help support your advisory businesses as best we can.

APPRECIATION

As always, we remain grateful to our supporters and thank you again for backing Rezco through these uncertain times. We continually remind ourselves of our duty towards our clients to manage risk but also create wealth over the long term – everything we do revolves around delivering these risk-adjusted returns to our clients, and we are glad to have delivered over this recent quarter.

ROB SPANJAARD
Chief Investment Officer

SIMON SYLVESTER
Co-Portfolio Manager