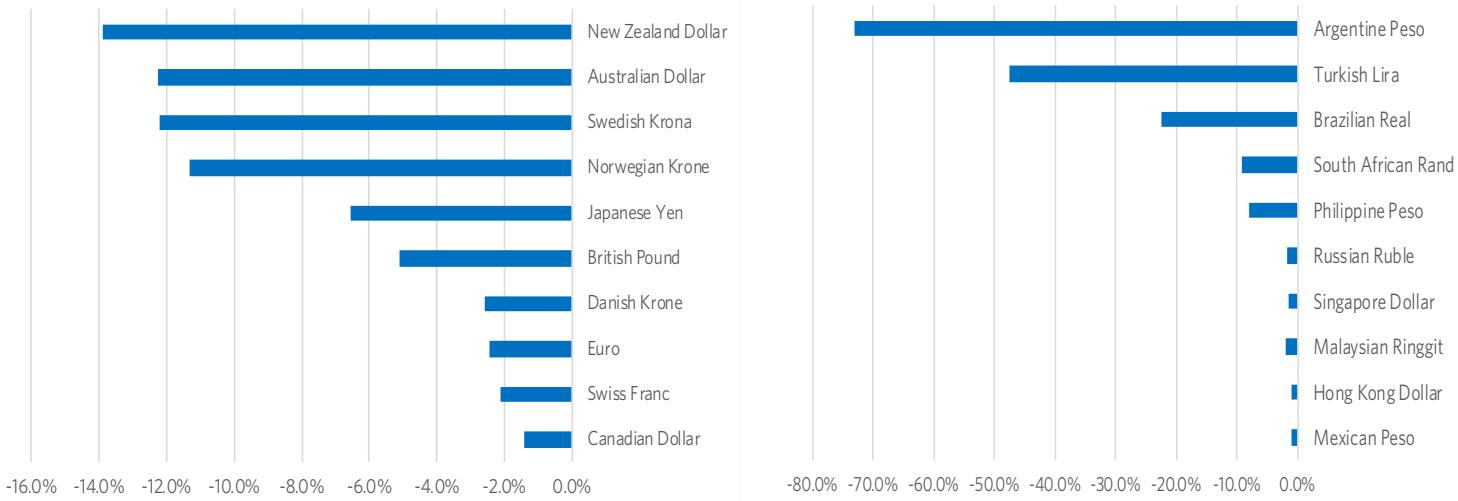
Portfolio commentary

Performance review

The Funds have delivered returns of 4.8% (Balanced) and 5.6% (Growth) per annum over the past three years, net of all fees and in dollar terms, and the dollar has been the dominant global currency, having appreciated against the other majors over that period and more notably against all emerging market currencies:

A dollar bias has benefited investors over the past three years (percentage change versus the US dollar):



Recent performance has been muted for two reasons: our underweight allocation to the US stock market and the underperformance of our Value managers, chief among them Contrarius.

US leadership

The US stock market has materially outperformed other markets over the past five years. Underlying earnings growth has been slightly stronger but the **key factor driving the US market's outperformance has been a significant rerating versus the rest of the world: in other words US companies have become more expensive.**

Higher prices can lead to disappointment which prompted us to reduce our exposure to US equities in favour of other markets such as Europe and Japan. This positioning has not paid off in the past five years but there has been a notable shift in relative performance in recent months: over the past three months the US market has been flat while Europe ex UK is up 4%, Japan up 5.5% and emerging markets up by over 6%. **We expect the outperformance of US equities to reverse as capital shifts towards cheaper markets offering higher prospective returns, and the Funds are positioned to take advantage of this.**

Are we approaching the bottom of the Value cycle?

Value managers believe investors get too pessimistic about the prospects for certain businesses, leading their shares to trade below their real value. **Historically this style of investing has been extremely successful, but periodically it goes through cycles of underperformance and we are currently in one of those periods.**

On average these periods of underperformance last for 20 months, and it is now 20 months since Value started to underperform, which is one reason we are optimistic we may be close to the bottom of the cycle. The other is the widening gap between cheap and expensive stocks, with cheap stocks trading at a 90% discount to expensive ones. **Historically Value has always recovered following periods when it has been out of fashion and we see no reason why this time should be any different.**

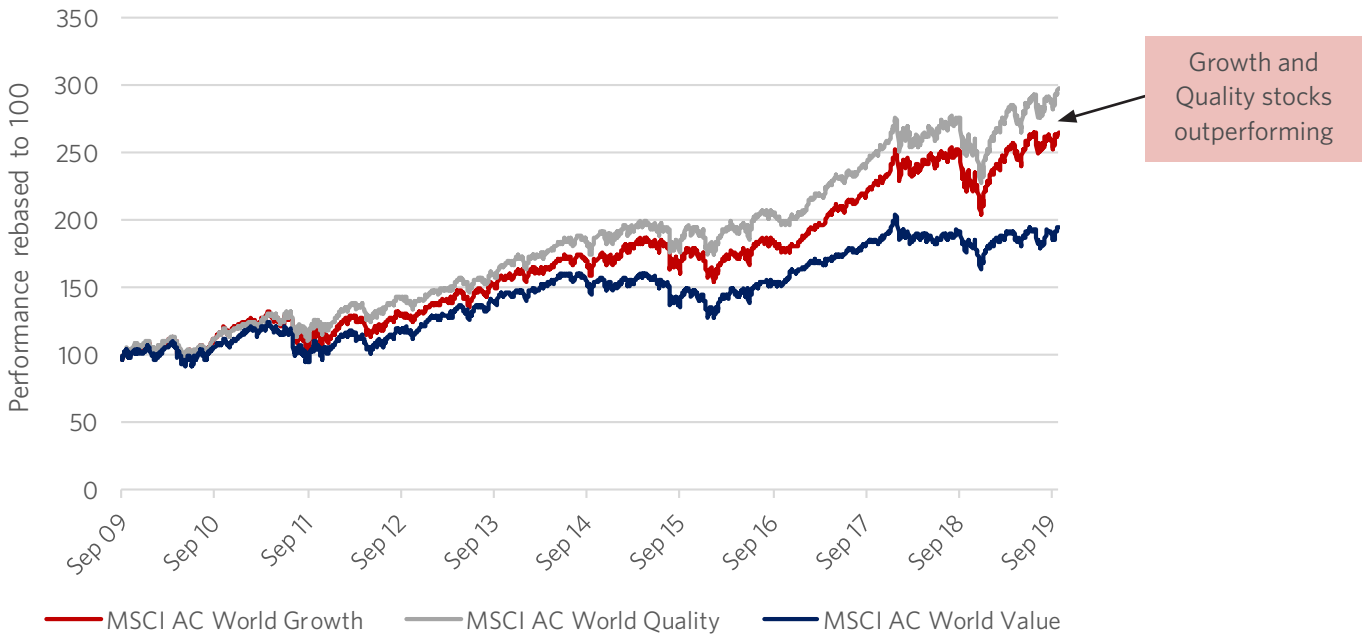
Contrarius, our global deep Value manager, fell 42% peak to trough between July 2018 and August 2019, and are still some 30% behind as at the time of writing. **Contrarius believe companies in the portfolio are trading at extreme discounts to fair value.** Retailers like Bed Bath & Beyond and Dillard's are trading below fire-sale book value in Contrarius' view, despite continuing to generate profit and service their debt.

While investors often make decisions based on rules of thumb such as *'avoid all retail stocks'*, **Contrarius undertake extensive research before making any investment, and this discipline underlies their excellent longer term track record, which has rewarded patient investors.**

The importance of style blending

While Value has been heavily out of favour over the past three years the Fintax Funds have nonetheless produced positive returns by investing in a balance of styles. Sands and Morgan Stanley are the two leading managers in the Funds, having returned 12.9% and 12.7% per annum over the past three years. Both invest in businesses that grow sustainably; are self-financing as a result of their positive cash flow; have robust balance sheets and disciplined, shareholder-friendly management. And this has been the place to be when investing in global stockmarkets over the past decade:

Growth and Quality stocks have materially outperformed Value since 2009:



We access growth through managers like Sands and Morgan Stanley, and they are complemented by our Value managers, who look for things that are out of favour.

The key for us in constructing the portfolios is genuine diversification, avoiding the dangers of outsize exposure to any particular outcome, **hence approximately 40% of each Funds' equity content is invested in strong global brands that have stood the test of time and should be defensive in the event that consumer spending is squeezed; 40% is invested in stocks with much lower valuations, including beaten-up businesses offering great upside potential; and the remaining 20% is in fast growing companies.**

Where next?

We added a new manager to both Funds at the end of the quarter, Merian Chrysalis, who invest in fast growing private businesses that are heading towards a stock market listing. **With more and more companies electing to stay private for longer, we need to ensure we are alert to opportunities outside of the public markets.**

The key driver behind markets in coming months will be the state of the global economy. **It is not a foregone conclusion that conditions will get worse from here and in our view the prevailing recessionary fears are probably overdone,** hence we retain our substantial holdings in equities.

We also seek assets which we expect to be defensive in periods of equity market weakens, such as property, infrastructure, precious metals and short duration bonds. Gold has proven its value as a hedge during times of market stress and prices have risen in lock-step with rising trade tensions so far in 2019. **Both Funds have built a meaningful allocation to the precious metal which should provide protection.**

The combination of equity investments with defensive assets should enable the Funds to participate in the continuing growth of the global economy, while providing a defensive buffer in periods of shorter term market setbacks.

Source: Bloomberg / Morningstar. Returns in US dollars unless otherwise stated, September 2019
Past performance is not indicative of future returns.

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