ROZENDAL
PARTNERS

Dear friends and fellow investors,

Rozendal's performance vs. benchmarks

Period	**Rozendal Flexible Prescient Qualified Investor Hedge Fund**[1]	**FTSE/JSE All Share Total Return Index**
Inception to 30 June 2018[2]	(0.5%)	(1.8%)

1. Returns shown for the B unit class, which is the earliest unit class in existence. Return numbers for other unit classes may differ slightly. Returns shown assume income is reinvested gross of tax.
2. Inception: 1 February 2018.

Introduction

This is our first letter to investors in the Rozendal funds. Our main aim with these letters will be to inform, entertain and stimulate in a way that will help readers to understand our thinking in making investment decisions. We will strive for brutal honesty, painful as that will no doubt be at times. And we would like nothing more than for readers to interrogate our decision making and processes based on what we share in these letters.

Generating good investment returns is the core of Rozendal Partners' existence, and we will do our best to help investors understand how returns, satisfactory or otherwise, have been generated. We will try to give an honest assessment of where we have been wrong and where we have been right, and whether we have been wrong or right for the right reasons. While potentially of lesser interest to many readers, we will also share developments within Rozendal Partners. Changes to the structure, culture or stability of an investment management firm can be of critical importance to the firm's ability to generate good long-term returns for investors. Hence these aspects of Rozendal Partners merit discussion.

There are two topics on which we will limit discussion. Firstly, general macro-economic commentary and overviews of markets. There are ample sources of freely available material covering this topic out there – we see little value in reinventing the wheel in our writings to you. We are inherently bottom-up investors concerning ourselves mainly with the economics of individual businesses. However, we may well share interesting macro-economic information if it has a bearing on our view of the world, if it serves to illustrate investor behaviour, or if it points to the backdrop that creates investment opportunities. And in some instances, even bottom up investors are forced to make macro-economic judgements in their investment decision making.

The second topic that we will treat with caution is detailed discussions of current investments. There are three reasons for this. The first and most obvious is that the intellectual property encapsulated in an investment idea is what investors in the Rozendal funds pay us for. Giving away this intellectual property for free strikes us as somewhat unfair to our investors. We prize robust interrogation of our investment theses, and endeavour to subject our investment ideas to as much of this as possible prior to implementation. We enjoy debating investment ideas with interested counterparties and do participate in forums where ideas are shared amongst peers where we feel there is mutual benefit to be gained from such discussion. But we are always cognisant of placing the interests of our fellow Rozendal investors first.

Secondly, we may well be transacting in the shares of some of our fund investments. Given that our fund structure (specifically in the Rozendal Flexible Prescient Qualified Investor Hedge Fund – 'the Hedge Fund' or 'the Fund') allows us to invest in illiquid listed securities, disclosing anything about our actions may well have a detrimental impact on the price we achieve to execute transactions in the market.

The third, and probably most important reason why we treat the discussion of current investment ideas with caution is the anchoring and consistency biases that such public discussions of investment ideas evoke. There is always a temptation as an investor to crow about the intelligent and diligent research one has performed on an investment idea. But the reality of human nature is that the mere action of publicly stating one's views on a topic biases one in favour of increased commitment to those views. As an investment team our primary edge on the market is to keep a more rational and level-headed perspective on investment opportunities than most. Any influence that biases our decision making away from objectivity can only be counterproductive in the long run.

At present, only the Hedge Fund is up and running. We hope to open the Rozendal Global Fund within the next few months but given the vagaries of global regulatory demands on the investment management industry, we can't make any promises. Be that as it may, given the status quo, the rest of this letter will deal mainly with the Hedge Fund. We can (and do) invest globally in the Hedge Fund, so our commentary will hopefully also be of relevance to those mainly interested in the Global Fund.

A quick word on the name of the Hedge Fund. Of the seven words in the name, only three - 'Rozendal Flexible Fund' - are really of our own choosing. The additional four – 'Prescient Qualified Investor Hedge' – are all imposed on us by regulatory requirements. Because the Fund is licensed on Prescient Management Company (RF) Pty Ltd's collective investment scheme management company license, regulations require that 'Prescient' appears in the fund name. And because the fund is a Qualified Investor Hedge Fund (the most flexible fund structure we can employ in South Africa), regulations require that the words 'Qualified Investor Hedge Fund' appear in the fund name. The intention behind this is to warn potential investors that this is a fund which may employ higher risk strategies than 'plain vanilla' collective investment schemes. But unfortunately, these good intentions leave us with a fund name that appears to hail from hell.

Investment returns

As Table 1 shows, the Hedge Fund delivered a negative total return of 0.5% for the five months from 1 February 2018 (the inception date of the Fund) to the end of June 2018. This modest start to the life of the Hedge Fund was better than that achieved by the benchmark, but clearly not what we envisage the future of the fund to hold. Our aim and incentive is to deliver high absolute returns, and investors do not incur any performance fees unless we deliver returns that are both benchmark-beating and positive.

A few comments on the sources of this first few months' modest return:

The most notable reason for the negative return achieved was a large holding of British American Tobacco that was held for a relatively short period in February. This holding came into the Fund as part of the subscription by the first investors in the Fund. Our best investment view at the prices prevailing for the stock at the time was not to own any shares, and we proceeded to implement this view forthwith. However, until the final sale of these shares, the share price declined substantially – especially by the standards of what has historically been a relatively stable and predictable business (and stock).

As we elaborate on later in this letter, tobacco companies fall into that category of companies that became so beloved of investors in the years post the 2008 Global Financial Crisis that share prices left little room for negative surprises. And negatively surprise they did in the first half of 2018: proposed limits on cigarette nicotine content by the Food and Drug Administration in the US and disappointing electronic cigarette sales in Japan resulted in some of the most severe daily sell-offs of share prices in the tobacco sector ever seen. Unfortunately, the Fund felt some of the early impact of these sell-offs. Fortunately, investors who invested after February have not.

On the positive side, the Fund held some foreign cash balances (Euro, Pounds and Yen) in anticipation of deploying cash in global investment opportunities. As the Rand weakened over this period, these cash balances contributed positively to returns. Of the stocks held in the fund, Allied Electronics made the largest positive contribution, as the market increasingly comes to appreciate the positive changes brought about by activist shareholders Value Capital Partners in the business.

Investment observations

Bearing in mind the caveats expounded upon earlier, we nonetheless want to give as much useful insight into our thinking and investments as prudence will allow. In some cases, these observations relate to current investments in the Fund; in other cases, these observations may illustrate interesting or important aspects of investor behaviour or market anomalies.

1. South African small caps

Political turmoil, a volatile currency, weak GDP growth – there certainly are echoes of the early 2000's in today's macro-economic environment in South Africa. And hence it does not surprise us too much that there are echoes of the early 2000's (when local small cap companies offered phenomenal value) in the stock market in South Africa today. With small cap companies typically being more exposed to the economy of their home country than larger companies, many of the smaller listed businesses in South Africa have borne the full brunt of the mismanagement of the local economy over the past number of years. The distress in the local construction sector bears grim testimony to this.

But this type of environment is typically fertile with opportunity for the patient and diligent investor. Babies often get thrown out with the bathwater. The following comment by a journalist in a recent media article about the South African construction sector is illuminating: 'Analysts were not available to comment. Years of dismal results in the local construction industry have diminished market interest in the sector.'[3]

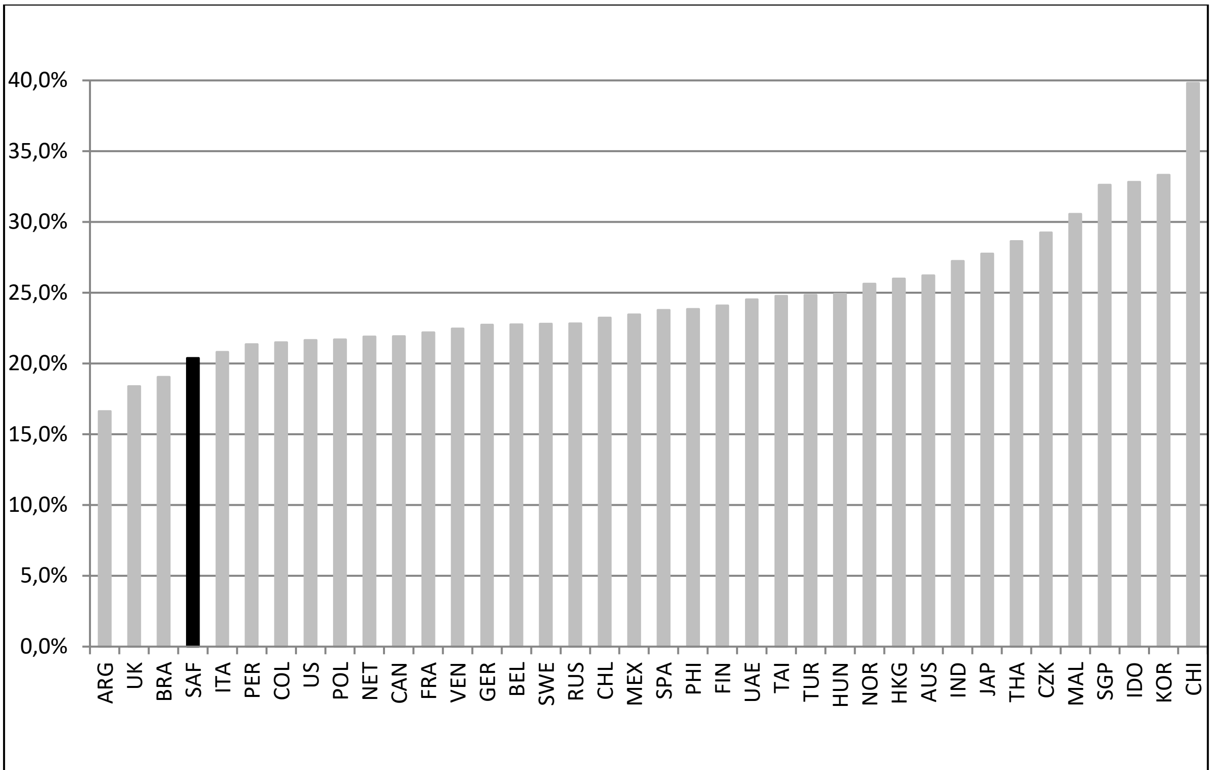
[3] https://www.businesslive.co.za/bd/companies/industrials/2018-05-17-banks-throw-group-five-a-bridging-credit-loan-lifeline/

While we don't have data to prove this, we also suspect that passive investing – specifically the classic market capitalisation weighted indexing employed by most passive investors – plays its fair share in creating opportunity in small cap stocks. Most widely tracked stock indices include only the largest stocks in a market. Increased passive investing will mechanically drive up the price of the stocks in the indices relative to the price of the stocks not in the indices.

Although we try to steer away from macro-economic bets, preferring to invest in the economics of businesses rather than in the economies of countries, investing in domestically-focused smaller companies inevitably introduces an element of 'investing in the future of South Africa' into the Fund. And while we don't hold a particularly optimistic view of the South African political and economic situation, our working assumption is probably something along the lines of 'we'll muddle through', and that 'this too shall pass'.

It is also important not to lose sight of the fundamentals of the supply and demand of capital at this point. South Africa has historically been a capital-starved country. Probably because of the pervasive climate of political uncertainty (or risk), investors have generally been wary of committing capital to the country for most of the past forty years. Chart 1 below illustrates this.

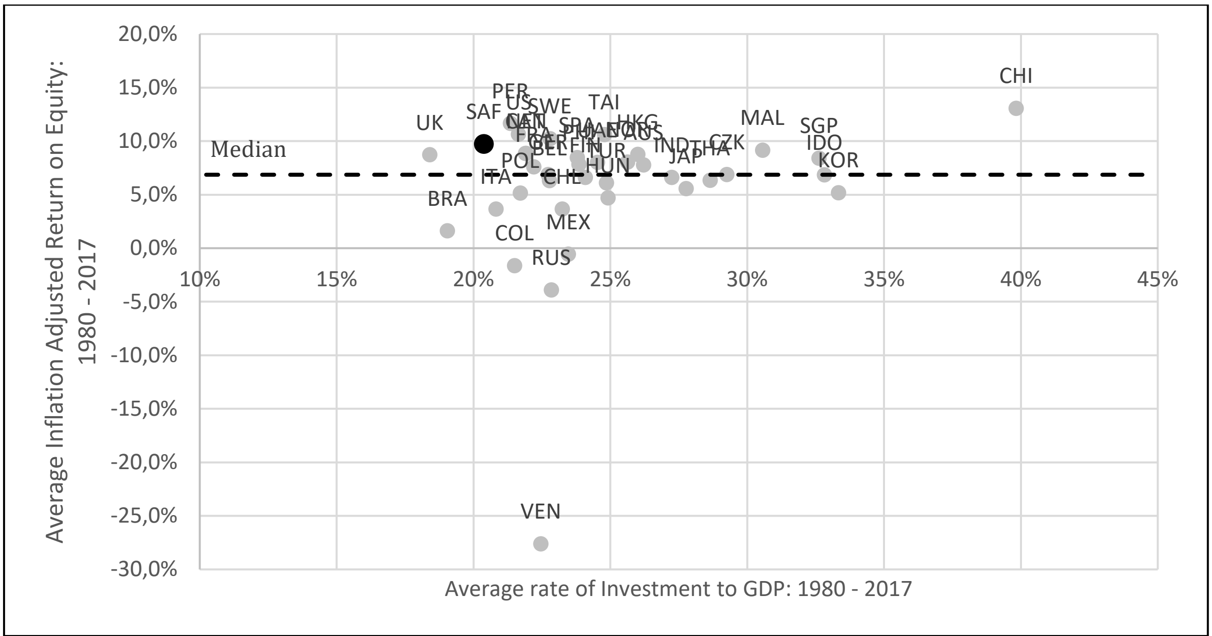
Chart 1: Average rate of Investment to GDP: 1980 - 2017



Source: IMF, RMB Morgan Stanley

Scarcity leads to high prices – in the market for capital as much as in the market for commodities. So generally, in countries where levels of investment have been low, we expect returns on that capital to be high. While the data we have seen does not support a clear conclusion on this, the South African market has certainly enjoyed a long-term inflation-adjusted return on equity well above global averages.

Chart 2: Average Inflation Adjusted Return on Equity vs. Average Rate of Investment to GDP: 1980 - 2017



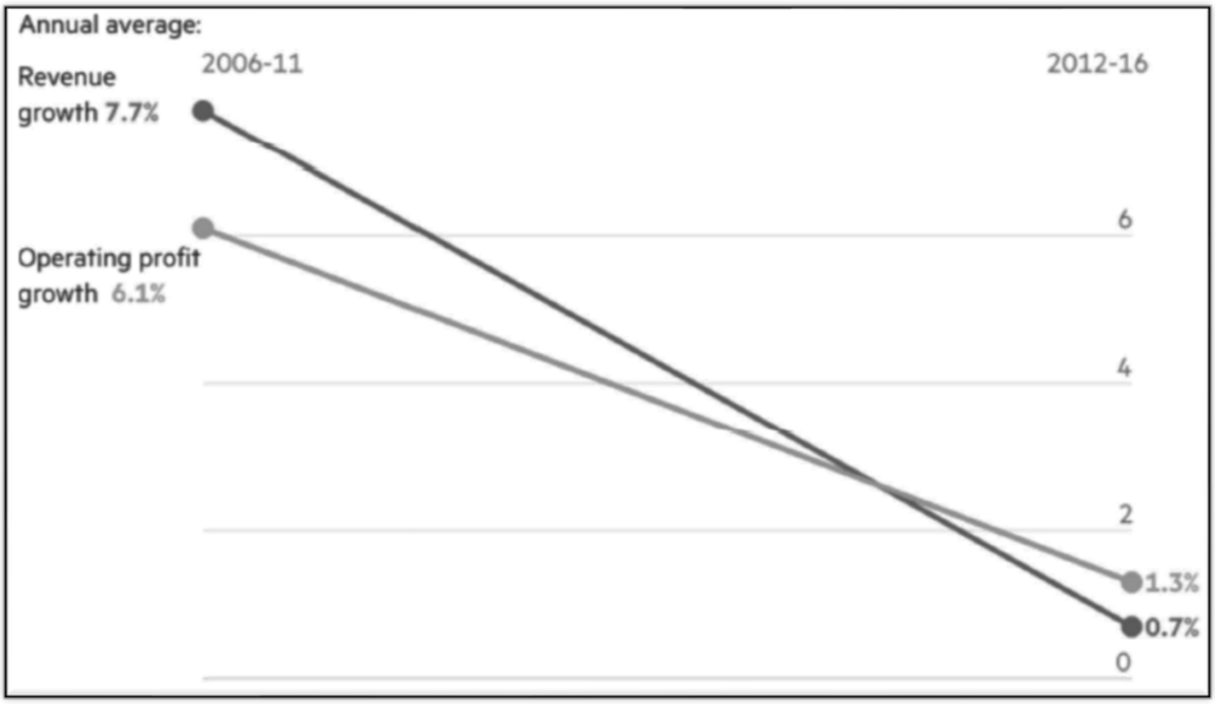
Source: Thomson Reuters Datastream, Rozendal Partners

While some of the smaller SA companies in the Fund will require a cyclical upturn in business conditions to prosper, in many cases there are avenues to unlock value that is not dependent on general business conditions. ‘Self-help’ measures being implemented at several investee companies include improved corporate governance, giving the market clearer line of sight to hidden assets, buying back (very cheap) shares, improving capital allocation, and taking market share from competitors. An improved South African economy will be a welcome sweetener on top of this but is not an essential requirement for these investments to deliver very satisfactory returns over time.

2. Consumer staples and the craving for stability

One of the most pronounced trends in global equity markets that we noticed following the 2008 Global Financial Crisis was the flight to safety – with safety perceived to be in the industries and companies that navigated the economic turmoil of the time with less drama than the cyclical sectors (financials, basic materials and the like) that suffered most during the global downturn. This herding resulted in some interesting outcomes. A prime example: growth rates and ratings of fast moving consumer goods (‘FMCG’) companies from 2006 to 2016, as shown in Charts 3 and 4 below.

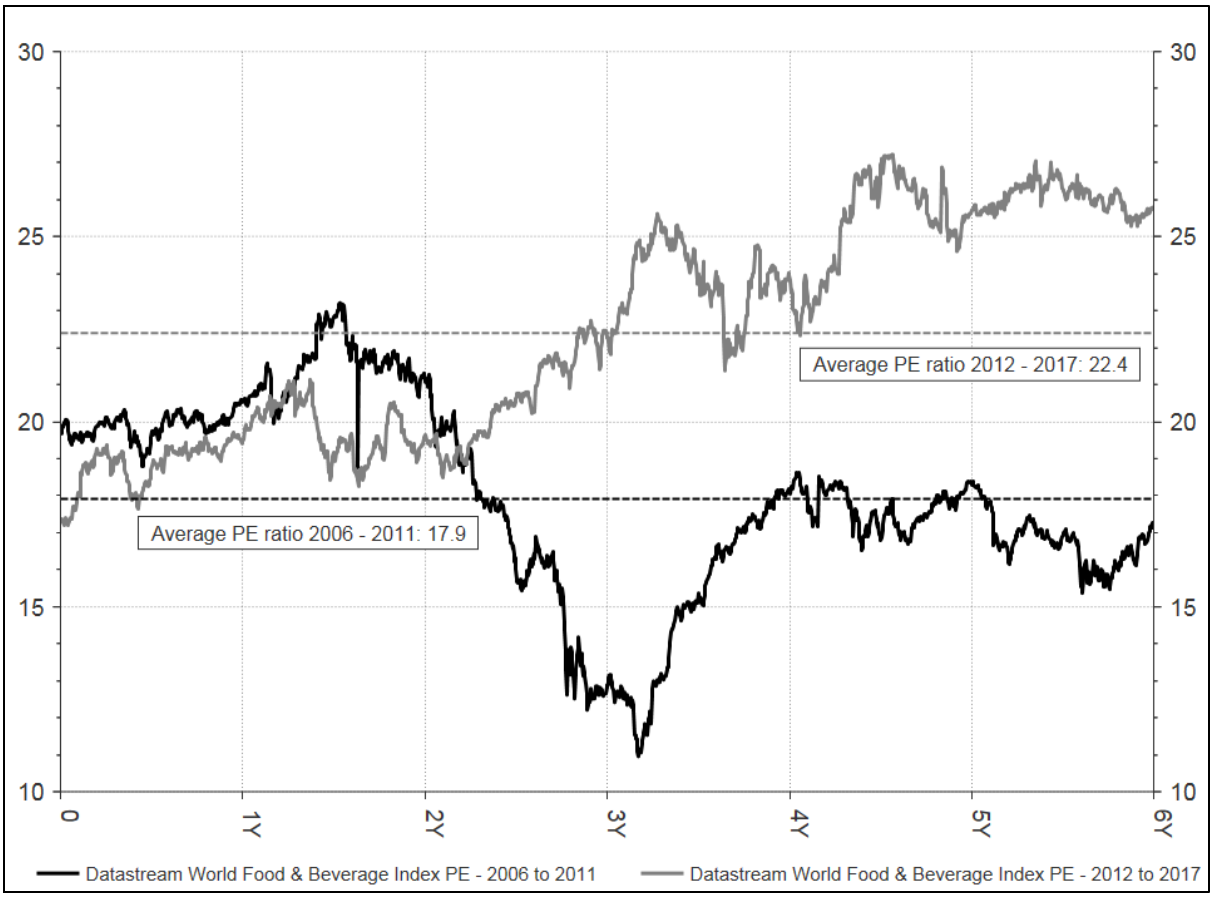
Chart 3: Annual Average Revenue and Profit Growth for Leading FMCG companies



Source: Bain and Company, Financial Times

Chart 3 shows how revenue and profit growth for the leading consumer goods companies have slowed down, from mid- to high single digit average growth rates between 2006 to 2011 to barely any growth between 2012 and 2016. Lower growth rates equate to lower ratings in the market, right? Not in a safety obsessed world where perceived low risk cash flows have been discounted at ever lower interest rates.

Chart 4: Price Earnings ratio for Datastream World Food & Beverage Index: 2006 – 2011 vs 2012 – 2017



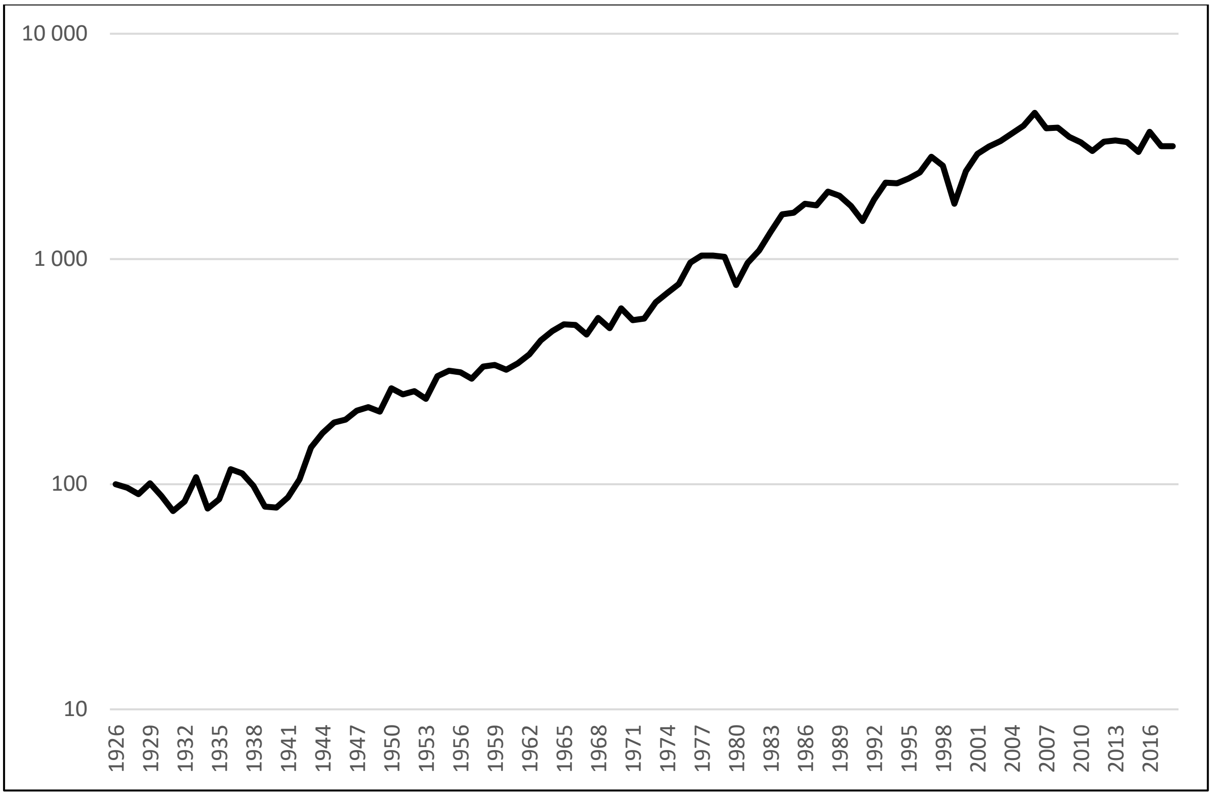
Source: Thomson Reuters Datastream, Rozendal Partners

Between 2006 and 2011, while growing at a healthy clip, FMCG companies were rated at a Price Earnings ('PE') multiple of about 18 times on average – hardly low, but quite palatable compared to long term market averages. From 2012 to 2017, this rating increased to an average of more than 22 times, while growth petered out to negligible levels. The 'low risk at any price' phenomenon that played out so vividly in the global government bond markets over this period clearly found its way into the equity markets as well. While the picture has started to change recently, with the market beginning to acknowledge the growth challenges facing many established FMCG businesses, we have struggled to find good value in the sector for a long time.

3. Value and growth

Simplistic value investing – buying stocks trading at a low price to book multiple – has historically been a good investment strategy. The chart below shows the strong outperformance of the so-called value factor in the US market relative to the overall US stock market since 1927. An investor who stuck with the strategy from 1927 until today will have multiples of the wealth of an investor who was purely invested in the market.

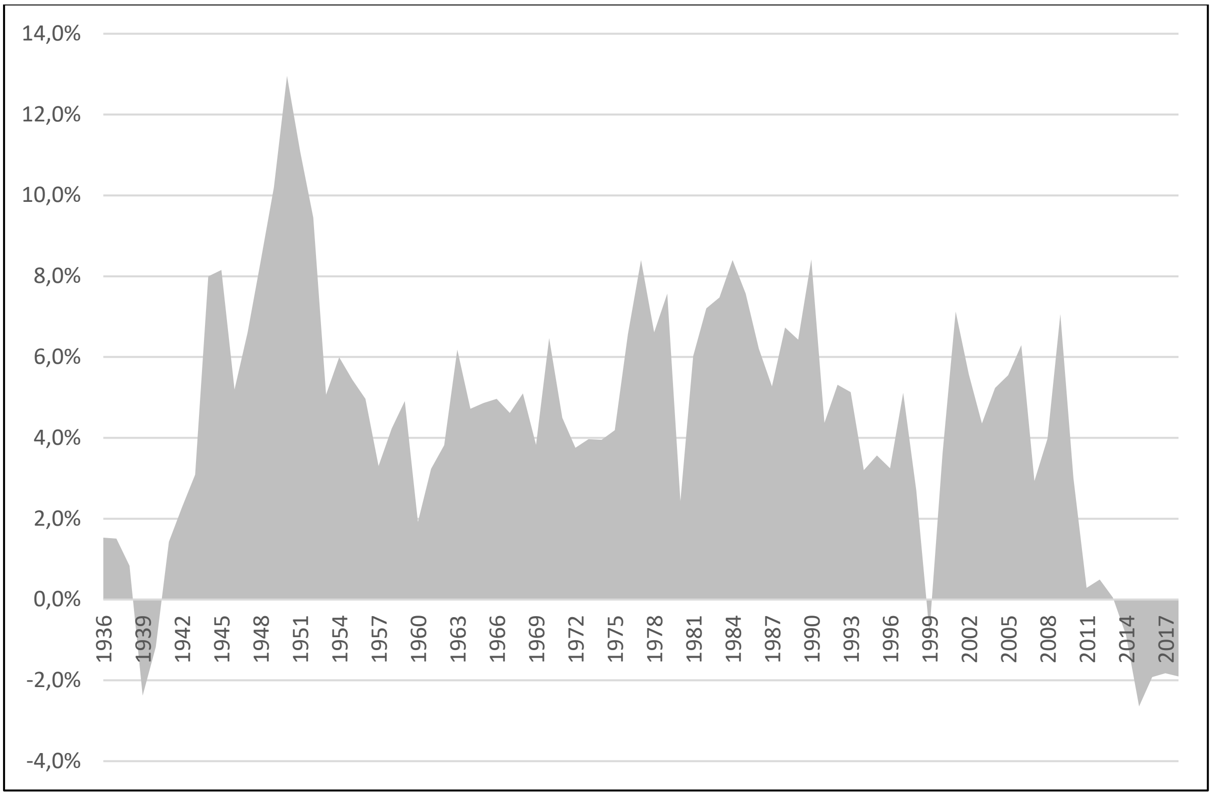
Chart 5: Value factor returns relative to the overall stock market in the US 1927 - 2017



Source: Kenneth French, Rozendal Partners

But it is clear from the graph above that value has not delivered strong returns in recent years. The next chart really drives the point home though.

Chart 6: Rolling 10 year compounded annual performance of value relative to the US market



Source: Kenneth French, Rozendal Partners

Looking at rolling ten-year returns (a timeframe in which most investors will realistically expect the true merits of an investment strategy to come to the fore), in every full ten-year period since 2004 value has delivered weaker returns than the market. This is unprecedented in the period for which we have data and has laid the investment track records of several storied investment managers to waste.

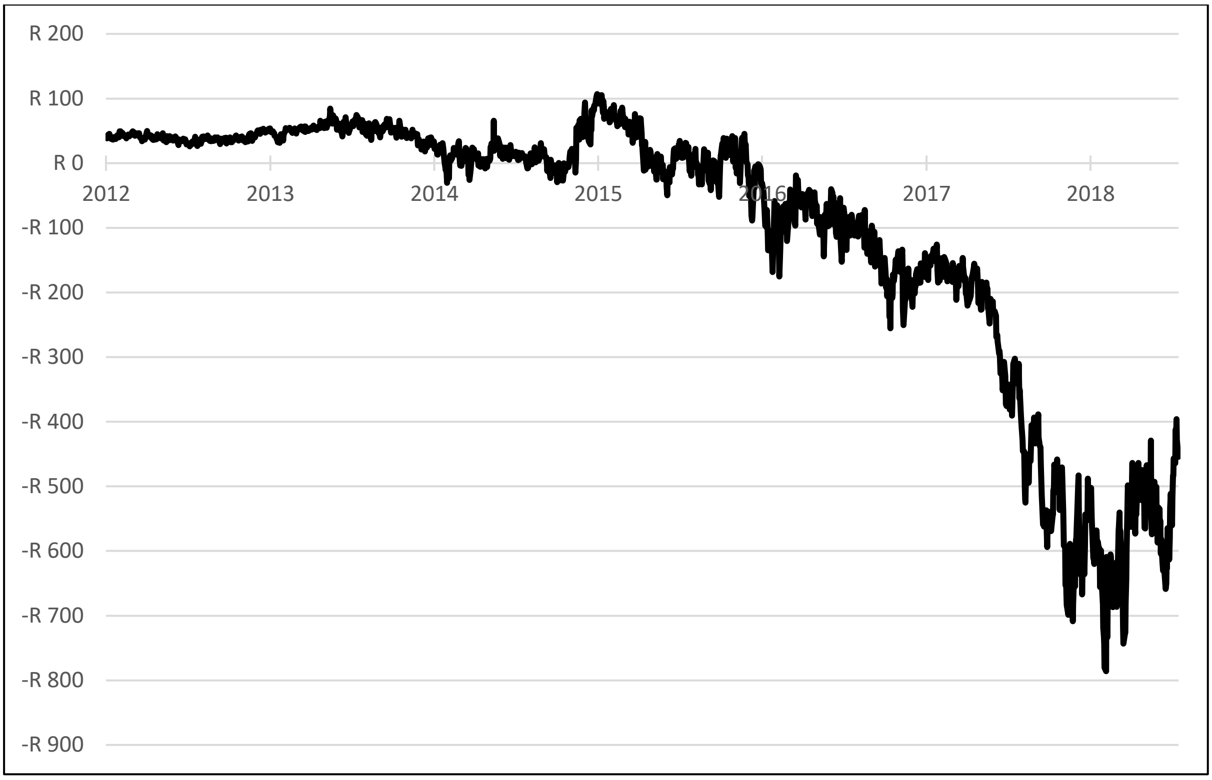
This raises the question: is simplistic value investing still a legitimate investment strategy? We tend to favour the longer-term evidence that suggests that it is indeed, rather than overweighting the experience in recent years. Simplistic value investing has historically worked because it exploits the human behavioural bias of long term (and here we mean longer than a year) over-reaction. Only a fundamental change in human psychology will change this over-reaction tendency of markets, and we doubt that this will ever happen.

However, simplistic value investing can be accessed very cheaply in so-called smart beta funds today, and we are very cognisant of the fact that active managers like us are paid to deliver superior returns to these simple quantitative strategies – effective as they may be. So, while the investment opportunity set today may well lie in traditional value strategies, that will not necessarily always be the case, and it is our job to assess those opportunity sets on an ongoing basis.

4. The Naspers stub and the limits to arbitrage

At the risk of violating our own principles laid out above about commenting on stock specific positions, we can't resist mentioning the Naspers stub. The Naspers stub is the businesses and investments owned by Naspers excluding its investment in Tencent. The discount that this stub is trading at has become mind-boggling in recent years. Chart 7 shows the price, in billions of Rands, that the market has been ascribing to the Naspers stub since the beginning of 2012.

Chart 7: Market price of the Naspers stub since 2012



Source: Thomson Reuters Datastream, Rozendal Partners

Yes, that is negative R400 billion Rand (c. USD 30 billion) which the market is currently ascribing to the value of Naspers excluding its Tencent holding. Bear in mind that this stub includes some market-leading pay-tv, online retail, classified advertising and payments businesses, which all fetch very high prices in private market transactions and should on any rational assessment be worth billions of Rands. As much as we agree that holding company discounts are justified for reasons like taxes and head office costs, we find it hard to believe that Naspers management will destroy the quantum of value implied by this extraordinary discount.

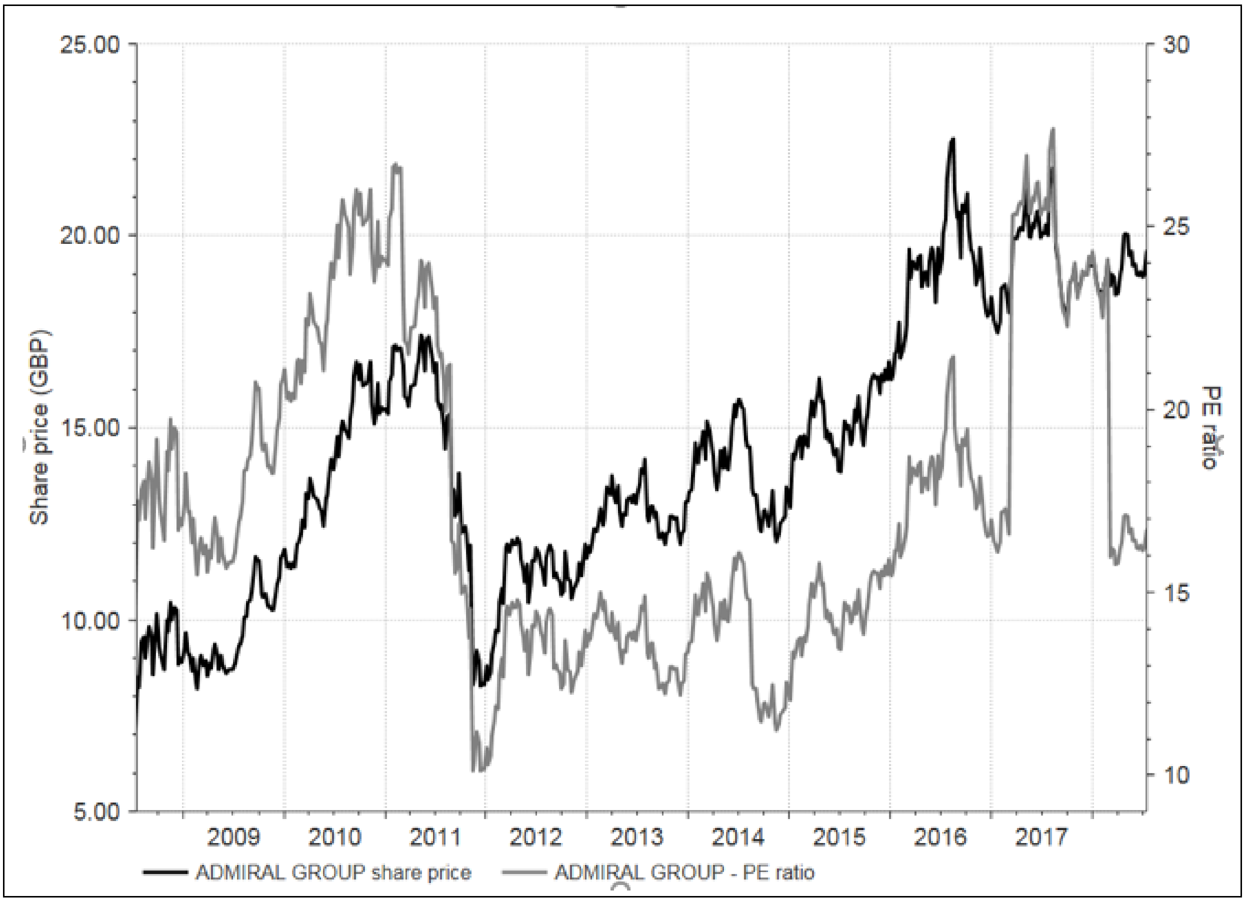
Our view on this discount is hardly controversial, or non-consensus though. So why does Naspers trade at such an exorbitant discount? It seems the reasons are mainly structural – the result of regulatory limits on fund position sizes and relative index weights of Tencent and Naspers in emerging market indices. The pervasively negative sentiment amongst global investors towards South Africa compared to China may also play a part. But whatever the reason, here we have a shining example of an asset that is clearly being assigned an irrational price by the market. 'Creating' the Naspers stub in a portfolio requires buying Naspers and shorting Tencent. Given the size of Tencent in the Naspers portfolio, acquiring meaningful economic exposure to the pure stub can involve quite large position sizes in both Naspers and Tencent. This can introduce significant volatility into a fund – which not all investors are necessarily comfortable with. However, for flexible, patient investors like us, this presents a very attractive opportunity to profit from the constraints on other investors not in our position.

5. Cycles and their opportunities

While it is not currently a holding in the Fund (and thus we are comfortable discussing the investment idea), as portfolio managers and investors, we have in the past been invested in the shares of Admiral Group, a superb direct motor insurance business based in the United Kingdom. Admiral ticks many of the qualitative boxes that we like to see in a business: cost leadership in its market, shareholder aligned management that own meaningful amounts of shares, very conservative accounting, exceptional conversion of earnings into free cash (resulting in a dividend pay-out ratio of almost 100%), and an aversion to acquisitive growth in favour of organic expansion. Such quality does not come cheap, but we are very happy to pay up for the right business. Value investing is the act of buying assets for less than they are worth, not necessarily for low multiples of earnings or book value.

Long term (i.e. multi-year) industry cycles often create opportunity for patient investors, and it was no different in the case of Admiral. Insurance is typically a cyclical industry, where years of favourable underwriting results attract more capital (in the form of increased sales of policies) and entrants into the industry, and unprofitable years result in new business being pursued less aggressively, giving scope for price increases in the market, which then supports improved profitability. As competitive intensity waxes and wanes, profitability of companies in the market sometimes throw up unexpected surprises in the short term. This occasionally scares the market, creating great opportunities for investors who can maintain a more even-keeled focus on the long-term economics of a business. The Admiral share price and price earnings ratio over the past ten years is testament to this phenomenon.

Chart 8: Admiral ten-year share price and PE history

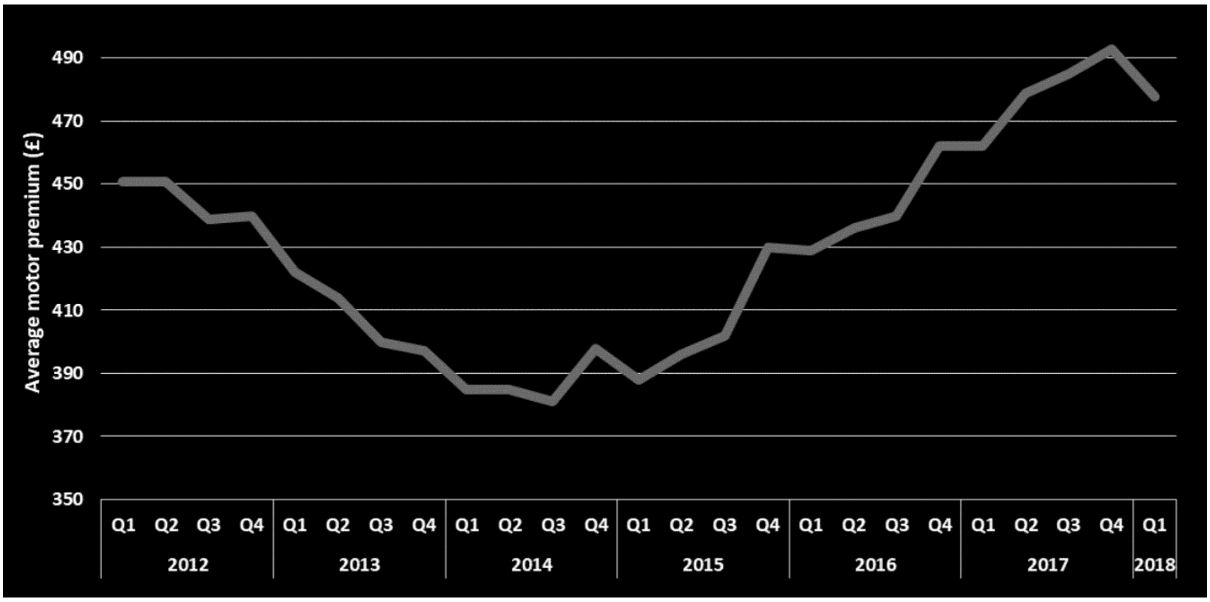


Source: Thomson Reuters Datastream, Rozendal Partners

The share price implosion in 2011 was a beautiful confluence of very high expectations (PE multiple north of 20) meeting a slight disappointment in operating results (an unexpected increase in large bodily injury claims in the market). We'll not be so arrogant as to suggest that it should have been an easy decision to invest in Admiral shares in the face of the uncertainties at the time, but it is worth noting that company management engaged in substantial (millions of pounds worth) of buying of Admiral shares right after the share suffered its worst price falls. So there certainly were signs that the market reaction was perhaps overblown. But the share price and market rating development in the ensuing years are of more interest to us for purposes of the current discussion. It was also more relevant to us, as it was during this period that we committed the capital of our clients at the time to Admiral shares.

More benign claims frequency than expected coupled to regulatory changes implemented in the UK to limit the abuse of bodily injury claims triggered a more aggressive push for business by companies during 2012. This pushed premiums down in the typical cyclical fashion. The downtrend accelerated in 2013, but then bottomed out during 2014, as underwriting results deteriorated, and companies started pricing for profitability again, not growth. In addition, regulatory changes to the rate at which provisions for long-tailed claims must be set aside jolted the market during 2017 and resulted in companies increasing prices to protect profitability.

Chart 9: Average UK motor insurance premium



Source: Insurance Times, ABI

Uncertainty about the duration of the soft insurance cycle weighed on the share price of Admiral for most of the 2012 to 2014 period. This resulted in a market rating (PE ratio) in the low to mid-teens – attractive value for this business, in our opinion. As the pricing cycle subsequently improved (and Admiral wrote increasing volumes of new business in this more attractive pricing environment) so did the share price. But 2018 has once again brought expectations of a less severe than expected impact of the regulatory changes to reserving requirements. So the policy writing taps have been opened, and prices are now falling. The similarities with the 2011/2 cycle are striking, and if we are lucky, the next few years may offer the same type of opportunity that the 2012 – 2014 period presented.

Rozendal Partners update

We have laid out many of the principles on which Rozendal Partners is built on our website (www.rozendal.com). But seeing that this is our first letter to investors, we thought it may be worthwhile to mention some thoughts in this respect.

Firstly, our reason for existence is to generate strong absolute returns for investors while limiting the risk of capital loss. We have done our best to reflect this mission in our ownership and incentive structures. Rozendal Partners is owned by employees of the firm and by seed investors. We are meaningfully invested in the funds we manage. And employees of Rozendal will only do well for themselves if we do well for investors in the Rozendal funds.

We debated the choice of benchmark – absolute or relative – at length. While the goal of not losing money seems more consistent with an absolute benchmark, the problem with an absolute return benchmark is that it is not ex ante investable, and hence does not necessarily represent a tangible alternative for investors considering an investment in Rozendal Funds. In the end we felt a benchmark that is representative of the risks and rewards investors in the Rozendal funds can expect to be exposed to, and that is also investable (and hence represents a true alternative to the Rozendal Funds) is more appropriate. Thus, our choice of equity index relative benchmarks. But to ensure that we don't succumb to the temptation of relative value investing at the expense of managing absolute risk of loss, we consider it only right that we earn performance fees only if we generate positive returns – hence the highwater mark employed in our funds. And of course, there is nothing like having a material part of one's net worth invested in the fund one is managing to focus the mind on limiting the risk of capital loss.

A further aspect of our fee structure worth mentioning is the crystallisation of fees – i.e. when performance fees are paid out. While the realities of fund administration and the equitable treatment of investors entering and leaving the fund preclude us from applying this to all investors in our funds, currently the bulk of any performance fees we may earn are only paid out over a five-year period. This creates opportunity for an element of claw-back of performance fees earned in a year should investment returns subsequently fall below hurdle rates. With this mechanism we hope to avoid the situation where a risky bet pays off in one year and performance fees are paid out, only for returns to implode in subsequent years with no recourse to the 'ill gotten' performance fees paid out before.

Despite the rise of passive investing, quantitative strategies, artificial intelligence and big data, we believe that the fundamental requirement of successful investing will remain the ability to implement a sensible strategy in a disciplined fashion. If humans remain the ultimate drivers of capital flows in markets, mispricing will arise due to the basic behavioural and psychological biases of human beings. Behind every cutting edge artificial intelligence investment strategy (sensible and powerful as it may be) there is still an investment manager who must convince human beings to stay the course with their money in his or her fund during periods of underperformance, just like any old-fashioned fundamental investor. Our aim with the structure and incentives of Rozendal Partners is to give us and all investors in our funds better odds than most of meeting that fundamental requirement of successful investing.

Yours sincerely,

Wilhelm Paul Jan

26 July 2018