Fairtree Flexible Income Plus Prescient Fund
Quarterly Update Q2 2023

Market Dynamics

Global Risk

The global bull market that started at the end of the 3rd quarter 2022 continued through the 2nd quarter of 2023 with most risk indices printing positive returns during the period. With the exception of the FTSE 100, the majors showed a plethora of good returns with the NASDAQ taking the lead (again) amongst a domination by North American indices over their European counterparts. The NASDAQ was indeed the star of the show, delivering just over 13% to investors in USD whilst the broad based S&P 500 also shone with a quite respectable 8.74%. What is quite interesting is that the Europeans produced "average" returns in their respective rankings over the past 16 years. Average in that the rank of the Dax was 32 out of 65 quarters, and still produced a positive 3.32%. When coupling this with annualised total returns, one sees the distribution negative skewness at play in that the median quarterly return is way higher than the average return.

Table 1 shows the performance of the major international equity indices as well as the European credit benchmark that we use as a yardstick for the fund performance. It is also interesting to note that the 2 x levered iTraxx Crossover Total Return Index, an index that produces similar levels of volatility as the European equity indices, produced outsized returns over the quarter on a like-for-like basis. The more vanilla iTraxx unlevered, a significantly lower volatility than equities also showed investors 3.40% over the quarter, a performance which has been buoyed by a rallying spread index, lower than expected default intensity as well as an ever increasing base level of rates which, coupled together, has produced a favourable backdrop for the asset class.

Table 1: Major Index Q2 2023 Total Return and historic rankings Q2 2007 – Q1 2023

	Dow Jones	S&P 500	Nasdaq	Dax	FTSE	CAC40	SX5E	TOP40TR	iTraxx	iTraxx *2
Total Return	3,97%	8,74%	13,05%	3,32%	-0,42%	3,54%	4,25%	0,95%	3,40%	6,02%
Rank (65)	31	15	8	32	45	30	29	38	22	24

(Bloomberg 31.06.23)

When looking at the longer series of returns, we can quickly ascertain which indices has delivered the best risk adjusted return. Our dataset from the beginning of Q2 2007 to the end of Q2 2023 is shown in Table 2. What becomes apparent, again, is the domination of North American equities on a risk adjusted basis. When one divides the

total return by the standard deviation of those returns, a good proxy for risk, we generate comparable return coefficients. The highest risk adjusted return over that period is 0.62 which is generated by the NASDAQ. This number suggest that for every 1% of risk, 0.62% of return is generated. This should not be confused with a Sharpe Ratio, which considers excess return to a risk free cash benchmark, but still gives some insight into where good risk adjusted returns were generated over the past 16 years. We have always suggested that investing is for the long term and with our dataset now at over 16 years, we could argue that the longer run is more represented as the dataset is elongated. Of course what we will not contend is the outlook for the indices over the next 16 years as we only have 1 sampled point of the entire distribution in that regard. It has always remained a mystery as to how fund managers and analysts alike can make longer term predictions, using such curtailed information. Predicting any investment outcome requires representative sampling, how this can be achieved with such short historic datasets remains nothing short of baffling. Analysts and managers alike might be construed as being overly confident in their abilities to forecast future outcomes and perhaps fooled by the law of small numbers.

Table 2: Index Risk Adjusted Return Co-efficient

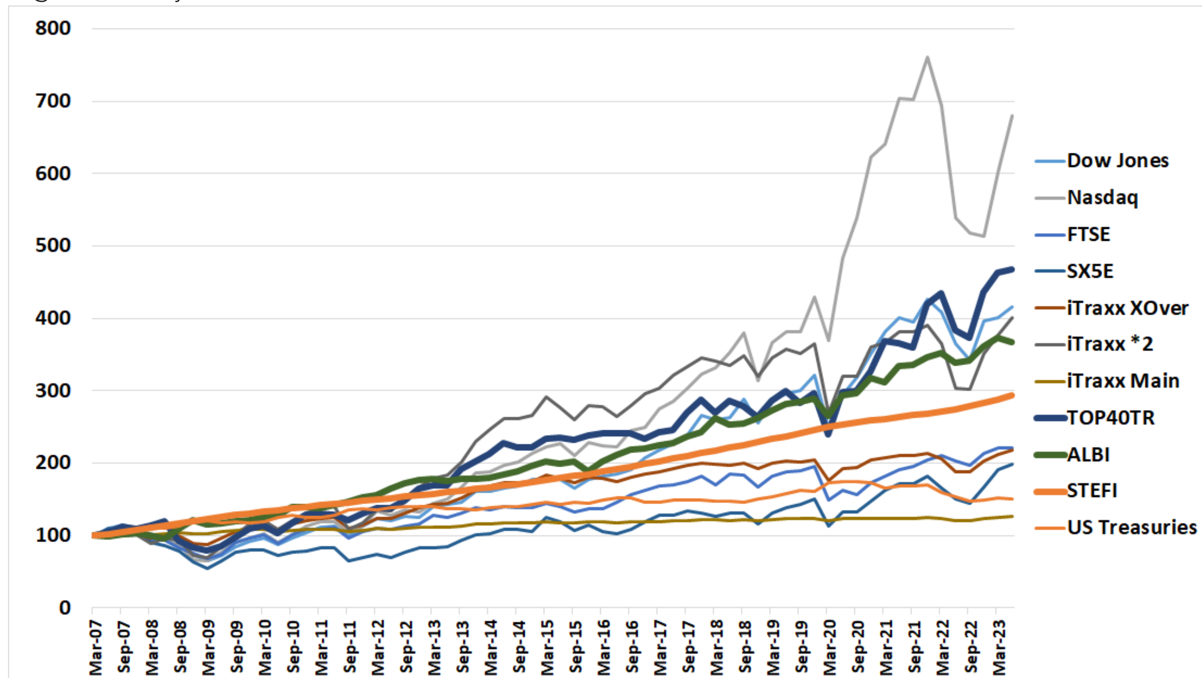
	Dow Jones	S&P 500	Nasdaq	Dax	FTSE	CAC40	SX5E	iTraxx	iTraxx *2
Annualised Return	9,17%	9,45%	12,52%	5,36%	4,99%	5,29%	4,31%	4,92%	8,91%
Annualised Risk	16,56%	17,51%	20,23%	21,18%	14,93%	19,57%	19,78%	9,57%	19,43%
Return coefficient	0,55	0,54	0,62	0,25	0,33	0,27	0,22	0,51	0,46

(Source: Bloomberg 30.06.23)

When looking at the risk and returns in a common basis (currency), one can finally perform a better inspection of the indices. The choice of basis is elementary and has no effects on the comparative outcome of any conclusions that one might arrive at, as long as all indices are converted to that same basis.

Figure 1, below, shows the cumulative return of the various indices in the currency of the particular index domicile. The various performance traces have been indexed to 100 at the beginning of the second quarter 2007, when we have the starting historic data for the iTraxx XOver total returns. As was highlighted last quarter, the outright domination of North American Equity indices has been tempered over the past 18 months, although the resurgence of the Nasdaq has been witnessed of late, primarily due to its great start to 2023 where it has delivered some 32.3% in USD.

Figure 1: Major Index Total Return Q2 2007 – Q2 2023

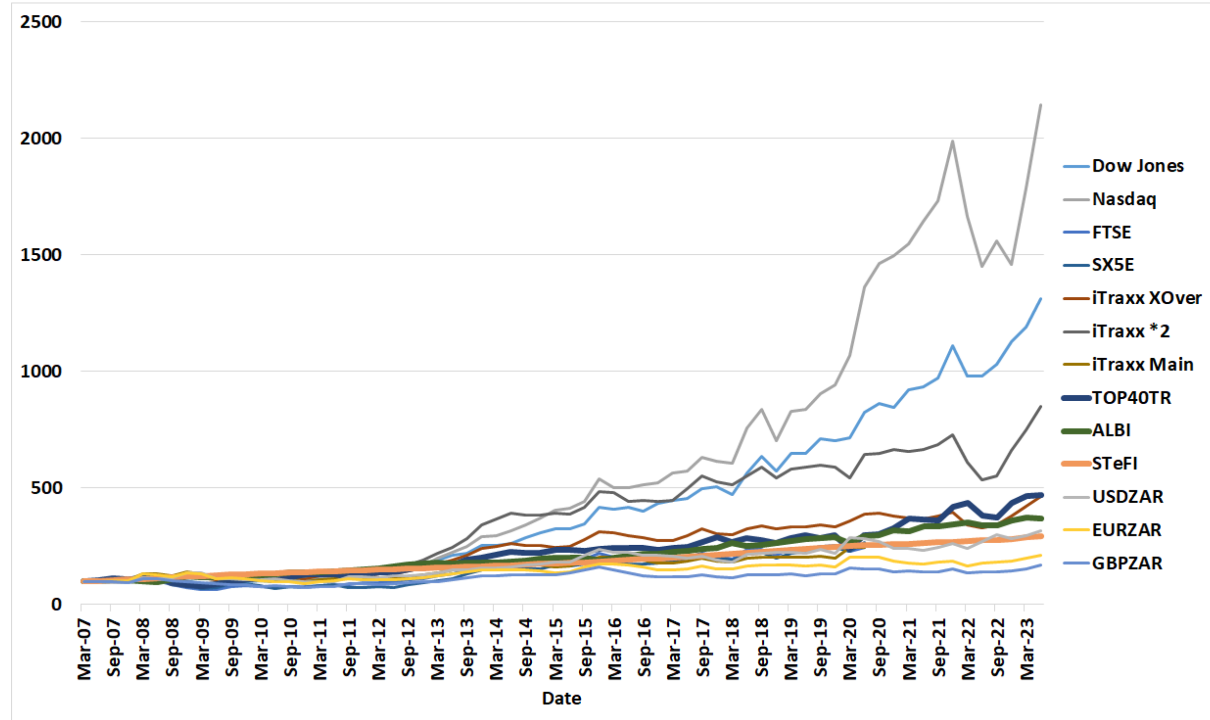


(Source: Bloomberg 30.06.23)

Of course the above figure shows returns in local currency which neglects any currency affect. As was previously stated, translating the indices to a common currency – a common basis – allows for direct comparison and shows what investors would have realised, albeit on an unhedged basis. A fuller picture of what has been delivered is now witnessed as all indices are comparable to 100 units of Rand being invested in the different indices then translated back to Rand at the end of each quarter. Obviously these returns have no fees associated with them and that investors may not have realised such giddy numbers. But the bottom line is that the NASDAQ has delivered returns in excess of 20x your original investment back in 2007, which underpins again that investing is indeed for the longer term, and trading in and out of stocks forgoes the possibility of generating these sorts of returns. It is also interesting to note that those returns have been generated amidst the backdrop of the Global Final Crisis, the Greek Crisis, the COVID 19 pandemic as well as the onset of the first major European conflict since World War 2. The other interesting fact to point out is that iTraxx XOver levered has delivered returns in Rand that have dwarfed the performance of South African equities – as proxied by the Top 40 Total Return Index.

Figure 2 shows the indices as well as the translation effects of GBPZAR, USDZAR and EURZAR.

Figure 2: Major Index Total Return in ZAR Q2 2007 – Q2 2023



(Bloomberg 30.06.23)

Table 3 converts the traces shown in Figure 2 to numbers that can be more easily compared in tabular form. The other more obvious point to make is that iTraxx Main, an index compromised of 125 equally weighted global investment grade names, remains a non-viable investment alternative to most South African investors. The Rand returns do not even match STeFI and thanks to FX translation, have high volatility. It remains inherently obvious that South African Banks themselves are more risky than the names that collectively make up the iTraxx Main index and therefore should generate excess returns due to that very fact. Obviously if we had chosen the EUR to be the basis of comparison, STeFI would have shown similar volatility thanks to FX translation effects. The other noteworthy point is the comparison between iTraxx XOver and the TOP40 Total Return Index. The returns are essentially the same, but the volatility of the XOver is substantially lower than that generated by the South African equity market.

Table 3: Index Total Returns and Risk in ZAR Q2 2007–Q2 2023

	Dow Jones	S&P 500	Nasdaq	Dax	FTSE	CAC40	SX5E	iTraxx XOver	iTraxx *2	iTraxx Main	TOP40TR	ALBI	STeFI
CAGR	17,16%	17,47%	20,76%	10,35%	8,38%	10,28%	9,26%	9,90%	14,07%	6,27%	9,96%	8,35%	6,84%
STDEV	15,49%	16,07%	18,97%	21,17%	15,63%	20,13%	20,60%	13,35%	19,31%	13,98%	17,56%	8,01%	0,92%

(Source: Bloomberg 30.06.23)

We as supporters of the asset class and proponents of the thesis that well diversified credit portfolios should provide the cornerstone to any balanced fund, find it interesting that although South African investors tend to avoid credit, they seem to do so in spite of the diversification and return benefits of the said asset class. For those that want to reduce the inherent risk of the FX translated series, an alternative would be to forward hedge the returns. We have proxied such a strategy by looking at hedging the quarterly capital amounts using FX forwards, which are priced off interest rate parity. We neglect trading costs and the realised risk and return characteristics of the series are shown in Table 4. Take note that hedging FX reduces risk and has generated excess returns to the unhedged series over time. This would in turn argue that there are excess returns to the associated spreads in emerging markets. A conclusion that provides to solace to the South African Reserve Bank. Risk premia associated with local interest rates have kept excess depreciation in check over the long run. It is important to note that this in itself is a distribution of outcomes and although the Rand has come under severe pressure of late, the longer run is a much more stable series – albeit against a weak Euro.

Table 4: iTraxx XOver Total Return in EUR, ZAR and ZAR(Hedged) Q2 2007–Q2 2023

	XOver Eur	XOver ZAR	XOver Hedged
Risk	10,05%	13,35%	9,99%
Return	4,92%	9,90%	11,26%

(Source: Bloomberg 30.06.23)

Local Interest Rates

The Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) met once during the second quarter of 2023 and raised the short term Repo rate by a further 50 bps to 8.25%. We highlighted in the last quarterly report that the heretofore diffusion administered rates opened up the possibility of another 50 bps increase in this hiking cycle, we felt that rates would have had to be nearer the top of the cycle. There is no doubt that this has come to pass and that current rates, although may still need to be raised by a further 25-50 bps are close to the terminal rate ceteris Paribas. The "ceteris Paribas" part is that should the Fed see the need to raise by more than 50 bps to reach their terminal rate, we feel that the Reserve Bank will have to raise rates in excess of the 50 bps that we have pencilled in.

The global "bogeyman" remains the inflation prognosis, and as long as inflation remains at elevated levels, Central Banks will be forced to tune their reaction functions to the stickiness of that said inflation. Rates might need to remain higher for longer than what the market is pricing in. Cycles should be slow moving at the extremes, unless they are driven by supply side shocks. The conundrum is that Russia's "Special Operation" in the Ukraine has developed a supply side shock, but the general underlying problem was

initially fuelled by excess liquidity and exceptionally cheap money provided by those same Central Banks in response to the Global Pandemic in 2019.

Figure 3 shows the annual change in the South African headline Consumer Price Index (CPI) which is commonly known as headline inflation, as well as the South African Reserve Bank Repurchase Rate (Repo). In looking at the figure, two things become apparent, the first is that inflation may have rolled over already, as the trace certainly has decreased of late, and the second obvious one is that the cutting cycle of 2020 was excessive. The cost of finance was excessively cheap, which has to result in a period of borrowings being excessively expensive. The system must equalise itself again and to do so requires rates to be either hiked more aggressively or the current rate to remain higher for longer than that is anticipated in the market.

Figure 3: 1 year percentage changes in CPI and Repo

(Source: Bloomberg 30.06.23)

One must sometimes be reminded that the mandate given to the South African Reserve Bank regarding inflation is to maintain CPI in a 3-6% target band to maintain price stability that should in turn bolster local growth. Steady and predictable inflation should empower companies to embark on new projects as the risk associated with volatile future input prices has effectively been taken out of their business equations. Companies should effectively feel more comfortable with longer payback periods as the riskiness of future cash flows has been managed, albeit from an arms-length basis. Reduced risk should result in lower risk premiums which should turn marginal projects into profit bearing ones.

Since inflation targeting was adopted in February 2000 or 280 months ago. Headline inflation has been in the target band for 163 of those months or 58% of the time. It has been lower than 3% in 19 occasions or 7% of the time and has been higher than 6% 98 times or 35% of the total observations. Average CPI inflation since February 2000 has been 5.6%, which goes a long way to explain why the observations are skewed to the topside.

Has the Reserve Bank been successful in its endeavours? Has it fulfilled its mandate? Is that mandate representative of what is achievable, or is equilibrium South African inflation higher than that what is indicated as the centre of the band? I will let the reader draw his/her/its own conclusions.

Moving back to the more mainstream fixed income indicators, South African Government Bonds sold off marginally over the 2nd quarter with all the benchmark tenor bonds increasing in yield. Table 5 shows the yield movements in basis points across the benchmark bonds. Points of interest are that the movements in the 2nd quarter were almost exactly 70 bps across the tenors, except the short dated 3-month JIBAR move which increased almost in lock step with the Repo rate over the quarter.

Table 5 SAGB Yield Movements (bps)

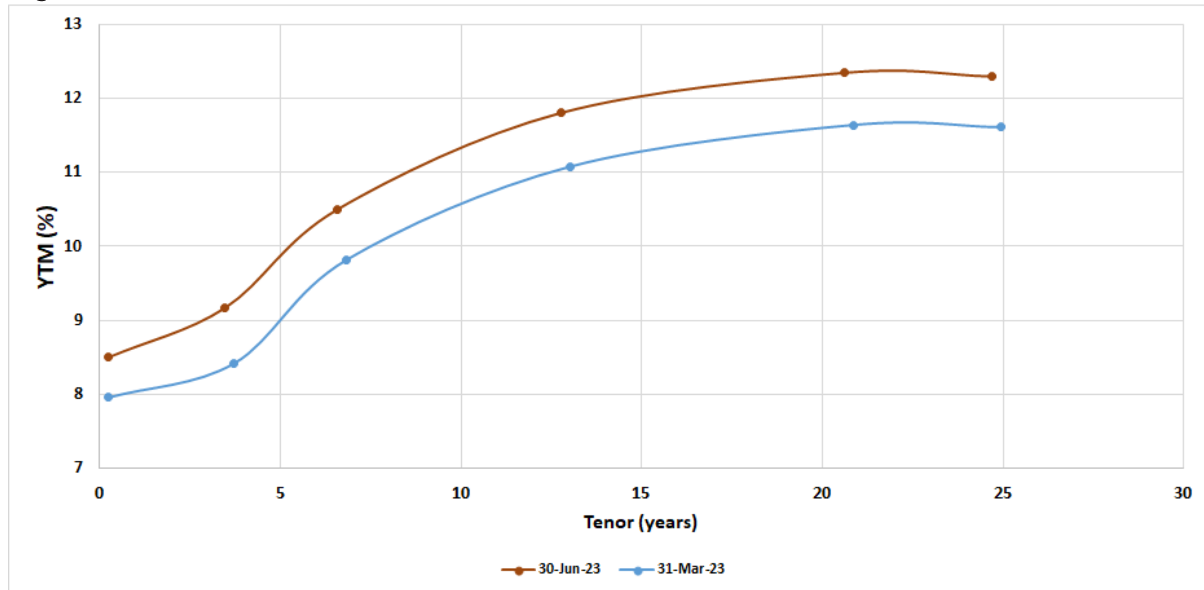
	3 m JIBAR	R186	R2030	R209	R2044	R2048
Year-on-year	349	30	-4	47	75	74
Q2 2023	54	75	68	73	71	69

(Bloomberg 30.06.23)

The other more fascinating point are the bond yield movements on a year-on-year basis which show a very strange movement in the yield curve. The R2030's actually rallied a few basis points over that period, whilst the ultras have sold off thanks to excessive supply pressures. Obviously the fiscal side remains a bone of contention at the moment with ever increasing supply pressures, coupled with the non-delivery of state projects, heightening fears of even higher levels of supply going forward. Given the rational actions of a highly indebted organisation, the major issuance becomes heavily weighted in the longer tenors. The "can is kicked far down the road". Unfortunately this behaviour generally ends quite badly for the said borrower, and affects the lender alike, who generally feels aggrieved when he finally realises that his capital has suffered irreparable damage. The first thing to look out for in this regard is fiscal slippage, where budgets are treated as mere suggestions, which leads to further issuance and then the spiral of ever increasing borrowings. The so called "debt trap" swiftly follows, where a country has to issue more debt just to pay off interest, this does pose a threat to the longer term prognosis for South African bonds, and it remains fascinating that the local bulls seem oblivious to the potential of this becoming reality. Perhaps Governments are "risk free" in that they have a funder of last resort in the local fixed income fund managers, who even up to the point of default will still scream "value". The solace that

we have is that someone has to fund the deficits and markets will always find investors at every price point.

Figure 7: SAGB Yield Curves



(Bloomberg 30.06.23)

Figure 7 shows graphically the movements of the yield curve over the second quarter. Take note of the almost perfectly parallel move. So managers who were short duration relative to their benchmark would have generated very similar capital returns irrespective of how they put their portfolios together. Lack of delivered volatility and steady state humpedness would still have had bullets outperforming barbells portfolios, but that is probably one for the bond bulls to describe what makes that up and perhaps would provide a loaded question to those that would ascertain that convex portfolios should always be sought after. I would contend that too few fixed income managers can differentiate the bond pricing formula once let alone twice.

Fund Performance

The strategy of the fund is to provide slow and steady excess income accrual to investors at low realised volatility producing definitely positive Sharpe Ratios. Table 6 shows the cumulative performance of the Fairtree Flexible Income Plus Prescient Fund (“the Fund) relative to STeFI, ALBI and the equity market as proxied by the Large Cap Top40 Total Return Index. Fairtree Flexible Income Plus Prescient Fund was launched on 3 June 2013 so we have included that date as “Ground Zero”. A few things become quite apparent, and even a touch startling, when analysing the table.

1 – The fund has outperformed STeFI over ALL measurement periods

2 – The fund has outperformed STeFI by around 4.20% over the past 12 months

3 – The fund has delivered around 43% of excess return to STeFI over the past 10 years

4 – Excluding the month of June 2023, the fund has outperformed the South African All Bond Index over ALL measurement periods.

5 - Fund returns are increasing in a linear fashion with low realised volatility

6 – The fund has outperformed equities over some longer dated periods

The managers feel that the mandate has been delivered to investors and the consistent performance of the fund in absolute and relative to the peer group warrants mentioning. The fund is not a fund that requires any sort of "timing" and requires no "hard selling" as the numbers sell themselves. The managers feel that, in spite of the various market commentators out there, the asset class has indeed delivered consistent and capital preservation for the investor base. It is obvious that the market timers will try to increase levels of efficiency within their portfolios, I might add that without the ability to short, the investors' instruments available to deliver any alpha are somewhat curtailed to the extent that it is probably a fruitless exercise. Markets do require managers to believe that they can add value though, and that mostly misguided belief, in our opinion, is what inherently drives alpha to the more patient investor. There is no fast fix to investing, this is no "instantaneous gratification" irrespective of what the shoeshine boy tells you. Investing is a process, it's a discipline, it can be quite tedious, but it is the grind of consistency that delivers returns. This is the main effort of our investment strategy, the marrying of patient capital with the grinding of credit asset performance. Of course, the actual process is a highly complex mathematical algorithm, but the description thereof can be summed up quite concisely. Table 7 is what inherently comes out the other side.

Table 7: Fairtree Flexible Income Plus Prescient Fund historic returns to end Q2 2023

30-Jun-23				
	Fairtree Flexible IPF	**STEFI**	**ALBI**	**TOP40TR**
Jun-23	1,33%	0,65%	4,58%	1,05%
QoQ	3,30%	1,94%	-0,87%	0,11%
YTD	5,72%	3,72%	1,84%	7,23%
6 months	5,72%	3,72%	1,84%	7,23%
1 year	10,92%	6,76%	8,23%	22,18%
2 years	15,21%	11,23%	9,59%	27,83%
3 years	25,49%	15,68%	24,57%	57,20%
4 years	32,69%	23,67%	28,18%	56,34%
5 years	46,05%	32,68%	42,89%	63,48%
6 years	61,48%	42,41%	57,41%	90,86%
7 years	74,71%	53,28%	69,89%	93,84%
8 years	99,22%	63,78%	78,79%	98,93%
9 years	109,36%	74,07%	93,47%	105,69%
10 years	127,15%	83,57%	104,07%	177,99%
03-Jun-13	128,94%	84,20%	99,56%	166,65%

(Source Prescient, Bloomberg 23.06.23)
All figures are net of fees.

Annualised Returns

Date	Fund
1 year	10.92%
2 years	7.33%
3 years	7.86%
4 years	7.33%
5 years	7.87%
6 years	8.31%
7 years	8.39%
8 years	9.08%
9 years	8.83%
10 years	8.80%
Highest Rolling 1 Year	14.03%
Lowest Rolling 1 Year	3.39%

All figures are net of fees.
Source, Internal, Prescient as of 30 June 2023

Table 8 shows the top 10 performers in the fund over the quarter in local currency. We look at the performances in local currency to take out the largest driver of the volatility of the underlying instruments, the FX risk. It should also be noted that currency risk is hedged at the portfolio level rather than the individual instrument level. There are a couple of interesting points to note regarding the composition of Table 8. The most glaringly obvious one is that all of the Top 10 performers, excluding the investment referencing the CDX High Yield Index and the ultra-short dated Eskom Credit Linked

Note (CLN), all reference the iTraxx XOver index. In other words the best performing credit assets for Q2 2023 were predominantly exposed to European sub investment grade credit. The next obvious thing to highlight is that the composition has changed compared with last quarter's components which included the longer dated Eskom assets. The risky Eskom exposure ranks 10th, and that position matures in August so is very short dated. That actual instrument pay a coupon of JIBAR + 9.80% so although we were aware of Eskom being a risky investment, we felt that the coupon outweighed the inherent risk of the investment and would deliver a good risk adjusted return. With around a month to maturity we feel quietly confident that the original thesis will be realised.

The final point to make is that the best performing asset, the JPM002, matures on 3 July meaning that the outsized performance of that instrument has been banked already.

Table 8: Top 10 performers in the Fairtree Flexible Income Plus Prescient Fund Q2

Name	Description	Total Return
JPM002	iTraxx XOver S29	17,16%
XS2315154968	iTraxx XOver S38	10,49%
FRC416	iTraxx XOver S37	6,86%
XS2613506968	iTraxx XOver S39	6,63%
XS2440849078	iTraxx XOver S36	6,21%
BNPP06	iTraxx XOver S32	6,06%
XS2582195389	iTraxx XOver S38 Tranche 10-20%	5,39%
XS2082795563	CDX HY	5,12%
XS1941755230	iTraxx XOver Total Return Index	5,00%
CLN857	Eskom	4,29%

(Source: Prescient, internal 30.06.23)

As per last quarter's commentary, where we predicted 2.75% return for the second quarter of 2023, with 3.30% the Fairtree Flexible Income Plus Prescient Fund comfortably exceeded this number and has produced some 5.72% during the first half of the year. This lines up rather neatly with the forecast of 10.50% – 11.25% for the calendar year and the fund looks to deliver those sorts of numbers. Obviously another Global Financial Crisis will derail that prediction, but given that the fund currently spreads around 3.75% and that 1 year swaps are at 8.60%, we would expect the next quarter to produce somewhere between 2.60% – 3.25%, excluding any excessive capital movements. We feel that these sorts of returns, coupled with a persistent supply of Government debt crowding out local credit issuance, should keep investors' attention focussed on the fiscal side of things. The mutterings of National Health Insurance (NHI) does pose a particular problem for the bond bulls, but I suppose they will find a way to argue themselves out of that corner as well. They have done well at diverting attention away from the hard numbers – "That's in the past man, let's concentrate on the next period rather"

So the diffusion of global inflation and the associated monetary response should keep us all focussed during the third quarter, we believe the future is inherently unpredictable but investors can find solace in knowing that we will do what we say – one's integrity is one's most valuable asset.

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Highest rolling one-year return 14.03% and lowest rolling one-year return 3.39% (information to 30 June 2023). The fund has returned an annualised return of 8.81% since inception (Benchmark: 9.27%). The fund's annualised performance over 1-year is 10.92% (Benchmark: 9.76%). The fund's annualised performance over 3-year is 7.86%% (Benchmark: 8.06%).

Fund returns disclosed are annualised returns net of investment management fees and performance fees. Annualised return is weighted average compound growth rate over the period measured. The information in this three-pager is provided as a general summary only. Past performance is not necessarily a guide for future performance. Fund investment risk indicator level: conservative. Full performance calculations are available from the manager on request.

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