OP

Oldfield Partners

**Overstone International All Cap Select Fund**

**2022 Investment Manager's Report**

The Overstone International All Cap Select Equity Fund (I shares) returned -14.7% in US dollar terms (total return inclusive of dividends and net of all fees) in 2022 compared to a fall of -14.5% in the MSCI EAFE Index (index used for illustrative purposes only).

Much of the performance can be explained by the following themes.

The UK

The Financial Times greeted the New Year with the headline "UK faces worst and longest recession in G7." Much of this is not new news. Since the outbreak of the war in Ukraine the UK has been seen as an economy heavily impacted by high energy prices. Furthermore, the attempts by Liz Truss' short lived government to manage the situation has created what many commentators have referred to as the "moron premium" for British assets. As a result, BT (-30%), IWG (-43%) and JD Wetherspoon (-54%) were among the fund's worst performers over the last twelve months. However, each of these represent compelling investment opportunities today.

BT has returned to top line growth for the first time in 5 years. Despite this, the current market cap is £5bn less than the current regulated asset base of its infrastructure business, Openreach. In addition, BT has the largest fixed and mobile businesses in the UK, serving both consumers and enterprises. The shares are trading on c. 5x price to earnings, and we receive a near 7% dividend yield whilst we wait for the value to be realised.

The UK (continued)

JD Wetherspoon, the UK pub operator, is also trading on a price-to-earnings multiple of 5x using pre-COVID earnings. At the end of March 2020 when the UK had just entered its first lockdown, Wetherspoon had a market cap of £900m. All their pubs had been forced to close and the company had hundreds of millions owed to its suppliers without the cash flow from its operating business to fund that working capital. The outlook could not have been worse. Yet today, with pubs open, its market cap languishes at half pre-COVID levels.

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.

China

Another economy to be knocked about by the toing and froing of expectations in 2022 was China. We have witnessed increased geopolitical tensions and the full suite of Covid 19 related scenarios including lockdowns, protests, and the ultimate end to the last major Zero Covid policy. Alibaba (-27%) has suffered from poor sentiment, regulatory crackdowns, the slowing economy and increased competition. There are some glimmers of light, and the company is engaging in self-help by cutting costs. It has also committed to repurchase $25bn of stock over

the coming couple of years, equating to approximately 10% of the current market cap. The shares trade at just over 12x price-to-earnings.

Energy

One consequence of the war in Ukraine has been higher oil and gas prices. The fund's main exposure to energy is through its holdings in BP (+22% since purchase). We estimate that BP is likely to generate c. $25bn of free cash flow in 2022. Earnings will be similar. This implies BP is trading on a free cash flow yield of c. 25% and a price-to-earnings multiple of just 4x.

Much of the free cash flow is being returned to shareholders. BP is paying a fixed dividend (c 4.5% dividend yield) and, having strengthened its balance sheet, is now returning 60% of the surplus cash through share repurchases. Assuming an oil price of $75/barrel 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 geopolitical environment.

Interest Rates

Another major theme of 2022 was higher interest rates as central banks around the world acted to combat soaring inflation. Several of our financial holdings were among the best performers: Mitsubishi UFJ (+48%), Fairfax (+31%), Japan Post Holdings (+17% to sale) and Handelsbanken (+7% since purchase).

Fairfax, the insurance company, is benefiting from the move in the short end of the US government bond yield curve. Liquid assets are being invested at more attractive rates, which is driving higher investment income. Fairfax's investment portfolio has a duration of just 1.2 years, allowing it to benefit from rising rates sooner than peers. Fairfax is also benefitting from the rising prices in insurance markets. The company recently repurchased $1bn of its shares (c.8% of shares outstanding).

Mitsubishi UFJ reacted positively to the surprise announcement at the end of the year by the Bank of Japan governor Haruhiko Kuroda that he will now allow Japan's 10-year government bond yield to rise to around 0.5%, from a previous 0.25% cap. As with other banks, the higher interest rate environment should increase net interest margins.

Takeovers

As in any year there are companies that perform well and those that perform poorly – but the best performance often comes from those that are taken over. This year was no different with Turquoise Hill receiving an offer from Rio Tinto, with the latter bidding for the 49% of Turquoise Hill which it does not already own. This resulted in a 50% rise in the share price.

Outlook

2022 will be remembered as the year that Russia invaded Ukraine. Europe was subsequently seen as the epicentre of geopolitical risk and global investors fled the region. There was indiscriminate selling of European equities, with all sectors falling as the war commenced. This was particularly noticeable when compared with the US, where sectors such as energy and materials (global sectors with similar drivers) saw wildly different performance. This impact

was then compounded as the US dollar strengthened through most of the year, with investors buying everything US in a perceived “flight to safety”.

There are large disparities in the valuations of markets around the world: the US remains very expensive versus long-term averages while, on almost all equivalent metrics, the rest of the world is at or below long-term average valuations. The outperformance of the US – both the market as well as relative strength from its currency – has lasted well over a decade. While we do not know when the outperformance of the US will reverse, we are confident that it will and that ‘global’ indices, where 70% is allocated to one of the most expensive markets, is neither diversified nor likely to provide good returns in the coming decade. The lack of diversification is likely to become apparent only in hindsight.

The upside of the portfolio is 80%. This is towards its historical high and compares very favourably with its long-term average. In terms of valuation, the fund has almost never been cheaper, trading on a price-to-earnings multiple of just 9 using expected earnings for 2023. We are optimistic about the future given this starting point today.

***Oldfield Partners LLP***

***April 2023***

**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**

This document has been made available only to persons who are Professional Clients as defined by the Financial Conduct Authority. It is not intended for Retail Clients. It should not be provided to third parties without the express written consent of Oldfield Partners LLP. Information contained in this communication must not be construed as giving investment advice within or outside the United Kingdom. This document is not a solicitation or offer of investment services. Any reference to stocks is only for illustrative purposes and opinions expressed herein may be changed without notice at any time. Oldfield Partners LLP does not warrant the accuracy, adequacy or completeness of the information and data contained herein and expressly disclaims liability for errors or omissions in this information and data. Past performance is not necessarily a guide to future performance. Investments and the income from them may go down as well as up and you may get back less than the amount you invested. No warranty of any kind, implied, expressed or statutory, is given in conjunction with the information and data. © 2023 Oldfield Partners LLP. Partnership No. OC309959.