Overstone Global Equity Income Fund

2022/23 Investment Manager's Report

Performance

Fund (J Class Accumulation) [1]: 5.1%

MSCI World High Dividend Yield, Net Dividends Reinvested: 2.8%

MSCI World, Net Dividends Reinvested: -1.1%

Source: Thesis Unit Trust Management Limited, Bloomberg, Oldfield Partners LLP and MSCI (Copyright)

1 Performance is calculated net of all fees and expenses and on a total return basis, inclusive of all distributions to unit holders.

Process

We look to invest in companies that are long-term winners trading at attractive valuations. We select investments through a bottom-up, research driven approach, searching for companies which have attractive business attributes and are trading at prices well below our view of their fair value. We are contrarian in our thinking, looking at parts of the market that are unloved and out of favour. Areas of poor sentiment are where we find companies priced at material discounts to fair value. The portfolio is concentrated – typically 20-30 holdings – but we look to diversify across countries and sectors. Finally, and importantly, we invest with a long-term mind-set. Our average holding period is 4-5 years.

There is a specific focus on dividends and income generation. At the portfolio level, we are looking to produce an attractive income stream which is sustainable and will grow over time. We target a portfolio dividend yield that is at least 1.3 times that of the broader MSCI World Index. Dividends are a critical part of our investment process. We have regularly stated that we expect to grow the dividend per share on a three to five year rolling view.

This fund, like all our funds at Oldfield Partners, is an equity fund. There are two reasons that we run our equity funds fully invested. The first is that this is what we tell all our clients we will do: Our funds are for investors who want to be invested (in this part of their portfolios) in equities, aiming to outperform the relevant indices over the long term. The second is that, even in dire times, even in times of great uncertainty and great volatility, we remain convinced of the long-term benefits of equity investment: it is not for those with a short-term outlook, but over the long term we believe that equities in general, and the equities we choose for the fund, will provide a good after-inflation return.

Overview

The fund rose 5.1% during the year ending March 2023 (in GBP). This was ahead of the MSCI World High Dividend Yield Index which rose 2.8% and the MSCI World Index which fell 1.1%.

At a stock level, the strongest performers, in order of impact on the portfolio, were Swedish Match (+64%, total return in local currency, to the point of sale), Fairfax (+34%) and BP (+42%). The largest negative contributors were IWG (-37%), Allegiant (-43%) and SS&C (-24%).

Having trailed the indices in the first half of the year to September 2022 the fund benefited in the second half of the year as Europe looked to be successfully managing the energy crisis. The Financial Times greeted the New Year with the headline “UK faces worst and longest recession in G7.” Since the outbreak of the war in Ukraine, the UK and Europe have been heavily impacted by high energy prices. However, a year later and a couple of prime ministers down, a full-blown recession in the UK and many of Europe’s economies maybe avoided. The recent area of concern has focused on small US banks; it does not take long for the attention of doomsayers to swing elsewhere.

Contributors to performance

Swedish Match received an offer from Philip Morris for SEK 106 per share in May 2022. This was approximately 40% higher than the price before the announcement. A key part of a smokefree future in the USA will be nicotine pouches and Swedish Match has a leading market share in this category with its Zyn product. Zyn has gone from non-existent to around 4% of the total US nicotine market in just 5 years. It commands a 65% market share of the category and volumes continue to grow strongly. We continue to participate in the performance of Swedish Match as shareholders of Philip Morris.

Fairfax, the Canadian insurer, announced 2022 book value per share growth of 6%. Although this may look underwhelming, it is impressive given that both bond and equity markets fell last year. The insurance business posted a combined ratio of 95%. Although one cannot rely on a single year’s figures to assess the quality of an insurance company, a combined ratio of less than 100% is good news.

The bond portfolio should now generate c.$1.5bn of interest income and, along with the profits of the insurance underwriting and non-insurance businesses profits, Fairfax should be able to generate around $3bn of operating earnings. This implies Fairfax trades on a single digit multiple price to earnings ratio.

BP generated c.$25bn of free cash flow in 2022. Earnings were similar. This implies BP is trading on a free cash flow yield of c. 25% and a price-to-earnings multiple of just 4x. Looking forward, we do not expect energy prices to be as strong as they were in 2022; however, the company is still trading on single digit multiples of net earnings and free cash flow.

Much of the free cash flow is being returned to shareholders. BP is paying a fixed dividend (c 4% dividend yield) and having strengthened its balance sheet, is now returning 80% of the cash through dividends and share repurchases. Assuming an oil price of $75/barrel (it is currently $80) and a gas price of $5.50/Mcf, we see a fair value of 750p. The benefit of dividends and buyback would provide additional upside. Moreover, there seems to be a reasonable chance that energy prices may stay high for some time given the current geo-political environment.

Detractors from performance

IWG recently announced it was in discussions to sell a stake in its digital assets to private equity for c. £1.5bn. The enterprise value of the business today is c.£2.5bn and the digital assets are c.20% of the profits of IWG. The implied value of the business, excluding the digital assets, is c.10x free cash flow for the largest, most profitable, and best capitalised serviced

office business in the world. In September Mark Dixon, the founder and CEO, added to his 28% holding.

Allegiant, the low-cost US airline, announced full year results for 2022 that showed an improvement in the company's operating performance. As with many other airlines Allegiant has struggled with the travel rebound from Covid. Throughout 2022 Allegiant faced staff shortages and higher fuel prices leading to full year margins of 4%, well below what we would expect from Allegiant. In Q4 we began to see what the company could deliver should some of these issues abate with an operating margin of 16%.

Looking to next year the company will focus on operating efficiency and profitability over revenue growth. Based on the Q4 margin, which is more in line with historical norms, the shares are trading on around eight times price to earnings; well below the pre covid average of fifteen times.

SS&C is a leading provider of mission critical, software-based services and software for the financial services and healthcare industries. The company has over 18,000 clients around the world. SS&C is well positioned to take advantage of rising spending on IT and software, particularly since it has a broad suite of products and solutions to help clients. SS&C operates in what appears to be a competitive environment. However, there are perhaps two or three genuine scale competitors with a long tail of subscale, regional or focused competitors. In addition, the major competitors are owned by banks while SS&C has an advantage of being an independent focused software provider. This is seen in customer behaviour – contracts are often 3 to 5 years in length and the customer base is very sticky with 95% retention from one year to the next.

SS&C trades on a free cash flow yield of 7%. We expect the company to grow organically at mid-single digits giving a return of c. 12% per annum. However, looking at management's ability to allocate capital, we expect the company to add value over and above this. Bill Stone the founder and CEO of the business retains a 13.5% stake in the business. He has a successful record of executing this strategy and is well-aligned with shareholders.

Portfolio changes - purchases

The fund purchased **Korea Tobacco & Ginseng Corporation (KT&G)** during the year. KT&G primary business is to produce and sell tobacco products in Korea and overseas (55% of sales). It also owns Korea Ginseng Corporation, a leading manufacturer of ginseng products such as red ginseng tea and herbal medicines (25% of sales). The rest of the business comprises real estate (15%) – developing former factory sites – and a healthcare supplements and cosmetics business (10%).

KT&G maintains a strong position in the domestic tobacco market. It has a 65% market share in combustible tobacco, helped by a portfolio of well-known brands, a strong distribution network and a history of successful product innovation. These competitive advantages have helped KT&G grow its market share in recent years. It is an attractive market to be in due to low prices ($4 per pack, half of the OECD average) and it has seen only very modest volume declines (1-2% p.a. since 2015).

KT&G has also developed a leading next generation tobacco product. Its heat-not-burn (HNB) product is called Lil and commands a 45% market share in Korea (including the sticks). The

market share of devices is closer to 80%, suggesting KT&G is taking share. HNB has grown strongly over the last 5 years as the penetration of next-generation products increases. The attraction for consumers is HNB provides nicotine consumption with a significant reduction in the harmful compounds related to traditional cigarette smoking. We expect HNB to continue to grow – as we have seen in many other countries around the world.

The success of the KT&G HNB product has not gone unnoticed. Philip Morris (PM), the global market leader in HNB, entered into a distribution agreement with them, allowing PM to sell Lil outside Korea. KT&G receives a royalty stream and benefits from PMI's scale and vast global distribution network. This will provide further top-line growth to KT&G.

In addition, we expect to see gradual margin improvement as the business increases the portion of sales coming from HNB (there is a negative effect from selling more devices as the category ramps). We should also see benefits coming from Asia 're-opening' as a result of more sales coming from the high-margin travel retail channel for both the tobacco and ginseng businesses.

KT&G has improved its shareholder focus in recent years. It has never cut its dividend since listing in 1997; it has grown the dividend by over 16% per annum over this period and the shares currently offer a 6% dividend yield. In addition, KT&G has committed to returning capital via share buyback: approximately KRW1trn between 2021 and 2023 (8% of the market cap). KT&G has net cash (25% of the market cap) and owns other financial assets and real estate. The shares are trading on a price-to-earnings multiple of 10 times.

Portfolio changes - sales

We sold **Britvic** in August having hit our price target.

We sold **E.ON** in June. The Russian invasion of Ukraine has resulted in the global energy markets changing in a way not seen since the 1970s OPEC embargo. Since the conflict started, we have seen a continued ratcheting of hostilities between Russia and Ukraine's allies, mostly liberal western democracies. The most acute element of this ratcheting has surrounded energy security for the EU and especially the supply of gas.

We were conscious that the slowdown in the supply of gas that we were seeing could foreshadow a total freeze in the supply of gas. The companies most exposed to the shortfalls are those that are procuring gas directly from Russia. Uniper, not a holding in the fund, was possibly the most directly exposed company. E.ON (the former parent of Uniper) is very dependent on Uniper to supply gas to its 14m customers in Germany. As a result, we are concerned that there would be a material knock on effect to E.ON should Uniper find itself in serious trouble (which it subsequently has, and is now being nationalised by the German government). It was possible that all's well that ends well but the risk that E.ON could face a substantial change in its circumstances was quite material. As a result, we sold the position.

Russian holdings

Please note that on 3rd March 2022 the Fund's investment in Lukoil ADR listed on the London Stock Exchange (LSE) was suspended from trading. Our Valuation Committee considered it was in the Fund's best interests that the holding of Lukoil ADR be fair value priced (FVP) at zero. In June 2022, we elected for the holding to be converted into local shares (Lukoil PJSC).

Given the current international sanctions on Russian securities and cash balances, we believe that if lifted and the Fund was able to access the local market, the holding in Lukoil PJSC (with a current FVP of zero) would represent 8.0% of the Fund and cash dividend of 1.4%. We continue to monitor the situation closely.

Conclusion

From 2008 to 2021, bar the odd exception, Growth outperformed Value and US outperformed Europe year after year. The outperformance was initially predicated on fundamentals. However, eventually the fundamentals morphed into pure momentum investing. Over the last five years MSCI World Value has provided a return of 5% per annum whereas MSCI World Growth has provided a return of 10% per annum. Over this period MSCI World Value has suffered from a derating whilst MSCI World Growth has rerated by nearly 5% per annum. Half of the return for growth investors over the last five years has come from an unsustainable source.

Turning to 2022 the momentum has begun to switch. Value and Europe have both begun to outperform. Certain pockets of the market, notably loss-making technology companies, have seen substantial share price declines. Many of these companies remain loss making and at some point their time will be up. However, some of our largest holdings, such as BP and Fairfax, that have done well over the last couple of years still trade at very attractive valuations. In 2019 BP had a market cap of $126bn and generated c.$10bn of net earnings so was on an implied valuation of twelve times since then profits have more than doubled yet the market cap is lower (it has also reduced its share count by ten percent over this period). There are numerous examples of this across the market today.

Given this back drop the discipline of investing in companies that are trading on attractive valuations can be challenging. It often means looking in areas where there is fear, which can be emotionally difficult. People like the comfort of being part of the crowd. Benjamin Graham, when asked what causes a cheap stock to find its value, responded “that is one of the mysteries of our business, and it is a mystery to me as well as to everybody else. We know from experience that eventually the market catches up with value.”

The upside of the portfolio is 70%. This compares favourably with the long-term average of 40%. In terms of valuation, the fund is trading on a price-to-earnings multiple of 10x using expected earnings for 2023 and provides a dividend yield of 2.5%. The MSCI World is trading on a price-to-earnings multiple of 17x.

Oldfield Partners LLP

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The value of all investments and the income from them can go down as well as up; this may be due, in part, to exchange rate fluctuations. Past performance is not necessarily a guide to future performance

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