platinumportfolios

thoughtful investing for private clients

Quarterly Newsletter

4th Quarter 2019

Market and Economic Commentary

The economic map for 2020 is far from clear. The U.S. expansion entered its 11th year in 2019 making it the longest expansion since 1900. However, as the effects of fiscal stimulus from the tax cuts, which boosted growth in 2018, fades, growth has slowed to a more trend-like 2%. Overall, global growth is likely to remain constrained by geopolitical uncertainty.

The Question on investors' minds: Where are we in the cycle?

The view on asset allocation is often based on an assessment of where we are in the cycle. Early in the cycle, valuations are cheap, policy accommodative and the economy has ample spare capacity to grow. It's often a good time to take risk. Conversely, late cycle is usually a good time to take chips off the table. When the economy is displaying signs of exuberance or overheating, higher interest rates usually put an end to the party. It's proving much harder to navigate markets today based on an assessment of the cycle. Things are far from clear. Unemployment rates – often a key navigation tool – are near record lows in most parts of the developed world, suggesting the economy is very late cycle. However, there are very few other signs of classic late-cycle economic exuberance. Neither business nor consumer spending looks unsustainably high. Indeed, the US consumer is looking remarkably prudent: the savings rate, which often falls sharply late in the cycle, is high. And inflation is certainly not suggesting the global economy has reached its limits. In fact, central banks are preoccupied with the idea that inflation remains too low and may be getting stuck. Rather than trying to tame the expansion, the primary focus for central banks is how to stimulate it. This makes it very hard to say confidently how much time is left on the economic clock.

A resolution in the US-China trade conflict, a Brexit solution, and an easing of tensions in Hong Kong, Chile and Turkey could fuel a turnaround in business sentiment and a reacceleration in activity in 2020. Against a backdrop of muted inflation, interest rates could stay low. This would be a good environment for risk assets.

But it is more likely, in our view, that geopolitical risk will linger. We think the trade conflict is unlikely to be fully resolved. The US administration does seem to appreciate that it needs to get the balance right between keeping the agenda alive and not damaging the US expansion, hence the recent more conciliatory tones. We'll see in the coming months whether this more measured approach does much to boost corporate sentiment. If geopolitical tensions linger but don't re-escalate, we should be facing a slowing rather than a stalling economy.

After the sharp falls in equities during the fourth quarter of 2018, the first four months of 2019 brought a strong rebound, as central banks signaled that rather than raise interest rates they would provide yet more stimulus to try to keep the economic expansion intact. Then, from the end of April to the end of September, global equities broadly traded sideways with some bumps in the road, as investors digested the ebbs and flows in the trade negotiations between the US and China, and the continued deterioration in macroeconomic indicators.

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By the end of September, the 20+ year Treasury index was up 20%, while the MSCI World was up 18% USD. The flood of central bank liquidity had lifted all boats. Such strong returns for both traditional risk-off and risk-on assets, at the same time, is unusual.   However, the fourth quarter has decided the year in favor of the bulls. Global equities rose 9% in the last three months of the year, while developed market government bonds gave up some of their gains.

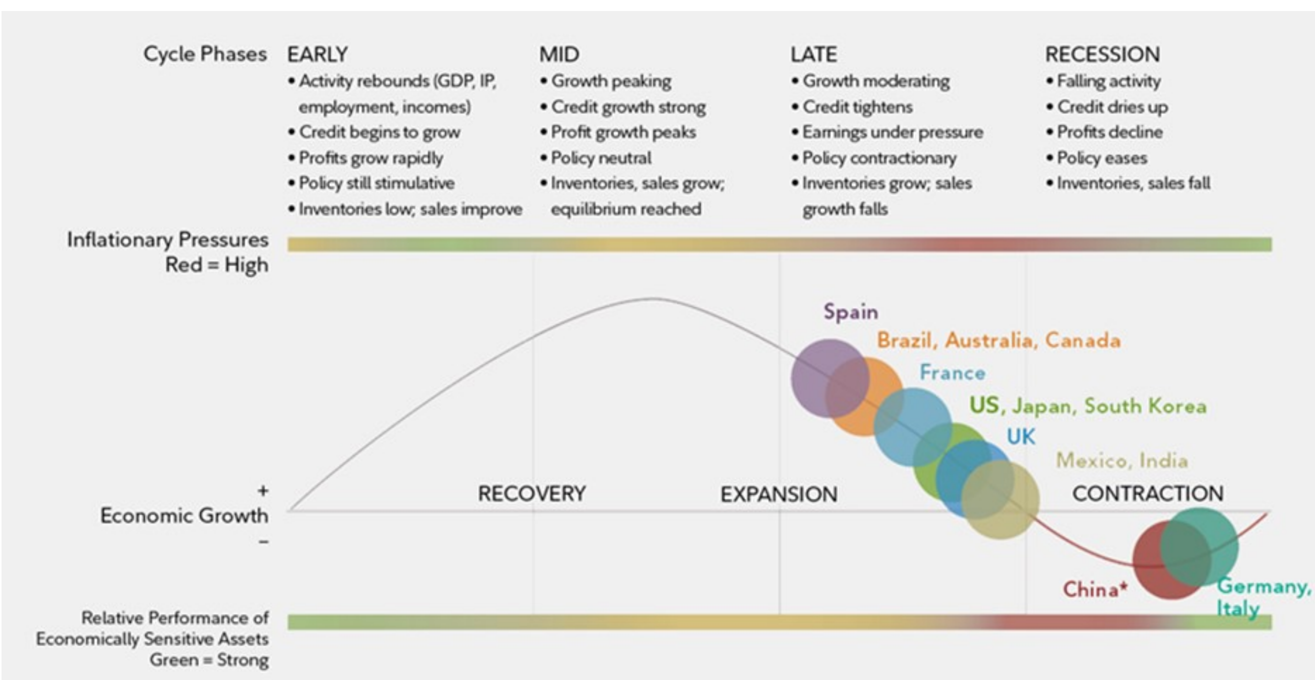
Several factors helped drive equities and bond yields higher in the final quarter. First, the US and eurozone manufacturing business surveys picked up slightly from September, although they remain weak. Second, the service sector business surveys in the US and Europe also picked up. Most importantly, despite headlines involving large job cuts at some companies in Europe, overall employment has held up well, and in the US over 200,000 jobs were added in November. The pick-up in the service sectors, and the resilience of overall employment to the weakness in manufacturing, has helped restore market confidence that a recession is not imminent.

The fourth quarter also saw two significant political risks avoided, at least for now. US tariffs on China were scheduled to increase on 15 December but a phase one trade deal avoided that outcome and provided a significant relief for equity markets. The fact that the US also didn't impose tariffs on European Union auto exports also helped support equities. How long the trade peace will last is anyone's guess, but the market ended the quarter cheered by the fact the worst-case scenario for trade had, at least for now, been avoided.

The large majority for the Conservative Party in the UK election in December removed the threat of nationalisation for some utility companies. The utility sector in the UK rallied 6% following the election result. In addition, the election meant that the UK could pass a European Union withdrawal bill, activating a transition period during which little will change, until the end of 2020. The combination of these election implications helped lift UK stocks and sterling over the quarter. However, sterling's initial rally after the election result soon faded when it was announced that it would be made law that there would be no extension to the transition period beyond the end of 2020, giving the UK government a very short period of time to agree a free trade deal that avoids a hard Brexit.

In our view and with continued uncertainly, a well-diversified equity portfolio focused on large cap, quality stocks is likely to continue to prove more resilient should the downside risks materialise.

Illustration of the business cycle.



Source: Fidelity Investments (Asset Allocation Research Team), as of Nov. 30, 2019.

BETTER BUSINESS, ON BEHALF OF BEETHOVEN

"For the last three years my hearing has grown steadily weaker . . . in the theatre I have to get very close to the orchestra to understand the performers, and . . . from a distance I do not hear the high notes of the instruments and the singers' voices."

These are the words of Ludwig van Beethoven in 1801. At the young age of 30 Beethoven's hearing was deteriorating and was going deaf. At this stage in his musical career, as both pianist and composer, Beethoven had already become a recognised sensation in the field of music. He continued to compose despite the ringing and continuous buzzing in his ears and by 1800 he had lost – almost completely – his ability to hear. As the years progressed so did the decline of his hearing. It became clear to him and those around him that there was no hope of remission. Nevertheless, resultant of what was a tremendous loss to the musician at the time, Beethoven's tragedy propelled the world of music to new developments and heights. It is in this that we hold a valuable lesson more than two centuries later.

While he was completely deaf, Beethoven achieved his greatest musical triumphs. To name a few: he wrote his best string quartets which contained a record number of high notes in his magisterial *'Missa Solemnis.'* Furthermore, it was during this time that he achieved what many see as his greatest triumph of all: the Ninth Symphony, which he insisted on conducting at its premier. It was this piece of music that became internationally regarded as the greatest orchestral piece of all time. It seems a mystery that Beethoven became more original and brilliant as a composer despite the adversity of his deafness.

It is here where I pose my point – maybe it is not so surprising but rather that this hardship opened a new world of perspective and experience to the great composer. This is because as his hearing deteriorated, he was less influenced by the prevailing compositional fashions of the time and more by the musical structures forming inside his own head. His early work is pleasantly reminiscent of his early instructor, the hugely popular Josef Haydn. Beethoven's later work became so original that he was, and remains to be regarded as the father of music's romantic period. This was put aptly by the French romantic master, Hector Berlioz who stated: *"He opened up a new world in music…"* and additionally added that *"Beethoven is not human."*

Therefore, it was his deafness that freed Beethoven as a composer because he no longer had society's soundtrack in his ears. Perhaps therein lies a lesson for us as fund managers at Platinum Portfolios.

Notwithstanding recent volatility, 2019 has been an undeniably strong year for Platinum Portfolios. This is evidenced by the fact that 2019 was one of our top performing years since we started out 20 years ago. In the face of adversity, the fund managers at Platinum Portfolios stayed "deaf" to the noise, paranoia and hysteria of others and focussed their energy on their own trusted purpose. The deaf investor stayed head strong on holding a well-diversified portfolio of great companies and following a disciplined strategy for decision making. This proved to serve both the company and our clients well.

So, as the end of this year looms, the deaf investor is not caught up in the current optimism and positivity that may lead some to be too aggressive and take on more risk. Nor are we brought down by negativity and unpredictable markets. Rather, we follow Beethoven faith in his own mind as we calmly do what we do best by continuing to follow our innovative and unique philosophies. These processes will guide as we rebalance our portfolios back to the correct asset allocation and strive to make the best long term decisions for our client's portfolios.

Finally, if there is anything we should all take away from the 2019 business year, is that when it comes to investing, being deaf to the noise proves fruitful in making decisions. It is with this attitude that we ready ourselves for anything that 2020 brings.

Report back on our funds

Happy New year and Happy Birthday to Platinum Portfolios as we celebrate our 20th Anniversary this year.

The past decade has not been the easiest for local investors, mostly due to the weaker than normal performance from JSE-listed stocks. From the start of 2010 to the end of 2019 the FTSE/JSE All Share Index delivered an annualised return of 10.78%. This is meaningfully lower than its long-term average of 13.7% per annum.

Looking back over the last decade, in 2009 we wore analogue watches, spent time in bookstores, rented DVD's, and had to hail or call for a taxi, to mention a few memories. We have all seen the massive changes that took place over the last ten years. We are sure that the changes over the next decade will be even faster than before.

The local market was exceptionally trying and worsened over the latter part of the decade driven by state capture and an economic malaise that reflected itself in the stock market's performance. SA fundamentals were not nearly as stable as our global peers. The FTSE / JSE All share index returned 10.78% over the last ten years, and during this period we have managed to deliver good, consistent returns to our investors. The Platinum Income, Balanced and the Worldwide Flexible Funds returned 8.12%, 9.31%, and 13.50% respectively. The returns were also generated at a much lower risk adjusted basis than most of our peers. Inflation during this period was 5.1% per annum. All our funds have provided real returns to our clients over this period. In 2019 we had an exceptional year. All Platinum funds performed well providing clients with inflation beating returns. All the Platinum Funds performed in the top quartile over three and five years, and the Worldwide flexible fund and the Balanced fund are in the top quartile over ten years.

Over the last 12 months to end December, the FTSE/JSE All Share returned 12.05% with the best performing asset classes being Resources (28.74%) and Bonds (10.32%). Returns for Property (1.93%) and Financials (0.63%) were positive. Industrials had a negative return over the period (-8.91%). The main contributors within the FTSE/JSE All Share were Naspers (2.89%), BHP Group (1.96%), Anglo American (1.64%) and Richemont (1.36%). The biggest detractors to equity returns were Sasol (-0.92%), Shoprite (-0.44%), Multichoice (-0.28%) and SAPPI (-0.28%).

The one institution that remained a pillar of strength locally was the South Africa Reserve bank. The strict monetary policy supported, a stronger rand, and we feel that the rand could be stronger for longer as our inflation rate remained lower than expected. The rand strengthened against the US dollar by 3%. The late rally in the Rand did take the shine of the performance of all our funds during the last two months of 2019. Instead of trying to predict where the Rand was going, we focused on ensuring our asset allocation reflected our overall view. In all our funds our asset allocation was weighted towards global stocks and remained overweight to SA enhanced yield. Our exposure to SA Inc. companies remained underweight.
Enhanced yield remains attractive to us from a risk adjusted return basis, SA assets are cheap, however our clients can still enjoy real returns without taking too much risk by having an exposure to enhanced yield.

The Platinum BCI Worldwide Flexible fund

The fund had a good year, ending up 16.6%. The leading contributors to the performance were: Apple, Microsoft and Starbucks. The global IT stocks were the top performing sector once again. Apple returned over 110% during the year. Apple's performance once again proved that great businesses continue to deliver and surprise investors. The Apple AirPods demand surprised the market, the company sold over 60 million this year and it is estimated to sell over 100 million in 2020. It's estimated that the Apple AirPods will generate over 15 Billion USD in sales this year, with a profit margin of over 50%. The AirPods sales coupled with a strong update from apple on the revenue generated from its apps has reduced the company's reliance on hardware sales even further. AbbVie recovered from its lows and ended the year with a positive return to investors. We reduced our exposure further to SA Inc. companies during the year. The current exposure to SA Inc. stocks is currently less than 3%. We bought Altria and Phillip Morris for yield which was prescient as both stocks rallied off their lows. During the quarter the asset allocation to equities increased to 69%, due to our purchases and the equities rally. Our allocation to cash was just over 30%. We are comfortable holding a 15% exposure to SA enhanced yield and we have the balance of the cash in Rands and USD. We like having cash on hand which provides us with liquidity should opportunities arise on the market.

The Platinum BCI Balanced Fund of funds and Income Provider FOF

Both funds have the similar underlying managers it's just the allocation to the various asset classes that is adjusted in terms of the underlying mandate of the fund.

The most important thing to us at Platinum Portfolios when selecting the underlying managers in our multi manager solutions is the experience, character and the quality of people managing the money. It's the first rule when we decide to approve a manager. Once managers have passed the first hurdle, we put them through our due diligence process and if we are satisfied, we will then allocate funds to them. We always plan to invest with them for the long term and so we take time with the selection process.

There are periods when all managers will underperform, but it's how they perform over time that's important to us. In 2019 all our managers performed exceptionally well. We are privileged to have a group of managers we have confidence in. Their reporting and feedback to us has been excellent during the year.

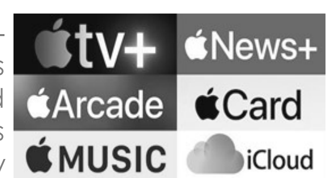
The Platinum Balanced fund returned 12.65% for the year and the Platinum Income Fund 10.01%. Both funds asset allocation remained the same for the year with a small increase in the equity allocation due to the market performance. During the year we made one change to our managers by switching the Allan Gray Equity fund into the Centaur Flexible fund.

The Platinum Global Managed Fund—USD

The fund ended the quarter up 6.20% and delivered a return for the year ending 31 December 2019 of +20.44% USD compared to its Morningstar sector average which was +18.67%. Apple, Microsoft, Starbucks and Visa were the top performing stocks for the year. We also had strong performance from Williams-Sonoma, BAT and Yum China Holdings. The only stock that did not deliver double digit returns for the year was AbbVie.

Apple has gone from being an undervalued, unloved stock to delivering the best performance in our fund this year. With trade war fears calmed and the Fed's easy monetary policy continuing, investors kept buying the stock. The main reason for this is because Apple has proved this year that it is far from being the one-trick pony that enabled it to prosper in the late 2000s, following the highly successful debut of the iPhone. The company's revenue composition changed noticeably in 2019. As smartphone sales struggled throughout the year in important markets like China, two of their business segments stepped up to the plate and picked up the slack: wearable and services.

Wearables: This business is flying! Apple Watch and AirPods helped propel the segment sales up by more than 40% last year. Apple hasn't said how many AirPods units have been sold, and it doesn't specify how much revenue it earns from AirPods alone. But analysts at Wedbush Securities predict Apple is on pace to sell between 85 and 90 million AirPods in 2020, an increase from the estimated 65 million AirPods expected to have been sold in 2019. All told, the latest research suggests that catching up to Apple in the wearables space will be more challenging than ever for rival gadget-makers like Samsung, Fitbit, and Google. Not only does Apple dominate the smartwatch market, but it doesn't seem like any other companies are even coming close to mirroring the success of AirPods.



Services: Apple's higher-margin services segment, is twice as profitable as the company's device business. The stock had a huge boost from a strong holiday for app sales on the IOS platform. App Store sales are a big part of Services. Apple documented some substantial App Store sales figures for the holidays: Christmas Eve to New years Eve - $1.42 billion, up 16%. News Years Day - $386 million, up 20%. Apple still has plenty of scope to grow in this segment with Apple TW+, Apple Arcade, and Apple Card just getting started.

The valuation now looks stretched although it is still trading on a lower multiple than most of the tech giants. We are monitoring this with a view to shaving off some of our holding to bring it down to a more neutral position.

AbbVie ended up being the worst performing stock in the portfolio, delivering a return of 5.4% for the year. It recovered well during the second half of the year and is up over 40% since its mid-August 2019 lows. AbbVie's latest earnings for Q3/2019 came in much better than expected, with a double beat as revenues rose almost 3% Y/Y and EPS surpassing expectations by $0.03. With investors having been obsessed about the announced $60 billion+ merger with Allergan and the 2023 patent expiry of Humira in the U.S., the positive earnings provided much-needed and surprising relief and helped lift the stock from the mid-$60s to a more reasonable yet still cheap mid to high $80s range. Even with this strong recovery the stock is still well below fair value. It has a dividend yield of 5.36% and a PE of just over 9 times. This is significantly below the averages for the S&P 500.

AbbVie is close to closing on its mid-June acquisition of Allergan. It has recently received conditional approval for the merger in Europe and it is likely that after Europe, the US may also give the green signal to the merger. AbbVie's presentation regarding the acquisition was titled "Creating a New Diversified Biopharmaceutical Company". Management is confident that this deal will allow it to both lower its dependence on Humira in the short term (prior to its patent running out) while also providing better long-term growth prospects which will allow the company to generate strong sales and cash flows past the 2023 date. We are positive about the merger and the synergies between the two companies and it certainly has made AbbVie more comfortable to hold.

The biggest challenge and question on our minds this past year was contemplating whether we should be looking at increasing other asset classes (ie. Bonds, property) in the fund. Our conclusion has been that in an environment where central banks are keeping interest rates low, we would rather invest in consumer staples and companies that have stable revenues in recessions. Particularly we looked for companies that generate large amounts of free cash flow and are paying high, well covered dividends.

It was this objective that lead us to buying Philip Morris and Altria. Both stocks were extremely undervalued due to negative news flow around vaping, and declining tobacco sales. These companies have had to deal with negative press since the 1970's when they had to stop advertising. So, this latest negative press didn't really worry us. Tobacco companies have built in declining cigarette sales into their business model. Both companies were giving us a good margin of safety i.e. trading well below fair value, and together with this their dividend yields were very attractive. At the time of purchase Altria had a yield of 7.24% and Philip Morris 5.6%. Our research showed that they are well covered. Both stocks have rallied since we bought them. Our investment thesis was based on a very conservative estimated forward growth rate of around 3 – 4% which is lower than market expectations, and this together with the dividends we will receive, we estimate will give us high single digit returns which we are happy with at this stage in the market cycle.

The funds asset allocation was conservative throughout 2019, with around 25% in cash, 4.7% in USD fixed income, 2.2% Global Property and around 67% in global equities. Our holding in the global property fund delivered a solid return for our investors of just over 15% and we invested a portion of our cash in the Coronation Global Strategic USD income fund as an alternative to a US dollar bank deposit. This fund aims to provide a better return than US dollar cash through active management in the fixed interest universe. The fund outperformed its benchmark by a wide margin and ended the year +4.23%.

Looking forward to next year, we will continue to manage the fund defensively and will become more conservative if any of the economic and technical indicators that we monitor become negative. We believe that it is better TO WIN BY NOT LOOSING.