QUARTER 03 2021

PRUDENTIAL INVESTMENT MANAGERS

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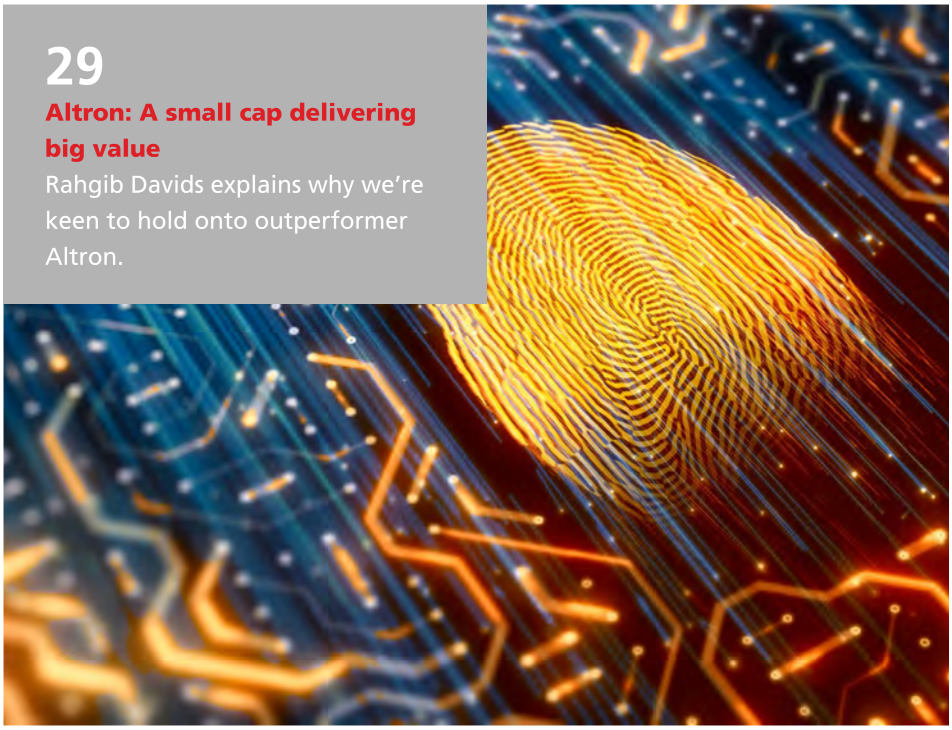

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Letter from the CEO

Benard Fick
CHIEF EXECUTIVE

During the second quarter (Q2) of 2021, more progress in Covid-19 vaccine rollouts worldwide, as well as positive corporate earnings reports and economic news, continued to lift returns, particularly in developed market equities, even as concerns emerged over high valuations and breakouts of more infectious Coronavirus variants in some countries. Bonds – both government and corporate credit – also recorded solid performances, retracing some of their Q1 losses and buoyed by reassurances from central banks that easy monetary policies would not be halted any time soon. Cheaper, previously out-of-favour equities like Listed Property and Financials were among the strongest performers, while more expensive sectors like Resources took a breather.

In the US, the approval of even more US government spending – this time on infrastructure - helped support the global growth outlook, as did improving conditions in the UK and

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Europe. However, emerging market equities lagged those of developed markets. South African equities broadly underperformed their emerging market peers due largely to the local market's higher Resources exposure, after outperforming in Q1. In contrast, South African nominal government bonds posted strong returns compared to those of many other countries over the three months.

As shown in the table, in US$ terms, global equities (the MSCI All Country World Index) returned 7.4% for the quarter, with emerging market returns of 5.0% lagging developed markets' 7.7%. For SA investors, the rand's 3.3% appreciation against the US dollar would have dented global investment returns. Global bonds delivered 1.3% for the quarter, regaining some of the losses recorded in Q1 as inflation fears receded somewhat. And finally, global property posted another quarter of good gains with a 9.7% return. As in previous quarters, central banks kept interest rates broadly unchanged at very low, accommodative levels –

Asset class	Total return Q2 2021 (Rand and US$)
SA equity – FTSE/JSE All Share Index (Rand)	0.05%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	0.6%
SA listed property – FTSE/JSE All Property Index (Rand)	11.1%
SA bonds – FTSE/JSE All Bond Index (Rand)	6.9%
SA inflation-linked bonds – JSE CILI Index (Rand)	3.0%
SA cash - STeFI Composite Index (Rand)	0.9%
Global equity – MSCI All Country World (Total) (US$ net)	7.4%
Global equity – MSCI World (Developed) (US$ net)	7.7%
Global equity – MSCI Emerging Markets (US$ net)	5.0%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$ net)	1.3%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	9.7%

SOURCE: Prudential, Bloomberg, data to 30 June 2021 less concerned about inflation than investors – and some governments continued to enact fresh fiscal support packages for consumers and businesses.

For South African investors, some positive developments for the quarter included Q1 2021 economic growth surprising to the upside at 4.6% q/q annualised, notably higher than the 2.5% market forecast. Covid-19 vaccine supplies also continued to make their way into the country and the government's vaccination programme made headway. However, this was hindered in June as the third wave of Covid-19 infections forced President Cyril Ramaphosa to reintroduce Level 4 lockdown measures. Post quarter-end, the social unrest and rioting that broke out in Durban, and spread to Gauteng, has set back the vaccination programme in these provinces, in addition to causing terrible damage to property and livelihoods.

Meanwhile, the South African Reserve Bank kept its benchmark interest rate unchanged at a record low of 3.5% at its 20 May MPC meeting, warning that slow progress on vaccinations, limited energy supply and policy uncertainty continue to pose downside risks to the economic outlook. This was despite the jump in consumer inflation to 4.4% y/y in April and 5.2% in May, attributed largely to coming off a low base. The central bank raised its growth forecasts for 2021 from 3.8% to 4.2%, but lowered its projections for 2022 and 2023 to 2.3% and 2.4% respectively. It is also projecting two 25bps interest rate hikes in 2021.

The FTSE/JSE All Share Index was basically flat for the second quarter, returning 0.05%, while the FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned 0.6%. The standout sector was Listed Property (the All Property Index) with an 11.1% total return. Financials delivered 7.5% and Industrials eked out 0.8%, but the Resources Index returned -5.0%. This performance reflected the value still seen in "SA Inc" counters, which have lagged during the recovery, and the growing view that Resources shares may be reaching the end of their bull run.

SA bonds posted a strong 6.9% return (as measured by the FTSE/JSE All Bond Index), remaining sought-after sources of yield for global investors compared to many other sovereign bonds. The yield curve between 10-year and 20-year bonds also flattened by 34bps, with the spread now down at 120bps from its peak of 216bps during the Coronavirus crisis in May 2020 and highlighting lower investor risk perceptions. Meanwhile, SA inflation-linked bonds produced 3.0% (Composite ILB Index) on the back of somewhat softer demand for inflation protection, and cash (STeFI Composite) delivered 0.9%.

Finally, the rand appreciated against the major global currencies over the quarter, rising strongly from its oversold position in April and May before retracing some gains in June. It gained 3.3% against the US dollar, 3.1% versus the pound sterling and 2.4% against the euro over the three months. However, post quarter-end, following from the social unrest, the rand weakened and gave back most of these recent gains.

Most Prudential funds outperform

The quarter proved to be another strong one for Prudential's client and fund performance, with most of our funds recording top-quartile returns in their ASISA categories (according to Morningstar). The Prudential Equity Fund, in particular, continues to demonstrate consistently competitive first-quartile returns over every rolling (and annual) period out to 20 years (measured to 30 June 2021). It is followed closely by the Prudential Dividend Maximiser Fund, which has also ranked in the top quartile over this long term (apart from three- and four-year annual returns). This represents excellent results from our equity team, throughout these truly unprecedented conditions.

Clients would also have enjoyed pleasing relative performance from our range of global funds, with the Prudential Global Equity, Prudential Global Balanced and Prudential Global Inflation Plus Feeder Funds all posting top-quartile returns for both the quarter and the year to 30 June 2021.

Our investment team's asset class positioning and stock selection both added relative value to client portfolios over the three- and 12-month periods. Our preference for SA nominal bonds, and for longer-dated bonds within this asset class, continued to add to our clients' returns over the quarter. Our overweight exposure to local equities also remained a significant contributor.

For investors who ignored valuations and switched out of SA equities into offshore assets amid the worst of the Coronavirus market crisis in 2020, subsequent market performance has

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shown that this decision has come at a cost. Over the 12 months to end-May, the combination of subsequent rand appreciation and local (equity) assets' outperformance of global assets has resulted in these investors foregoing some substantial returns. See **Pieter Hugo's article** for more details on this.

The table below shows the annualised returns of our Prudential Unit Trust funds for periods up to 10 years.

Prudential Fund Performance to 30 June 2021 (Rands)

Prudential Unit Trust Fund	1-year Return %	3-year Return p.a. %	5-year Return p.a. %	10-year Return p.a.%
Equity Fund	36.9	8.6	9.1	11.4
Benchmark	25.0	5.5	3.2	8.1
Dividend Maximiser Fund	30.1	7.2	7.5	10.5
Benchmark	25.0	5.5	3.2	8.1
SA Equity Fund*	30.5	9.8	6.2*	10.3*
Benchmark	25.0	5.5	4.8	9.2
Enhanced SA Property Tracker Fund	25.3	-10.1	-7.8	4.6
Benchmark	25.2	-8.9	-6.9	5.1
Balanced Fund	20.4	5.8	6.4	10.1
Benchmark	17.3	6.8	5.8	8.6
Inflation Plus Fund	15.3	3.6	3.8	8.4
Benchmark	10.2	8.9	9.3	10.1
Enhanced Income Fund	7.5	5.4	6.1	7.1
Benchmark	4.0	6.1	6.6	6.8
Income Fund	6.7	6.7	N/A	N/A
Benchmark	4.0	6.1	N/A	N/A
Global Equity Feeder Fund	25.8	16.0	13.8	16.7
Benchmark	14.5	16.1	14.0	18.4
Global Balanced Feeder Fund	6.4	9.1	N/A	N/A
Benchmark	4.4	12.8	N/A	N/A
Global Inflation Plus Feeder Fund	-3.2	7.9	5.3	10.5
Benchmark	-14.9	2.1	1.3	8.6
Global Bond Feeder Fund	-13.1	6.2	2.2	10.2
Benchmark	-15.6	5.7	1.8	10.0

SOURCE: Morningstar
**SA Equity Fund 5- and 10-year data reflect zero-fee B Class fund and benchmark returns. All other funds are A class returns (returns after all fund management fees and other charges).*

Protecting your personal information

This quarter has been a busy one with the finalisation of our personal data protection project, which was brought about by the implementation of the Protection of Personal Information Act (POPIA) on 1 July 2021. POPIA is the primary law that governs the protection of personal information for both people and juristic persons (e.g. companies), and all South African companies must comply with POPIA. We have accordingly reviewed how we communicate with our clients while also ensuring that we have the best possible operational and technical processes in place to safeguard your data and to meet the other POPIA obligations.

Some of our Q2 priorities related to POPIA included staff training, implementing a new **Privacy Policy**, and amending our agreements with clients and service providers where necessary to ensure all are fully compliant with the POPIA requirements. Among the changes, for example, you may have noticed that from 18 June we started to password protect all our email correspondence that contains information relating to your Prudential investments, which includes your investment statements and tax certificates.

Where possible we have tried not to affect the client experience onerously. Our **article** in this edition of *Consider this* provides more clarity on these changes and how they may affect you as a client.

Looking ahead

Although the emergence of the third wave of Covid-19 infections has been discouraging over the shorter term, I would like to emphasise that our focus remains on a longer-term three-to- five-year view, and that this has not changed materially during the quarter. Corporate earnings prospects, apart from local Listed Property, continued to improve during the quarter even as share prices moved sideways, creating better value in the equity market and more attractive investment opportunities. Many SA companies have emerged stronger from the Coronavirus crisis than when it first began, with better cash flows and stronger balance sheets, and investors are able to take advantage of this. More broadly, progress also continues to be made on the vaccinations rollout and anti-corruption measures. So it remains for clients to look through the short-term disappointments, and stay patient and exposed to risk assets as appropriate. For our part, we believe the bigger-picture trend remains positive and are confident that our

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portfolios are positioned appropriately to continue to perform strongly, given current asset valuations, with clients set to reap the benefits over the next three to five years.

The social unrest, looting and rioting that erupted in Durban and Gauteng around the time of writing is a truly low point in our country's post-apartheid history. We are monitoring these events closely. Having consulted with management of those companies affected, we have not altered our views on any of our current investment positions. However, at this time our thoughts are with the people, communities and businesses that are directly affected.

We hope you enjoy this latest edition of *Consider this*, and as always welcome any feedback you may have.

Sincerely,

Bernard

Bernard joined Prudential in 2008 as Head of Institutional Business and was appointed as Chief Executive Officer in 2010. With more than 28 years of industry experience, Bernard previously worked at Alexander Forbes in a range of leadership roles, including Managing Director of the Namibian business as well as Head of the Asset Consulting Division. Bernard holds a Bachelor of Commerce degree in Maths and Actuarial Science from Stellenbosch University and is a Fellow of the Institute and Faculty of Actuaries and the Actuarial Society of SA.

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TABLE TALK

PIETER HUGO
CHIEF CLIENT AND DISTRIBUTION OFFICER

KEY TAKE-AWAYS

- *Data subsequent to the March 2020 Coronavirus market crisis shows that South African investors have been adding to or moving high volumes of their assets offshore in a quest for safety and/or higher returns.*
- *To date this has proved to be a costly decision, due to a combination of rand appreciation and strong SA equity and bond returns over the period.*
- *Investors ignored the prevailing relative asset valuations and bought offshore assets when the rand was weak, and offshore assets were also relatively more expensively valued than SA assets. However, Prudential bought local assets and sold offshore assets at the time and our portfolio returns have benefited subsequently.*

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Q In May last year, after the Coronavirus market crash, I moved about 20% of my portfolio offshore because I thought it was safer and would give me better returns. But so far I've been disappointed by the performance – it seems like even though offshore equity markets have been strong and reaching record highs, I'm not seeing the same results in my own rand portfolio. Can you help explain this?

A You're not alone in this experience. After the Coronavirus market crash we've seen a lot of money in the unit trust industry moving out of South African assets – via both new investments and switches. In fact, an astounding R41.4 billion moved into the ASISA Global funds category for the year to end March 2021 (the latest available data), which is more than the entire previous five years' total of R40.8 billion (March 2015 to March 2020). Note that this is only the sum that went into locally-domiciled global funds – even more would have been sent directly offshore into myriad foreign-domiciled investments.

The severity of the JSE's drop and the rand's depreciation in last year's crisis caused many to react emotionally and opt for perceived safer havens overseas. Yet was this really a well-considered move to safety? Now that more than a full year has passed, we can see that the answer is definitely "no". To date this has, yet again, proved to be a sub-optimal investment decision based on historical returns rather than the valuations on offer from the assets. Investors may have obtained some extra diversification, but it has certainly come at a significant cost.

Why is this? First of all, we think you need to make investment decisions based on the current valuations on offer, rather than on the most recent historic returns of those same assets. Investors like yourself were selling rands at low prices and buying foreign currency at highs, not usually a profitable strategy. Over the 12 months to 31 May 2021, the rand has rebounded strongly from its historic lows, appreciating substantially against all three major global currencies, especially the US dollar, which has weakened for its own fundamental reasons: the rand was up some 22% against the greenback, more than 10% against the pound sterling and nearly 15% versus the euro. This would have necessarily undermined any gains in offshore portfolio assets.

Given the rand's extreme undervaluation a year ago (versus its own history), astute investment managers would have anticipated the improved odds of some rand appreciation going forward – albeit not the timing or extent – and seen this as an excellent opportunity to buy more rands and sell offshore assets, which is exactly what we did. There was far more upside than downside risk for the local currency.

Then, apart from the rand, South African equities and bonds have recorded strong gains along with the rest of the world since the crash. The MSCI All Country World Index has returned nearly 42% in US$ terms in the past 12 months, representing an impressive "V-shaped" recovery in global equity markets. Yet in rand terms investors received only a 10.2% return from the same Index due to rand appreciation. Investing in the local FTSE/JSE All Share Index in rands over the same period would have yielded a total 38% return in rand terms. Meanwhile, the Bloomberg Barclays Global Bond Index produced around 4% in US$ terms, but lost nearly 19% in rands. By comparison, a South African bond investment (in the All Bond Index) delivered 11% for the 12 months.

Graph 1 illustrates the cost of not sticking with a longer-term investment plan, by selling a rand investment in SA equities around the height of the Coronavirus crisis at 31 March 2020, and then buying a rand-denominated global equity investment. The red line shows the result if you had sold R100,000 on 31 March 2020 and switched it into global equities, while the grey line depicts the impact of sticking with local equities: the result is the difference between R124,824 and R152,070 – R27,228 or 18% less due to moving to offshore investments during the past 14 months.

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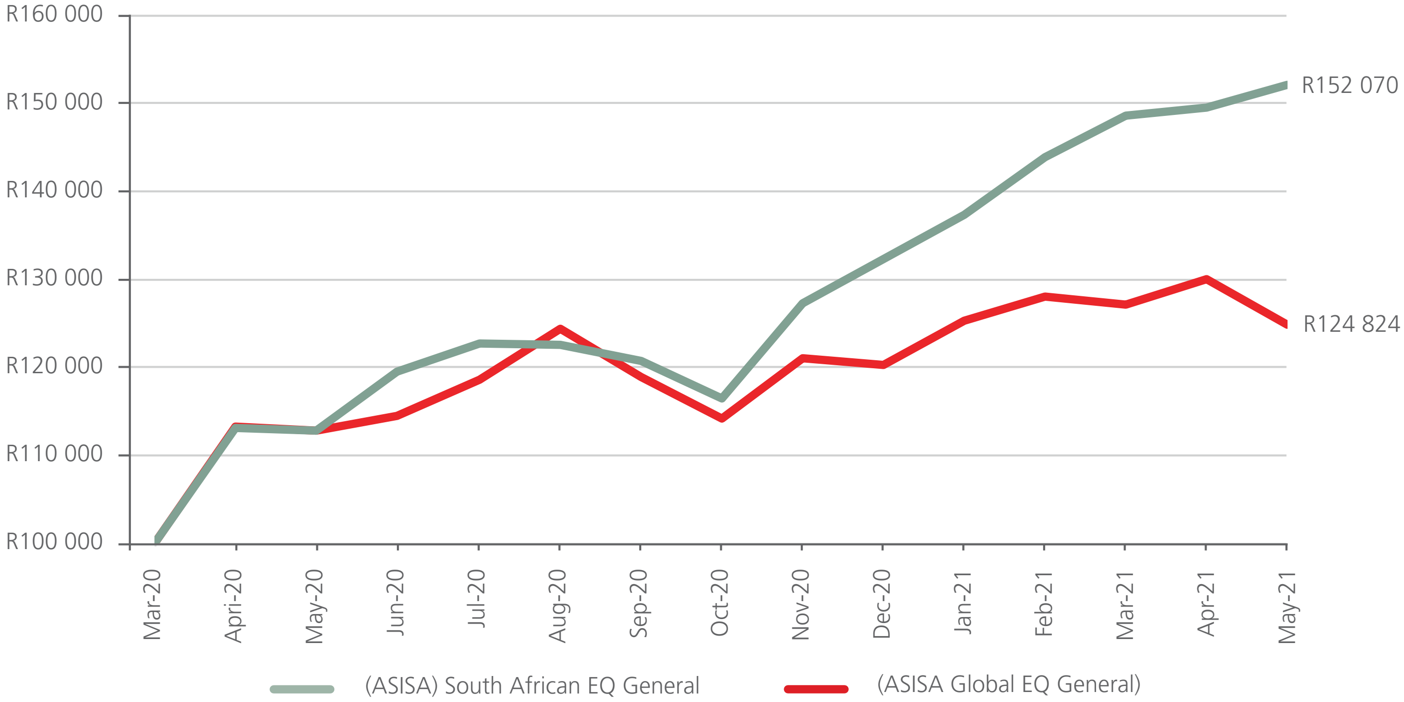
Graph 1: Cost of moving into global equities after the Coronavirus crash

R100,000 invested 31 March 2020 - 30 May 2021



SOURCE: Morningstar, Prudential Investment Managers

Instead of selling South African assets at lows during the crisis it would have been much more lucrative for you to have instead sold developed market equities, which were valued more expensively, and used the proceeds to add SA equity and SA bond exposure when others were selling. These local assets had higher prospective returns, and this is what some active managers like Prudential did. Yet we know that when markets are crashing, it is very difficult for individual investors to go against their natural instinct to avoid losses and instead take the perceived risk of doing nothing, or even better, buying the very instruments that have plummeted in value.

Although this is obviously a fairly short-term example, the point here is that investors can act very emotionally with their investments, especially during times of financial stress. What you should rather do is base your investment decisions on the current asset valuations on offer. This way you

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would have subsequently reaped the rewards of their relatively stronger returns and added significant market returns (beta) and alpha to your portfolio. ■

Pieter joined Prudential in 2015 as Managing Director of Prudential Unit Trusts and Head of Retail Business. In November 2019 he was appointed as Chief Client and Distribution Officer. He is also a director of Prudential Portfolio Managers (South Africa), PGF Management Company (Ireland) and Prudential Global Funds ICAV. With 23 years of industry experience, Pieter was previously employed at one of South Africa's largest financial services groups, spending most of his time in various senior management positions in the asset management and wealth management businesses. He holds a B.Comm (Maths) degree from Stellenbosch University, and is a Fellow of the Institute of Actuaries (UK) and the Actuarial Society of South Africa. He completed the General Management Program at Harvard Business School in 2010 and a course in Behavioral Finance from Duke University during 2020.

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Exxaro: What is coal worth now in a de-carbonising future?

Aeysha Samsodien
EQUITY ANALYST

KEY TAKE-AWAYS

- *Exxaro's growth strategy is to move away from coal production to become a cleaner alternative energy supplier.*
- *As long as it remains a key player in South Africa's energy supply chain, it is obliged to continue coal production to support the country's living conditions during the economy's transition away from coal dependency.*
- *In Exxaro's current valuation, investors are getting its coal and energy assets for free, making it an attractive investment.*
- *There should ideally be a balance between investing in falling coal vs rising renewables so that energy is never too expensive.*

As the pace and importance of de-carbonisation accelerates around the world and reaches ever-further into the daily lives of people and business operations, coal has become a more complex investment choice, and renewable energy sources important investments of the future. But what about now - the transition period between the two? Energy supplies need to be readily accessible and relatively cheap in order to avoid significant disruptions in living conditions, especially in countries like South Africa that are heavily dependent on coal as an energy source. There should ideally be an ever-evolving balance between the phasing out of coal and the growth of renewables.

Investors have a role to play in ensuring that this transition unfolds as smoothly as possible. In a free market, capital would generally go to those companies offering the biggest returns, which in the past has not included renewable energy producers due to their high cost of production. But as the need for their cleaner energy has become increasingly important, they have received government subsidies and improved their technology such that they have evolved into legitimately rewarding investment alternatives. Coal companies, meanwhile, have become much less attractive from an Environmental, Social and Governance (ESG) perspective.

In Exxaro, the listed coal producer, we can see a microcosm of this transition away from coal playing out, and investors may be wondering whether it could still be worthwhile to invest in the group. Here we offer an overview of the company and its latest plans for growth, while also assessing its investment prospects going forward.

About Exxaro

Exxaro is predominately a coal company with most of its sales going to Eskom, as well as a growing export business. The group also has an equity stake in the unlisted Sishen Iron Ore company (SIOC), and owns Cennergi, a renewable energy business, and smaller non-core assets.

Over the last few years, Exxaro has been simplifying its portfolio and strategy. Earlier this year it completed the sale of its holding in Tronox (a Minerals Sands business), and it is currently in the process of disposing of other non-core coal assets including the Leeuwpan mine and Exxaro Central Coal (ECC) Complex of mines in Mpumalanga, as well as its equity stake in the Black Mountain zinc mining business. It has also implemented an "early value" strategy, in which it extracts value from its operations earlier by growing the share of its export business (where profit margins are higher) and by reducing "stranded" assets (those that have devalued prematurely or unexpectedly) through its sale of non-core assets.

Some terminology:

Iron ore has differing physical forms: fines, lump and pellets.

Lower-grade sources of iron ore generally require beneficiation, using techniques like crushing, milling, gravity or heavy media separation, screening, and silica froth flotation to improve the concentration of the ore and remove impurities. The results, high-quality fine ore powders, are known as fines.

Fines require sintering, which is a thermal process where iron fines are agglomerated to get the product suitable for blast furnaces. The lump and pellet forms are of higher-quality iron content and do not need to go through this process; they therefore attract a premium price above fines.

Sishen Iron Ore (SIOC)

As a South African iron ore business, SIOC is differentiated from other iron ore companies due to its higher-quality product. It delivers a higher iron-content "lump" versus its peers (who predominately produce iron fine), and a higher grade versus the 62% Iron Content benchmark. Consequently, it receives a premium for its ore relative to other miners. In addition, most of the iron ore SIOC produces is exported, and about 50% of these export sales go to China. These factors give the company a level of defensiveness for investors in the sector.

As environmental restrictions tighten, our view is that SIOC will benefit given that it produces higher iron-content and lump products that do not require sintering. The risk to SIOC is that it has a relatively low life-of-mine, and therefore over the next decade the company will need to consider life-extension work; however, there are options for it to pursue both within and outside its portfolio.

We are also cognisant of the fact that iron ore prices are elevated at the current levels relative to long-term expectations, which is mainly being driven by supply side disruption from Brazilian production and strong Chinese demand. Over the short-to-medium term we do expect there to be supply normalisation, which will place downward pressure on prices.

Like its peers, the current elevated iron ore prices globally are allowing SIOC to generate high cash flows which - beyond covering its capital spending - will be supportive of paying a strong dividend for its 2021 reporting period, and for as long as iron ore prices remain high. Exxaro's current policy is to provide 100% flow-through of SIOC's dividends directly to its shareholders. Because Kumba's share price is not discounting the elevated spot price of iron ore, and we use it as a proxy to value SIOC, we would note that SIOC shares would also not be discounting it. And we are receiving the SIOC dividend cheaper via Exxaro than if we were to receive it from Kumba directly.

Exxaro's coal business: Looking offshore for growth

Exxaro's coal business trades on a very low valuation multiple due to the numerous headwinds facing coal from an environmental aspect. As mentioned, the majority of its coal sales go to Eskom, although the company does have a growing export business.

One of the key risks that faces its South African coal business is its dependence on Eskom as a customer. On this front it has few outlets for growth due to existing competition and the continued opening of the local market to new energy suppliers, largely in the form of renewables. A mitigating factor to this risk is the high standards of its Grootegeluk mine, a world-class operation based in the Waterberg that produces more than 50% of Exxaro's coal (this includes assets the company is selling).

Grootegeluk supplies 20% of Eskom's required coal and it provides coal to the export market. Grootegeluk coal is used by Matimba and Medupi power plants, with the latter being one of Eskom's newer power plants, thereby making it an integral part of the SA energy complex. Medupi has a life expectation beyond 2040.

Part of Exxaro's current growth strategy is to mitigate its dependence on Eskom by diversifying its customers. The focus of this plan is to improve the quantity

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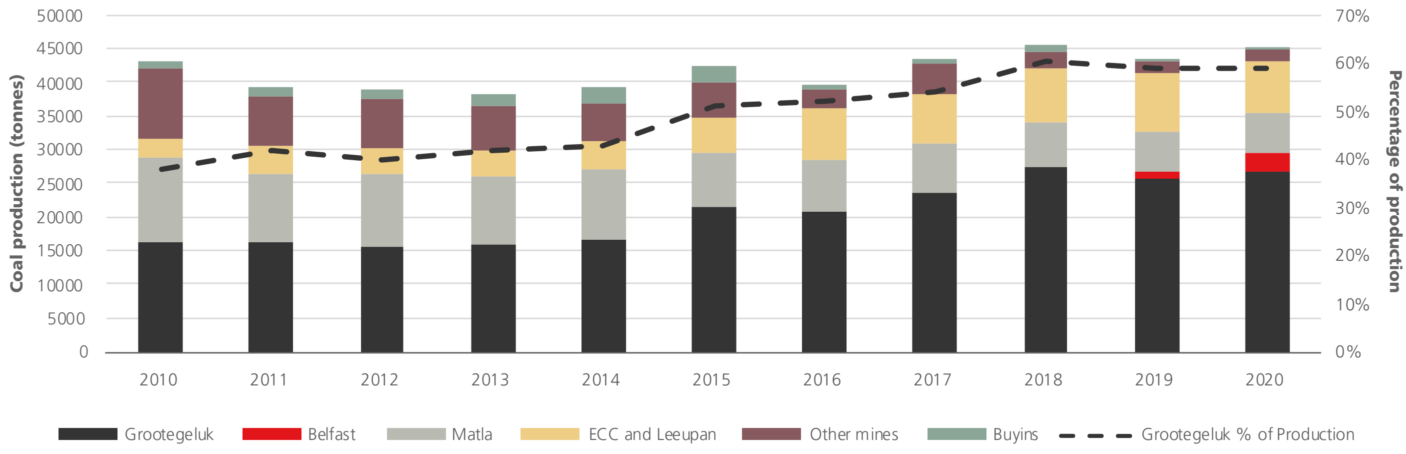
Graph 1: Grootegeluk: Largest asset in Exxaro's coal portfolio



SOURCE: Company data and production forecasts

and quality of its export coal product. This will increase the realised prices it receives, in turn widening its profit margin.

However, one of the challenges to the company's export sales is the issue of domestic transport, which relates to the problems being experienced by Transnet. Since the Covid-19 pandemic we have seen a decrease in locomotive train capacity and a rise in cable theft and vandalism on the rail lines. There is a possibility that locomotive capacity can improve over the shorter term, but the bigger risk is the increased theft and vandalism, which may require public-private solutions that are complex and will likely take time to resolve.

A de-carbonised future

Another obvious challenge for Exxaro's future growth is the global coal market, which is facing increased pressure from an environmental aspect as the world moves toward de-carbonisation. But while many developed nations are moving fairly quickly to curb their demand for coal, there is still good demand from Asian and other emerging markets that are more focused on economic growth at a cheaper cost. For South African coal producers like Exxaro, China and smaller Asian markets are natural export markets where demand is likely to remain firm for years to come. That is, until alternative energy technology becomes cheap enough.

Exxaro is very aware of the global energy transition now underway, as well as its own need to embrace and participate in a low-carbon world. It is doing so via its "Just Transition" strategy, which involves increasing its diversification into renewable energy sources by building onto their existing energy operations,and exploiting opportunities for potential growth into battery minerals. These minerals will be vital for the global energy transition journey.

Exxaro's renewable energy business, Cennergi, comprises two wind farms in South Africa. Signalling its commitment to the business, in 2020 the group bought out its JV partner, Tata Power. Going forward Exxaro plans to use this renewables expertise by focusing on working with mining companies to transition to a greater use of alternative energy sources, as Exxaro has experience managing large capital-intensive projects.

As Exxaro undertakes its Just Transition strategy, one of the risks lies around capital allocation. Management will need to decide how much to invest in expanding its (arguably relatively new) non-coal operations, which will take time to generate cash. Nevertheless, the company has made a clear commitment to no longer spend its capital on expanding its coal assets, and limiting this to "stay-in-business" capex to maintain life of mine. Their dividend policy is equally clear: after paying dividends, the remaining cash flows will go towards growing their renewables business.

An investor ESG perspective

We cannot get away from the fact that Exxaro is a coal business, but at Prudential we have certainly considered the implications of investing in this company from an ESG perspective. Sustainability has been a key element of our investment process for over 20 years. Going forward, Exxaro will no longer be investing in coal growth projects, while at the same time they are currently divesting from coal assets that are no longer core to their operations. The product they supply to Eskom is critical for South Africa's energy needs (at least for the foreseeable future), and its export products to Asian markets are destined for locations where coal remains a key part of the energy mix. Finally, the growth strategy for Exxaro is firmly focused on renewables. The management team is very aware of

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the path toward de-carbonisation and the disastrous impact of climate change, and they are actively working to implement their strategy despite the risks and constraints they face.

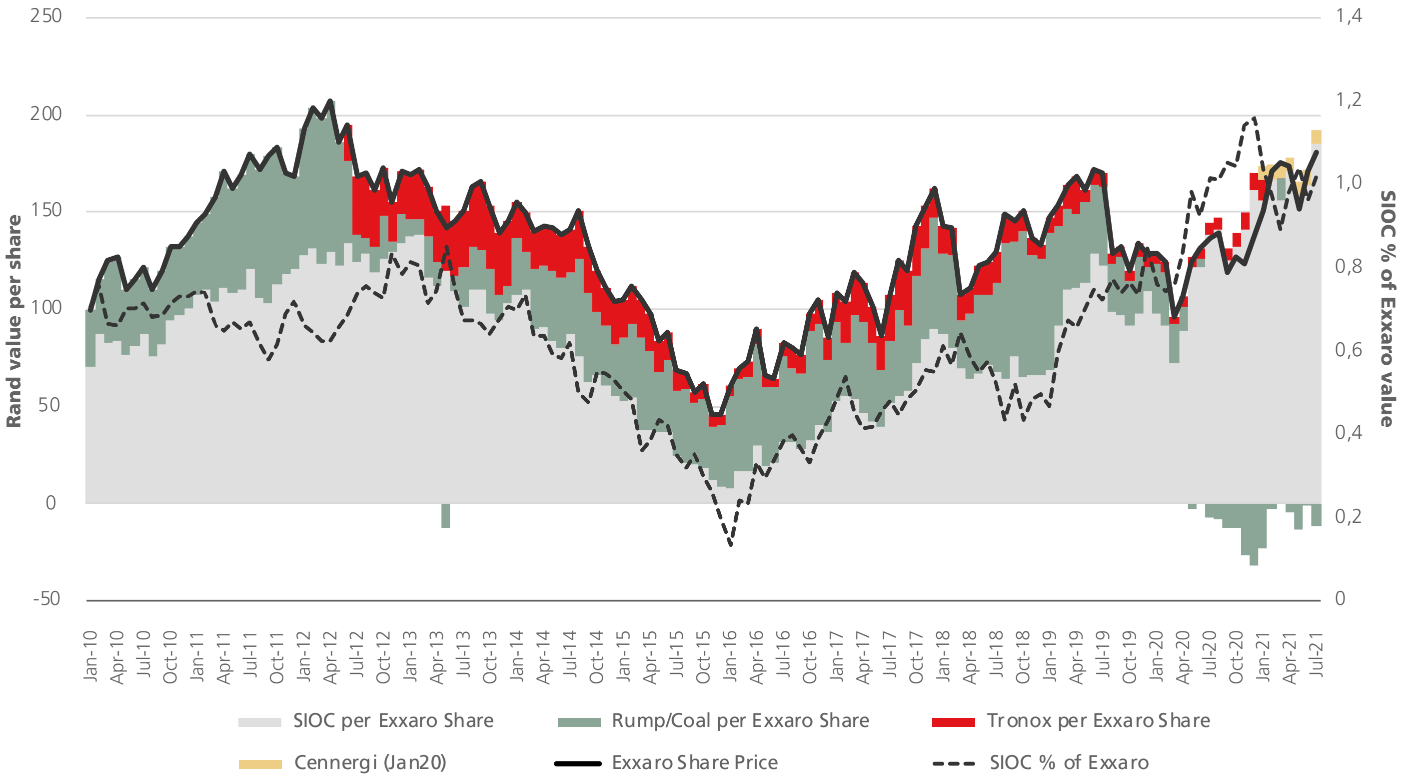
Getting Exxaro's coal and energy assets for free

We are holding overweight positions in Exxaro in our two main equity unit trusts, the Prudential Equity and Dividend Maximiser Funds.

Since the beginning of 2021 to 30 June, its share price has outperformed the equity market, helped by the rising iron ore price over the period, making it a top-10 contributor to the relative outperformance of both of these funds versus their benchmark (the average of the ASISA general equity category). Over the past 12 months to 30 June it has also performed strongly and added relative value to these unit trusts' returns.

Graph 2: Components of Exxaro share value

Exxaro's share price attributing no value to coal assets or Cennergi



SOURCE: Prudential Investment Managers

As Graph 2 highlights, most of Exxaro's value is now derived from its 20.6% stake in SIOC, with Kumba Iron Ore owning the other 76%. Using Kumba's share price as a proxy for SIOC, we can see that Exxaro's assets other than SIOC (i.e. rump assets) are not being valued in Exxaro's share price at all. Essentially, investors are getting the company's still-valuable coal business and Cennergi for free. (Note, Cennergi is only separately valued after it became 100% owned.)

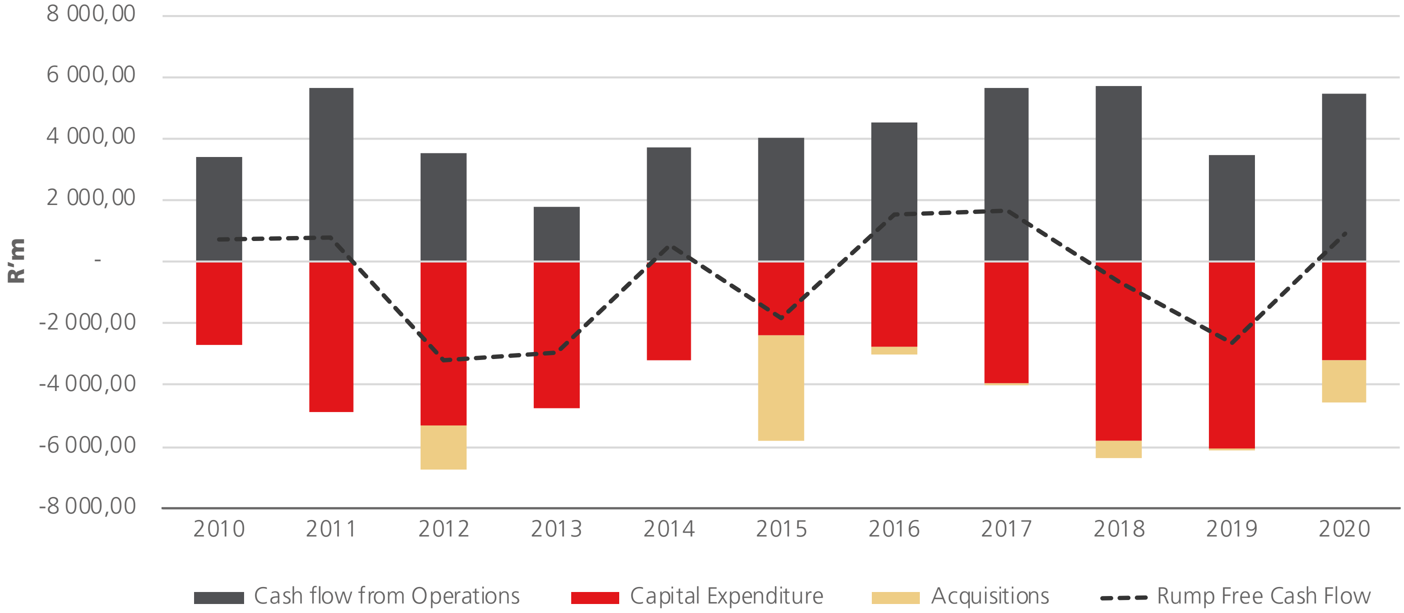
If we focus solely on the Grootegeluk mine, which is a large and long-life orebody, we feel that the market is undervaluing that asset. The mine's supply contract with Medupi power station, which has a long operational life beyond 2040, is another positive element in the investment case.

At the same time, the value of its Renewables business (Cennergi) should emerge over time as the ring-fenced project debt is paid off.

The other positive for investors is the group's attractive dividend yield. As mentioned above, Exxaro will pass through the full dividend from

Graph 3: Exxaro's coal and Cennergi cash flows on the rise

(Excluding SIOC and Tronox dividends, Rand millions)



SOURCE: Company data, Prudential estimates

SIOC, and that is attractive at current commodity prices. In addition, over the last few years the coal business has been investing into its assets and the capital spending programme is winding down. Therefore in 2019 we have seen the cash flows reaching an inflection point (as shown in Graph 3), and we expect the business' coal assets will soon start contributing positively to group cash flows (as shown by the dashed line in Graph 3). This will provide an underpin to dividend payments going forward. ■

Aeysha joined Prudential as an Equity Analyst in April 2013 and is currently responsible for conducting research on the Mining sector. With eight years of industry experience, Aeysha spent the first three years of her career completing her articles at PwC prior to joining Prudential. She holds a Bachelor of Commerce degree in Financial Accounting from the University of Cape Town and is a qualified Chartered Accountant (SA).

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Despite tough times, Listed Property still a sound investment

Yusuf Mowlana
PORTFOLIO MANAGER

KEY TAKE-AWAYS

- *Despite the shorter-term headwinds facing SA Listed Property, it remains a sound investment due to its diversification benefits and the combination of steady income and capital growth that it can offer over time.*
- *Valuations are attractive now, but some companies carry more risk than others due to higher debt levels or exposure to the harder-hit market segments like office space, among others.*
- *Investors therefore must tread carefully and opt for high-quality companies with low debt and earnings diversification, like those held in the Prudential Property Fund*

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Listed property companies have experienced a tumultuous past 18 months given the Coronavirus crisis, the slow rollout of the country's vaccination programme and, most recently, the social unrest and looting that have impacted severely on properties in KwaZulu Natal and Gauteng. The severity of the resulting downturn was made worse by the weak fundamentals prior to the onset of the pandemic. However, it is important for investors to distinguish clearly between longer-term, secular trends (such as the growth of online retail), medium-term cyclical trends (such as fluctuating vacancies and rents) and events which are hopefully once-off and non-recurring, such as the recent destruction of property in two of South Africa's main economic hubs and the Coronavirus pandemic.

Although we are under no illusion that many short-term events may have significant longer-term implications for the Listed Property sector, these developments should not result in investors abandoning a focus on asset valuations or the diversification benefits Listed Property offers investor portfolios over the longer-term.

As a reminder, over five-year periods or longer the asset class has the ability to deliver growing distribution streams that provide regular income under many conditions, with distributions based on underlying rental contracts usually incorporating inflation-linked increases over time. This can make certain Listed Property market segments beneficiaries of higher inflation. Capital growth is a bonus for investors, and although it comes with volatility, the relative consistency of distributions makes property stocks somewhat less risky than other equity sectors if the property fundamentals and balance sheets are intact.

"Capital growth is a bonus for investors"

Property companies structured as Real Estate Investment Trusts (REITS) are required to pay out 75% of their distributable income to shareholders, which allows some retention for future growth. For this reason, our recommended investment horizon for investing in Listed Property, including the new Prudential Property Fund, is five years or longer, rather than seven years for other equity-only funds. However, investors must be willing to accept some shorter-term volatility in exchange for longer-term outperformance.

Latest valuations remain inexpensive

For Prudential, the last year has proved to be a rewarding time to invest in the sector due some of the attractive valuations that have been available for careful investors. Listed Property has been the best-performing sector (and asset class) on the JSE so far this year, recording a 20.1% return over the six months to end-June. Although investment risks are high for some property companies due to either large exposure to the weakest segments of the property market, unsustainable levels of debt or insufficient diversification in their underlying holdings, certain other companies with strong fundamentals have been offering good value. For example, we have been able to add a high-quality company like Growthpoint to our client portfolios at very cheap valuations. In addition, companies with favourable long-term tailwinds like Stor-Age (self-storage) and Equites (logistics) are priced attractively relative to their ability to produce growing cash flows and development profits.

As of 20 July 2021, the SA Listed Property Index was trading at a 9.0% dividend yield for the year ahead and an 11.0% distributable earnings yield, implying a dividend payout ratio of 82% for the sector. The ability of property companies to strengthen their balance sheets by de-levering organically (via asset sales and dividends withheld, as opposed to equity raised) over the past year has no doubt surprised the market positively, as has the fact that vacancies have held somewhat steady during the course of 2020 and 2021, with the exception of the office sector. Coupled with attractive income yields, we are therefore constructive on the sector's valuation in absolute terms, given reducing risks.

Currently, the mixed fortunes of property companies can be evidenced by stable vacancies with lower rents and ongoing rent relief to affected tenants in the local retail space, and some evidence of tenant failures and downsizing in the industrial market segment. Unfortunately, the office market has demonstrated weak demand and little pricing power. In contrast, the self-storage segment as represented by Stor-age had an exceptionally robust year as they managed to both grow rental rates and also occupancy by 'letting up' space.

One sign of cheap valuations is that the sector has been attracting significant interest from private buyers as well as corporate activity in recent months. For example, Growthpoint rebuffed an offer for its stake in Globalworth; Arrowhead and Fairvest announced a likely merger; and the iGroup made a compulsory offer to minorities of Emira. Tower also announced an expression of interest from RDC Properties, based in Botswana, for its entire share capital, while RDI Reit was the subject of a successful bid from Starwood Capital.

The current unrest in parts of the country will no doubt unsettle many Listed Property investors. At the time of writing, we assess the immediate impact on Prudential Property Fund's holdings as immaterial in the short term. The facts supporting our view include:

- Landlords are fully insured for physical damage and largely insured for the resulting loss of income;
- The properties affected represent a fraction of companies' respective portfolios;
- Not all tenants within affected properties were necessarily looted; and
- The majority of retail rents are paid by large national tenants.

Of greater concern to us are the secondary effects, especially the likelihood that small businesses may not be able to restock given underinsurance or a lack of insurance. The likely loss of confidence in the country and associated higher cost of capital and of doing business due to additional security measures are further long-term consequences.

Prudential Property Fund has attractive active positions

We would like to remind investors that in May we added the Prudential Property Fund to our selective range of unit trusts. The new active fund is Prudential's response to the changing fundamentals and greater company divergence in South Africa's Listed Property sector.

The globalisation of the sector in the past decade, with both foreign property companies choosing to list on the JSE and local property companies expanding offshore, has introduced greater complexity into what was previously a somewhat homogenous industry. On top of this are the longer-term trends of greater competition from online shopping, increasing popularity of work-from-home models and changes in consumer behaviour, all adding pressure to landlords in the sector and leading to different company strategies and new investment opportunities. Consequently we are observing widely diverging company valuations and fundamentals, which create opportunities for active investment managers like ourselves to take advantage of. This was our foundation for offering investors a fund with a more active approach, allowing clients to benefit from the value now available in Listed Property, alongside our existing Enhanced SA Listed Property Tracker Fund.

Although this is a new fund, it is managed based on the same investment principles and processes that we have been successfully employing for over 20 years now – our valuation-based, risk-cognisant approach. Just as with Prudential's other equity funds, stock selection and portfolio construction are carried out according to a team-based process. And this active methodology already has a strong track record: it has been used in actively managing the Listed Property exposure within our multi-asset funds like the Prudential Balanced Fund and Prudential Inflation Plus Fund since the beginning of 2019. The fund's benchmark is the All Property Index, so that investors have access to the largest possible universe of property stocks available in South Africa.

The Prudential Property Fund is available directly to retail investors for a minimum R500 investment. For more fund details, visit the Prudential website. ■

Yusuf joined Prudential in October 2018 and is the joint-Portfolio Manager of the Prudential Equity, Enhanced SA Property Tracker and Property Funds. He is also responsible for the property allocations within Prudential's multi-asset funds as well as equities for Namibian clients. Yusuf joined Prudential from Allan Gray where he spent five years as an investment analyst, covering companies across various sectors, with a special focus on Listed Property. He currently has eight years of industry experience. Yusuf holds a B.BusSc from the University of Cape Town, is a qualified Chartered Accountant and CFA Charterholder.

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Altron: A small cap delivering big value

Rahgib Davids
EQUITY ANALYST

KEY TAKE-AWAYS

- *Altron's share price has outperformed the JSE in recent years due to the company's value added through restructuring, consolidation and debt reduction, plus a change in management.*
- *The dual-listing of its Bytes UK subsidiary on the LSE also unlocked tremendous value.*
- *Despite its strong outperformance, Prudential is holding onto the share due to its ongoing strong growth potential. Altron plans to sell more low-returning businesses and focus on high-growth areas like digital platforms, cloud computing, analytics, automation and cyber security.*

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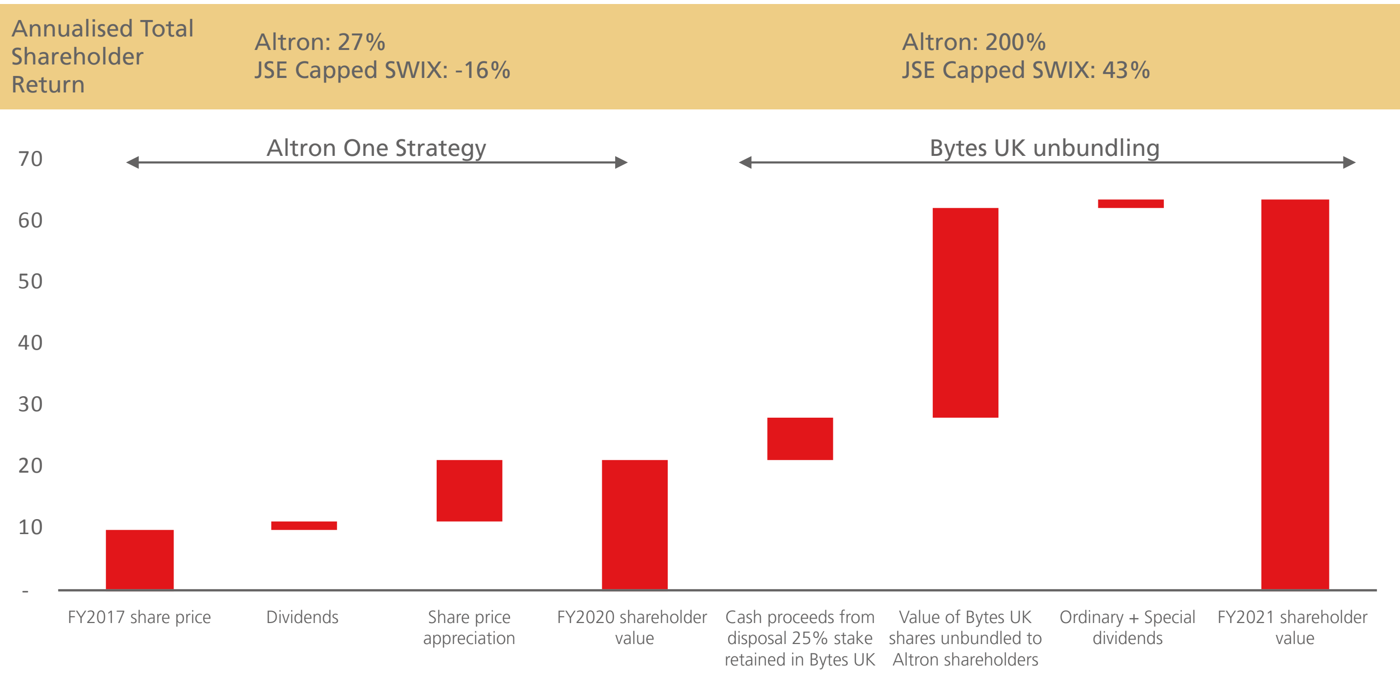
Small cap stocks are often neglected and underappreciated, but that is what makes the sector the perfect hunting ground for the value investor seeking investment opportunities. Altron was one such opportunity we identified that is an excellent example of how Prudential adds outperformance (or alpha) to our client portfolios. We have been holding active positions in Altron in the Prudential Equity Fund and across our Namibian unit trusts.

Altron is an information, communication and technology (ICT) business that has delivered a tremendous amount of value for shareholders over the last four years, as new leadership successfully executed on a transformational "value unlock" (added value) strategy. The company delivered a return of 60% p.a. over the last four years, massively outperforming the 7% recorded by the FTSE/JSE Capped SWIX.

Graph 1 shows the two component parts contributing to this value unlock – the Altron One Strategy, and the Bytes UK unbundling.

Graph 1: Components of Altron's value added per share since 2017



SOURCE: Prudential Investment Managers, Company data

Altron was formed in 1965 and was a family-run business for 51 years, over which time the business grew into a holding company of many separately managed businesses within the electronics manufacturing and ICT services industries.

The manufacturing businesses produced electric cables, power transformers, automotive batteries and decoders used for Pay TV. Following some years of weak economic growth, declining state infrastructure spending and increased competition from cheap imports, the group's manufacturing capacity utilisation fell to a point where the businesses became loss-making. By 2016 Altron experienced a drastic decline in group profits, while debt levels remained unsustainably high. Consequently, its share price halved.

Fortunes began turning in 2017 when Altron formed a strategic partnership with Value Capital Partners (VCP), who provided a much-needed equity injection in return for a 15% stake in the business. VCP is an investment group that applies private equity principles to unlock value in listed companies. Their involvement sparked some much-needed change. For starters, the dual share structure giving the founding family absolute voting control was collapsed. The founding family father and son stepped down from their chairman and CEO positions, respectively. VCP appointed two of their founding members to the board, and a new CEO, Mteto Myati, was appointed. Having served as CEO of MTN and Microsoft and held various leadership roles at IBM, he brought a wealth of experience to Altron.

For the first time, Altron was now an independently run business, setting the stage for the Altron One strategy. This entailed disposing of loss-making manufacturing businesses and using the proceeds to pay down debt, while simultaneously cutting head office costs by centralising corporation functions and consolidating office space. By 2020 the company's net debt had halved, and its earnings (earnings before interest, tax, depreciation and amortisation, EBITDA) were back to historic levels, as Graph 2 highlights. The business was stabilised and the balance sheet de-risked, leading to a re-rating in the share price.

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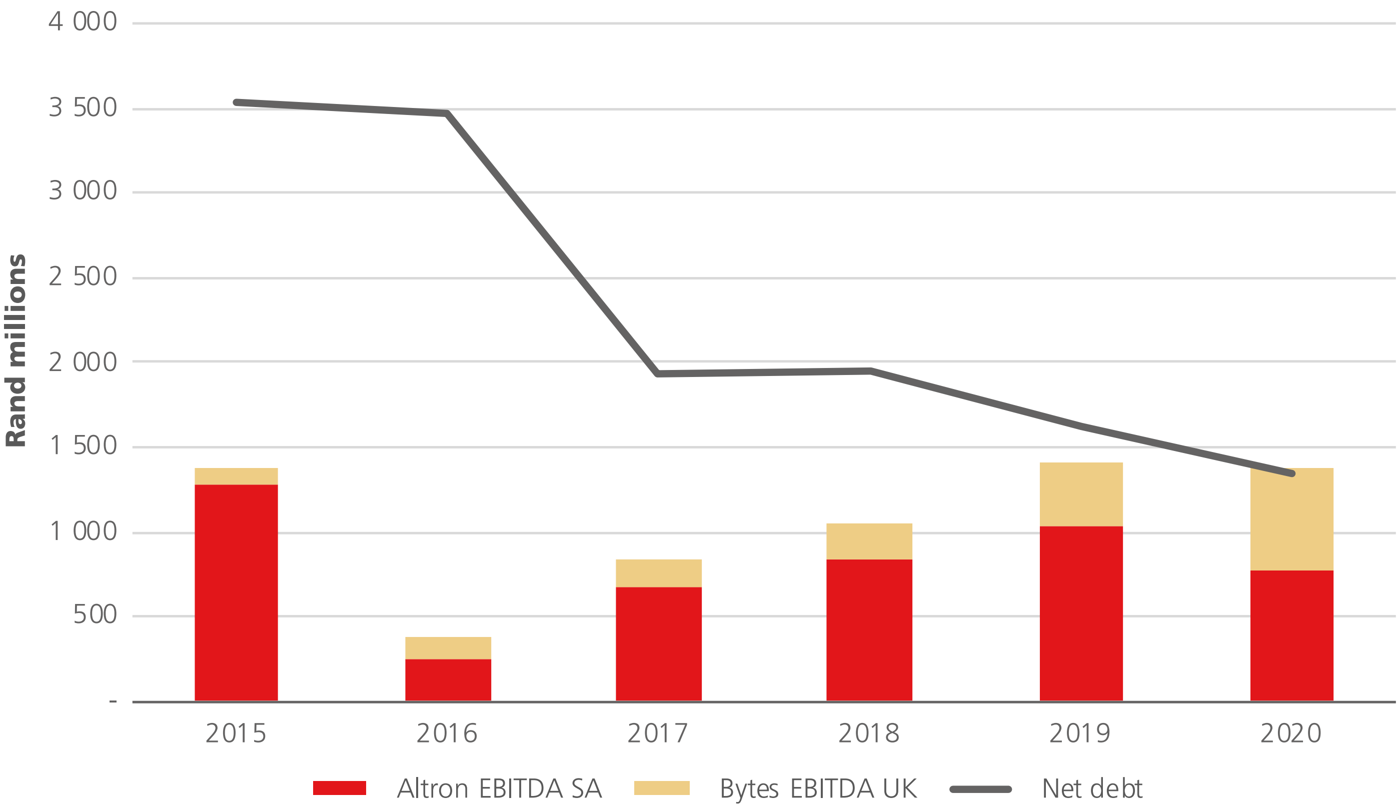
Graph 2: Altron's earnings rebound and debt falls significantly



SOURCE: Prudential Investment Managers

Next step: The UK Bytes unbundling

Altron acquired the Bytes UK business in 1998, a business providing software and hardware solutions to corporations and government organisations, and the biggest Microsoft product reseller in the UK. While its South African businesses struggled to deliver real growth, the UK business boomed and by 2020 contributed 45% of group EBITDA. At that time, Bytes UK had a peer group listed on the London Stock Exchange (LSE) which traded on a 27x EV*/EBITDA multiple, a material premium to Altron which traded at only 7x EV/EBITDA. This was a clear opportunity for management to unlock value.

In December 2020 Bytes UK was dual-listed on the LSE, with 75% of Altron's

*EV (Enterprise Value) = Market capitalisation plus net debt stake unbundled to shareholders (one Bytes share for every two Altron shares) and 25% sold in the open market. The net proceeds were then used to settle debt and the rest returned to shareholders via a special dividend. The unbundling was a huge success; Bytes UK re-rated in line with peer valuation multiples, and the share price gained another 70% from the date of unbundling.

Altron 2.0: Reasons to keep holding on

Although so much value has already been unlocked, we still see more value on offer in Altron as management embarks on the next phase of their strategy. Their objective is to dramatically improve Altron's return on invested capital (ROIC)** which currently falls materially below their cost of capital. This shortfall in a key measure of investability indicates that the company is not deploying its capital in the most efficient way that maximises shareholder returns.

The plan is to dispose of those businesses that require considerable capital and generate low ROICs, and invest in businesses that require little capital and generate high ROICs (essentially, capital-light businesses driven by skilled employees and intellectual property).

Businesses it has earmarked for sale include operations in print and document solutions, call center management, and its last remaining electronics manufacturer. These businesses require significant investments in inventory and fixed assets and operate in struggling markets with limited growth prospects. Together they account for 50% of Altron's invested capital, while only contributing 5% to group profits, thereby significantly depressing the group ROIC. Some offers have already been received, and we expect sales to be concluded over the next year.

Once the low-returning businesses are sold, the businesses remaining within Altron are mostly high-quality, capital-light operations that we believe are underappreciated by the market. More on what we like:

The platform segment of Altron (generating 60% of group EBITDA)

**Return on invested capital = [net operating profit after tax/capital employed (net debt + shareholder equity)].

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consists of well-established, scalable platforms that generate exceptional returns on capital, produce defensive annuity income underpinned by long-term service contracts, and achieve high operating profit margins (north of 30%). These businesses include:

- Netstar, one of South Africa's biggest vehicle tracking and fleet management businesses;
- Health-tech, which provides the healthcare sector with a cloud-based health administration system that facilitates online patient management with linkages to medical aid systems for claim submission; and
- Fin-tech, which provides unbanked consumers, informal traders and unregistered micro-lenders with solutions to digitise their operations. Offerings include point-of-sale devices, lending systems to facilitate credit checks, disbursements and collections.

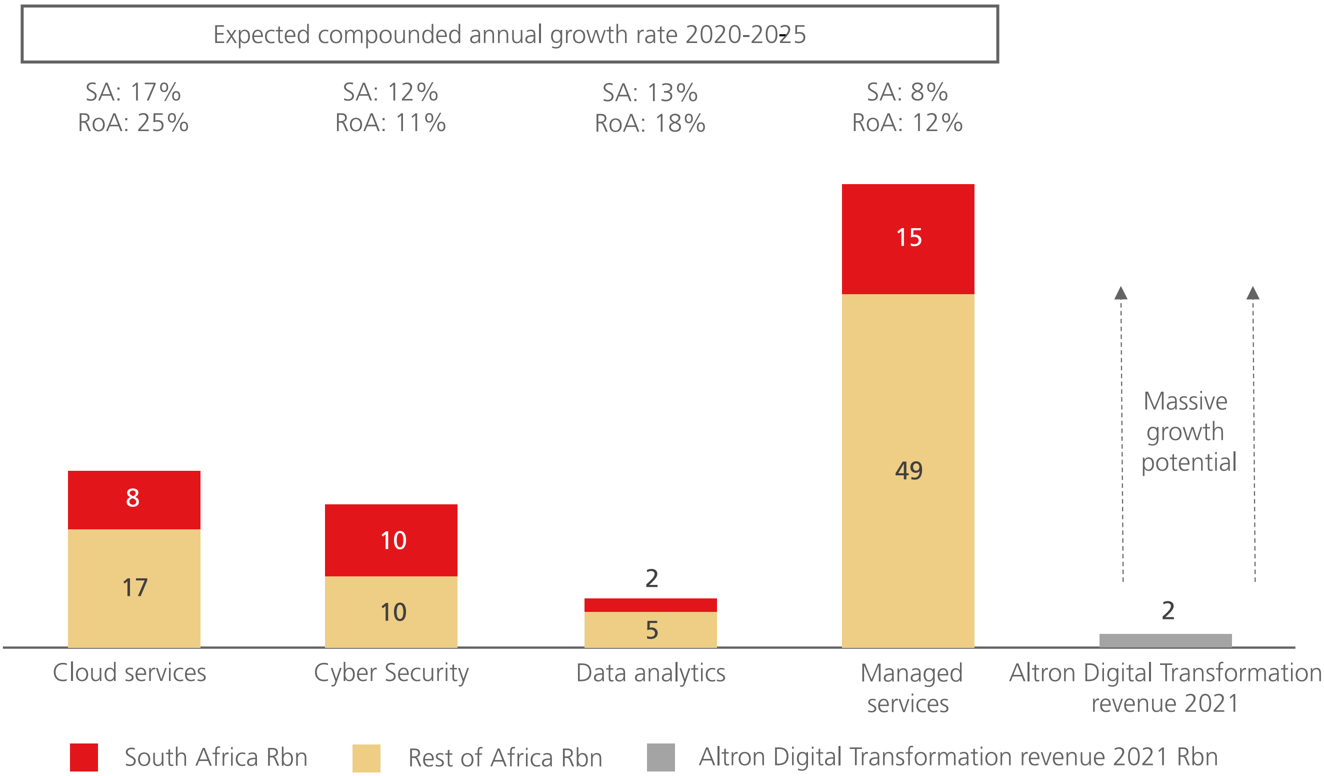
The Digital transformation segment (20% of group EBITDA) provides bespoke integrated ICT solutions that help businesses transition into the rapidly evolving digital age. Altron's clients include some of SA's blue-chip listed companies in the Banking, Insurance, Telecoms and Media sectors. Core services span cloud computing, data analytics, automation, and cyber security – sizeable markets offering a robust runway for growth over the next five years.

What the digital transformation segment can do

Graph 3 shows that Altron Digital Transformation has a R115 billion-rand market opportunity in South Africa and the Rest of Africa through to 2025, driven by robust demand from companies for modern technology solutions, shown in four primary segments. Off a mere R2 billion rand revenue base, its runway for growth is massive, with ample opportunity for Altron to expand and take market share.

If we look at the first segment, Cloud services, cloud computing is the future of how business computer systems operate. In the past, applications were loaded onto physical computers located in offices. Cloud computing runs all applications from the Internet (the cloud), allowing multiple users to access data in real time and share project work effortlessly – from anywhere

Graph 3: Digital transformation: A R115bn market opportunity



SOURCE: Prudential Investment Managers

and on any device. This capability is critical as work from home becomes the new norm in a post-Covid world.

Data science and machine learning, meanwhile, is about analysing vast amounts of data to drive insights into customer demand and business performance. This allows business strategy to be informed by real-time data that can be visualised and communicated using powerful dashboards and autogenerated reports.

Cyber security, the third segment, serves to protect the businesses' data and applications as they become increasingly vulnerable to external threats in a digital age. Services include a range of access controls, threat detection, firewalls and encryption solutions.

Finally, Managed services is the end-to-end package deal offered by Altron, which comprises consulting, solution implementation and ongoing servicing

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(to ensure client needs are met as technology rapidly evolves). Businesses can then focus on core operations, while being assured their technology needs are being handled by the experts. Altron benefits by getting a "sticky" client who pays a recurring service fee, thereby improving the quality of earnings – whereas in the past there was a once-off sale until the next time the client needed something.

Altron is well worth holding onto

Based on the above, we believe Altron presents a unique opportunity to invest in a business with ambitions to grow aggressively in the modern ICT market, where demand is robust and underpinned by the undeniable need for businesses to adapt in a rapidly advancing digital landscape. Its strong balance sheet and adept leadership give us confidence that the next phase of Altron's value unlock journey will, once again, be very rewarding for shareholders.

Lastly and most importantly, despite its strong share price gains and re-rating in more recent years, Altron's current valuation remains very attractive. If we subtract the total proceeds expected from the disposal of its businesses earmarked for sale from its current market capitalisation, investors are effectively buying the remaining high-quality capital-light businesses at a very undemanding price-earnings ratio (P/E) of 8X compared to the Capped SWIX P/E of 11X.

With excellent growth prospects and a very attractive valuation, Altron should be able to deliver its shareholders an above-market performance over the medium term, making Altron a counter well worth holding onto. ■

Rahgib joined Prudential as an equity analyst in July 2020, and is responsible for select coverage of the Listed Property sector. Prior to joining Prudential, Rahgib completed his) articles at PwC before taking up a position at Kagiso Asset Managers as an equity and property analyst. He currently has five years of industry experience. Rahgib holds an Honours Degree in Business Science and Accounting from UCT, a Post-Graduate Diploma in Accounting, and is also a qualified Chartered Accountant and CFA charterholder.

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Investing with safety in mind

Lebona Khabo
RETAIL LEGAL AND COMPLIANCE MANAGER

KEY TAKE-AWAYS

- *Personal data is becoming more valuable, and is under threat from increasing leaks, hacks and misuse. The Protection of Personal Information Act (POPIA) came into effect on 1 July 2021 with the goal of ensuring every individual's personal information stays safe.*
- *Companies using personal data have had to improve their security through new IT systems and processes, staff training and awareness, and other measures. For example, Prudential introduced password-protected client communications from 18 June.*
- *Companies have also set up mechanisms to deal with security breaches, complaints and rectification, and individuals can lodge complaints with the Information Regulator.*

The value of data to a business is immeasurable. It is used in the day-to-day functioning of the business, in the development of processes to provide exceptional service and products to its clients, and as a tool to measure success. Data is a very broad term that encompasses a business' proprietary information as well as the personal information of its clients. It is this latter set of data that has become increasingly topical and in need of specific protection by the law, given the proliferation of its use in unintended ways and the increase in hacking and data breaches.

Arguably, your personal information is of greater value to you than anyone else. Should that information land in the wrong hands the consequences thereof are potentially dire, and may lead to great harm and loss. It is on this basis that several countries, including South Africa, have pushed for greater protection of client information by any party that possesses that information. Globally, changes to data protection laws have developed gradually, for example the European Union (EU) enacted the General Data Protection Rules (GDPR) in 2016, which came into effect in 2018 -- but many countries have yet to enact any specific data protection laws.

For the purpose of this article, our focus is the law directly governing the protection of personal information in South Africa, the Protection of Personal Information Act of 2013 (POPIA). Although POPIA was signed into law in 2013, it has undergone a long process of gestation, with the main provisions of POPIA coming into effect only recently, on 1 July 2021. As a South African company, Prudential must comply with POPIA to ensure that our clients' personal information is always protected and processed lawfully.

Just what is POPIA?

As the name indicates, POPIA is the primary law in South Africa responsible for ensuring the protection of personal information of natural and juristic persons (e.g. companies). This is a significant difference with the EU's GDPR, a which only protects the personal information of natural persons. The Constitution of South Africa provides all with the right to privacy, and POPIA is one of the tools that gives practical application and teeth to this general constitutional right. POPIA governs any processing of your personal information in South Africa and imposes certain minimum requirements for this processing.

Personal information is defined broadly in POPIA, but in short refers to any information that can identify you or is capable of identifying you. By personal information we do not mean general, statistical, aggregated or anonymous information, or other derivative data that does not, alone or with other data, identify a specific individual or person. Rather, examples of personal information include names, ID numbers, banking details, nationality and financial information. Another important term to understand is "processing", which is also very broad and includes anything done to personal information such as collection, storage, retention, distribution and deletion of personal information.

In most cases clients provide their personal information to companies voluntarily for the provision of services or products. In the context of Prudential, as a client you would provide us with your personal information to ensure that we open an account in your name, administer the account, manage the assets you have entrusted to us, communicate with you, and collect and pay money to you.

Prudential is what is referred to as a "Responsible Party" under POPIA, which simply means we create the rules for the collection and usage of client information. In terms of POPIA, these rules are legitimate when we have a legal obligation or business need to ensure you are provided with services. However, it further and more importantly states that we are bound to use the information only for the purposes it was collected for and, where applicable, dispose of it when it is no longer required. This means that we may not provide your information to any unauthorised person without your consent, but instead ensure we have measures in place to guard against this, and consistently and diligently ensure that the processing of your information is in line with the provisions of POPIA and other applicable laws.

How do we protect your personal information?

There have been numerous cases of breaches of client data both globally and locally, and POPIA is meant to create obligations on all Responsible Parties to ensure that they have: 1) both operational and technical safeguards and measures to proactively guard against any breaches; 2) mechanisms for how to deal with breaches; and 3) an avenue for any person that has had their rights under POPIA infringed to request rectification or lodge a complaint. The body responsible for ensuring compliance with POPIA is the Information Regulator, and it has put in place measures to deal with any non-compliance by Responsible Parties and, more importantly, is open to the public to lodge complaints.

Despite the main provisions of POPIA only coming into effect recently, this does not mean that Prudential has previously taken these fundamental rights to privacy lightly. It has always been a cornerstone of how we conduct business to ensure that a high level of trust is maintained between ourselves, our clients, their intermediaries and our employees. This includes ensuring that our information technology systems are on par with best international standards and regularly tested; that our staff is adequately trained on an ongoing basis; that we have appropriate agreements with all our service providers so that they too are kept to this standard (because we are ultimately responsible for ensuring the protection and confidentiality of client information); and that we at all times keep an open avenue of communication with our clients.

Since POPIA is a new law, there is little to use as a yardstick or case law to assist with its interpretation and implementation. While this will inevitably lead to teething problems, we are confident that we have put the right measures in place to ultimately protect those that have entrusted us with their investments, and we will adapt accordingly as we receive further guidance.

Despite this being new terrain, the basic principles of privacy and confidentiality have always been a part of our business, and we have endeavored to ensure any changes that we make do not adversely affect how you interact with us. Where possible we have tried not to affect the client experience onerously.

Among the more noticeable changes we have already implemented, for example, you may have seen that from 18 June we added more security measures and encryption to all our email correspondence that contains information relating to your Prudential investments, including your investment statements and tax certificates. Your emails are therefore now password protected.

Aside from the communications that we are required to send to you (such as statements and product updates), we will also continue to provide you with articles and webinar invitations to better understand our business and investment philosophy, our products and any changes to them, and the often-turbulent environment in which we operate. This includes sharing market, economic and product information and any events and competitions we may be running. Your ability to opt out of these communications remains, and we will ensure that the process is clear and hassle-free.

Prudential is supportive of this legislation and any legislation that has client interests at its center. We will continue to treat your information with the utmost care, and endeavour to communicate only that information that we are obliged to send, or that we believe is useful and of value. We will also continue to engage you to ensure that our services are suitable and of a high standard. As always, we value any suggestions you may have to better improve our services and only provide you with the information you need and wish to have. ■

Lebona joined Prudential in January 2021 as Retail Legal and Compliance Manager. He provides legal advice to the business, focusing on the retail market and distribution channels. He is also involved in product development oversight, implementing new legislation, and training and development. His areas of expertise include POPIA, FAIS, CISCA, the Pension Funds Act and the Insurance Act. With 5 years of industry experience, Lebona previously worked at another large investment manager as a retail legal adviser. He completed his articles of clerkship in 2014 and was admitted as an attorney by the Western Cape High Court in 2014. His qualifications include: LLB (UCT), LLM (UCT), PGDip Financial Planning (USB).

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For love of the game: (Re)Thinking Sustainability

Aadil Omar
HEAD OF EQUITY RESEARCH

KEY TAKE-AWAYS

- *People naturally opt for sustainable choices when that choice is iterated over time: their intuitive decisions are based on rewards in relation to how sustainable an activity is. Short-termism usually has sub-optimal results.*
- *The spirit of sustainability is akin to an infinite game, where there are no winners or losers, only ongoing interaction that benefits all sides. This is opposed to a finite game which has rules, and participants have a short-term win/lose mindset.*
- *If people approach sustainability with the aim of winning, there is an incentive to cheat. This can lead to serious harm, as in the VW "Dieselgate" scandal. Short-termism and self-interest trumped sustainability.*
- *The flood of money into "sustainable" investments now gives people an incentive to cheat by "greenwashing" or hyping their funds, exacerbated by the complexity of measuring sustainability. Investors need to be aware of this risk.*

Hear the word "sustainability" and you are likely to imagine the whirring blades of a windmill out at sea or the glint of photovoltaic solar panels as they shimmer in the mid-day sun. Keep your eyes closed a little longer and you dream of futuristic cities adorned with water-efficient vertical gardens, teeming with electric vehicles like bees through a hive.

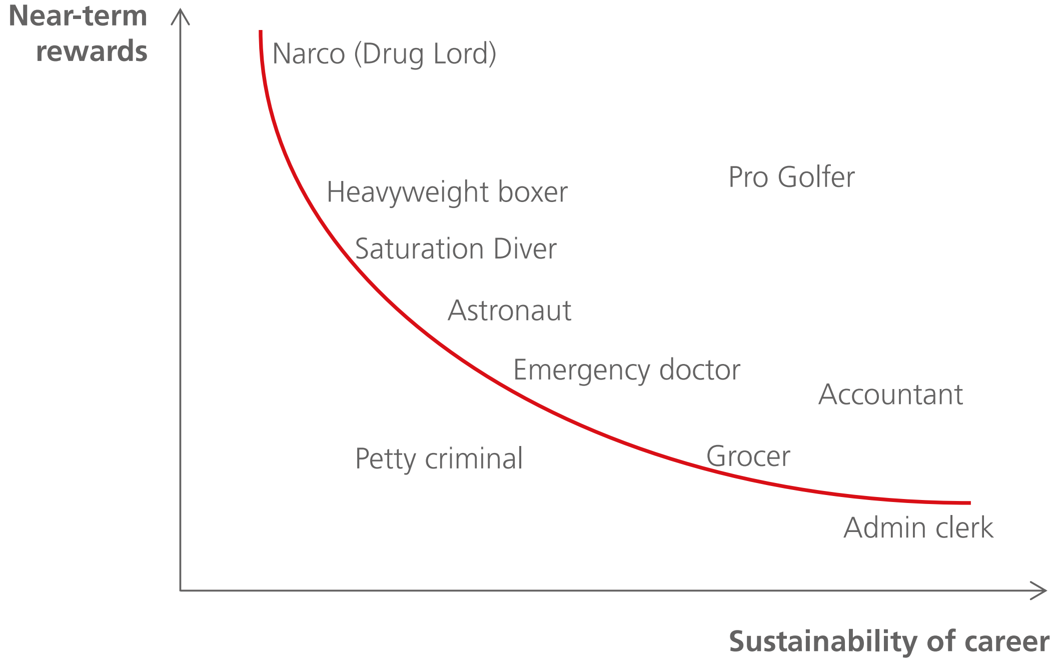
Sustainability, as a concept, has become synonymous with visions of the future and is a natural bedfellow of acronyms such as ESG (Environmental, Social and Governance) and UNFCCC (United Nations Framework Convention on Climate Change). To be clear, these are positive associations, and I support the agenda and goals articulated by the agencies championing these causes. But this is not an article about frameworks or fund characteristics – rather, I am hoping to dive a little deeper into the spirit of sustainability.

Sustainability is intuitive when we're not thinking about it

The characteristic of sustainability can be broadly defined as the ability to maintain at a certain rate over time. As far as the practicalities of life are concerned, people easily grasp the concept of sustainability. We make intuitive decisions based on rewards in relation to how sustainable an activity is.

Take career choice as an example: most people would appreciate that while it can be financially (or socially) lucrative to pursue a career as a drug lord, the longevity of such a career would fall short of a less lucrative choice – a plumber, for instance. A self-interested economic agent (also known as an econ) would weigh the benefits accrued in a particular choice against the length of time one is able to carry out the activity. With a few notable exceptions, sustainability should be negatively correlated to short-term gratification, as illustrated in Graph 1. More generally, we can understand that the less threatening a job is, be it exposure to harm or requiring specific attributes, the more sustainable it should be.

Graph 1: The higher a career's short-term reward, the lower its sustainability



SOURCE: Prudential Investment Managers

For readers interested in trivia

The question of career sustainability really hit home recently when I learned of a fascinating way of earning a living – a task known as saturation diving. Saturation diving is one of the most demanding, dangerous, and well-paid commercial jobs that exists today. A diver breathing pressurised gas accumulates dissolved nitrogen in their body tissues. If allowed to come out of solution too quickly, they could suffer decompression sickness. Saturation diving is a technique developed to overcome the loss of time involved in decompressing the human body when surfacing from the depths of the blue. It involves divers living in a pressurized environment (chambers) for up to 28 days while on tour of duty. The risks of such a job are obvious to someone with even partial familiarity of deep-water diving. But for readers interested in understanding why such a job probably won't make the list of sustainable careers, have a look into the Byford Dolphin Accident[1] , a gruesome but fascinating incident if ever there was one.

Infinite games

James Carse introduced the differentiation between finite and infinite games with his widely influential title "Finite and Infinite Games", first published in 1986.

"There are at least two kinds of games. One could be called finite, the other infinite. A finite game is played for the purpose of winning, an infinite game for the purpose of continuing the play"[2].

Finite games are played for the purpose of winning. They are played by participants who obey rules, recognise boundaries, get judged and announce winners. Finite games can be hacked, the rules bent (or broken) and they can be tactfully gamed. They are theatrical, necessitate an audience and require judgement.

An infinite game exists for the purpose of continuing play. There is no rule book – the strategies employed in infinite games are geared to keeping the game alive, not beating an opponent. Infinite games are not trying to outrun the march of time, but rather to exist beyond the scope of time-bound objectives.

An example of the two in the same domain would be the finite game of a debate versus the infinite game of a conversation. In a debate each side tries to undo the argument structure of the other with the objective of being announced the winner (either explicitly in contest or through public opinion). A friendly conversation, on the other hand, is an infinite game engaged in by participants who have no agenda beyond the utility of conversation. There is no judges panel to award points for credible arguments, nor is there a social benefit for the party who speaks more (or less). The objective is self-contained. In the words of novelist Michael Shaara, it is done "for love of the game".

Liar, liar

By now we can probably see the golden thread of sustainability as the essence of an infinite game. When we approach

[1]The Byford Dolphin accident, serving as a stark reminder of the dangers of saturation diving, involved the loss of four divers' lives and resulted in the formation of the North Sea Divers Alliance, created by the relatives of the victims.
[2]Carse, James. Finite and Infinite Games (p. 3). Free Press. Kindle Edition.

an activity without an agenda, we abandon the win/lose mindset, and the activity stands unburdened. I've always been intrigued by the vocabulary used to describe the labour of vocational activities such as those of a medical doctor – we say a doctor practises his craft, as opposed to completing a job. The subtlety is suggestive of an infinite game – perhaps because tending to the ill will never be complete.

The sting in the tail for this analogy of finite versus infinite games lies in the strategy employed by participants. More particularly, when people approach what should be an infinite game with a finite game mindset, the consequences can range from mildly annoying to existentially risky. I am sure you've had the unfortunate experience of attempting a casual conversation with some nit-picker, only to have them silently keep score by correcting your grammar, pointing out your unsubstantiated generalisations and accusing you of poorly constructing arguments. The next conversation will surely be confined to talking about the weather if you're unable to avoid them.

Greater consequences, however, arise when people try to defeat the common and professional decencies required for a well-functioning society. Two of the more recent high-profile situations come to mind:

- The Volkswagen emissions scandal: Also known as Dieselgate, the incident involved deliberate actions on the part of the VW group to misdirect regulatory authorities as to the noxious emissions of diesel-powered vehicles. VW intentionally programmed diesel engines to activate their emissions controls during laboratory testing using what is known as a defeat device. The diesel-powered vehicles emitted up to 40 times more nitrous oxide in real-world driving as compared to lab tests.
- The Wells Fargo account fraud scandal: This was a controversy brought about by the creation of millions of fraudulent banking accounts on behalf of Wells Fargo clients without their consent (or knowledge). Under pressure from supervisors, Wells Fargo employees would open accounts without customer consent in an effort to meet sales targets.

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These accounts and countless others (many of which we will never hear about) illustrate the harm caused when short-termism and self-interest trump real sustainability. We often resort to moral judgements and character restorations as a way out of the quagmire, but these have limited effect. Understanding what game is being played, and why there might be an opportunity for people to cheat, may be a better starting point in reconciling the dilemma.

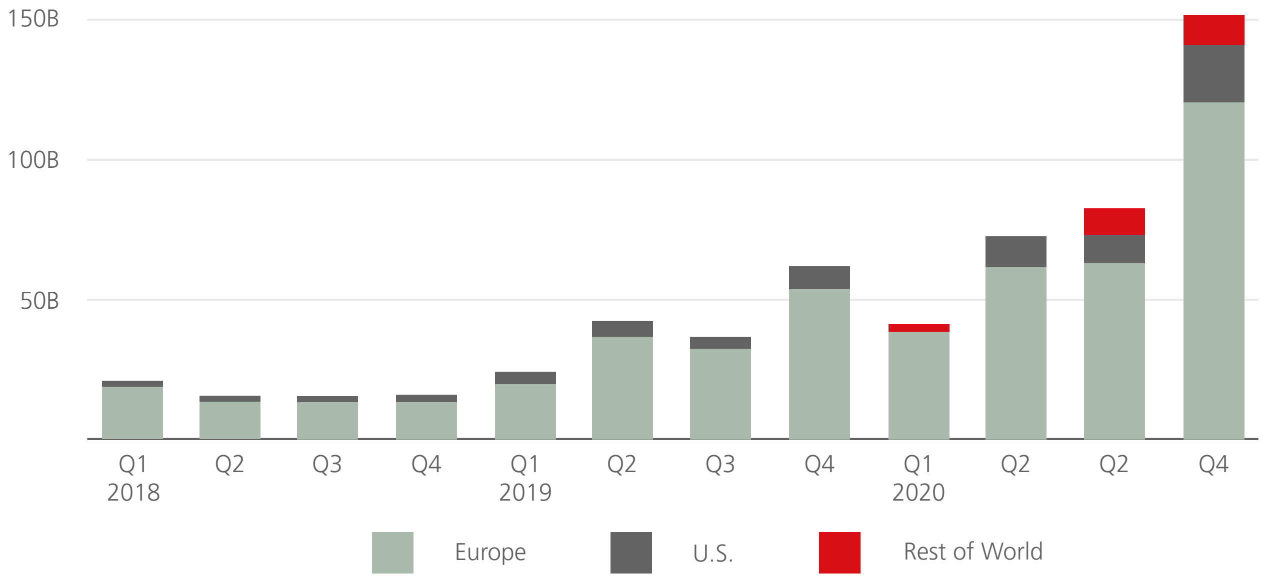
We respond to incentives

"Show me the incentive and I'll show you the outcome" - Charlie Munger

Graph 2 below clearly illustrates the flood of global capital that has been drawn into funds that invest with a mandate of sustainability. These significant flows into ESG and related products have been a strong motivator for market participants to get the accolades necessary to participate in the windfall.

Graph 2: Sustainable fund flows surge past US$150 billion

Flows into sustainable funds over time, US$ billions



SOURCE: Morningstar

The desired outcomes and ultimate goals intended by the agents and agencies championing the sustainable agenda is not in question. Rather, the risk lies in the accreditation and categorisation of these investments. Given the detail and nuance involved in cataloguing thousands of products, accreditation agencies have no choice but to rely on checklists, logic rules and yes/no decisions. In so doing, we must accept that the risk of greenwashing – the process of creating an impression, even if false, of a product's environmental friendliness – and other methods of gaming the system are real. As capital providers and custodians, we may feel that the real responsibility of sustainability is a step removed from our activities, but this does not nullify the responsibility that lies squarely before us. Perhaps there is merit to re-fitting the lens through which we perceive the problem.

I want it all, and I want it now

I will conclude this article by striking one more anecdote that should be close to home for readers based on the African continent. The last two northern square-lipped rhinos on earth, Najin and Fatu, live in a 700-acre, 24-hour armed enclosure in Kenya. The mother and daughter pair represent the only hope for this species' continued existence as scientists grapple with the ethical dilemma of artificial propagation. Even if we resolve to restore these majestic creatures on the African savannah, it may already be too late from a biological perspective.

Najin and Fatu stand as physical mascots for the relentless attack many species have been suffering as human activities demand ever-more of nature. Wildlife populations have plummeted by more than two-thirds in the last 50 years, according to a recent report by the World Wildlife Fund.

These stories are usually told from the perspective of nature's fight for survival, but in so doing we succumb to the myopic view. We should not view our relationship with nature as a win/lose game where one side is sacrificed for the benefit of the other. Our sustainability is incontestably dependent on our environment. Ecological and social destruction has a tipping point beyond which there is no return. We should remember the farmer from Aesop's fables who wanted it all, before we lop off the head of our goose laying golden eggs.

There are no easy answers, but love is a good starting point

The questions, associated debates, missives and compromises related to sustainability are far too complex and nuanced to address in a few paragraphs. But I invite you, dear reader, to consider the usefulness of the infinite game as a framework to aid in unravelling some of these complexities. When you boil it down, sustainability is more akin to matters of the heart and is best served when you love the game. Sustainability is not something "won", but something that prevails over time. ■

With 15 years' investment experience, Aadil joined Prudential in July 2013 as an Equity Analyst. In August 2018 he joined a global equity hedge fund in London, before returning to Prudential in January 2020 as Head of Equity Research and joint-Portfolio Manager of the Prudential SA Equity Fund. He holds a BCom degree (Hons, cum laude) from the University of Pretoria and a Masters in Finance degree from INSEAD. He is also a CFA charterholder.

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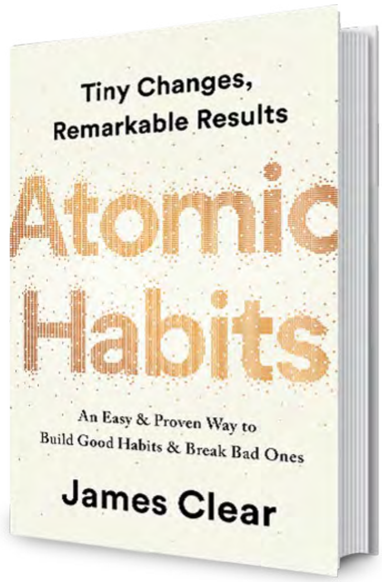
Atomic Habits - Why all your small decisions do matter

Miranda Van Rensburg
Regional Sales Manager

At Prudential, we aim to build up small, positive returns continually over time, while also avoiding large losses, in order to deliver strong outperformance to our clients. This consistent effort has paid off, resulting in our equity funds achieving top-quartile returns over many different periods, for example. This same approach of aggregating the positive and limiting the negative can be applied in daily life, too, in order to stay happy and healthy. In the book "Atomic Habits", James Clear suggests that real-life change also comes from the compound effect of hundreds of small decisions. He calls them Atomic Habits.

What makes this book different is that rather than focusing on the individual's measure of willpower, the author argues that breaking bad habits and building good ones result from having the right systems in place. He explains that motivation is often overrated, and that the environments we create for ourselves often matter more when trying to create good habits. "Disciplined" people who appear to have a lot of self-control are often just those who have structured their environment right so that they don't need heroic willpower to overcome tempting situations. It is therefore best to be the designer of your own world and not just the consumer of it.



Instead of focusing on what we want to achieve, the book calls for a focus on who we want to become. Incentives start a habit; identity sustains a habit. The book teaches us to become the best versions of ourselves.

The author describes four laws of behavioral change which can help us build better habits. He also provides practical, real-life examples of how better habits can be instilled. Clear calls on examples such as troops returning from Vietnam with heroin addictions, as well as well-known individuals such as the comedian Steve Martin in his quest for better habits.

In making sense of habits, the book also delves into what motivates human behavior. The human brain associates specific habits with specific contexts. Habits thrive under predictable circumstances. We also tend to adopt habits that are approved by our society because humans have a strong need to fit in and belong to the tribe. The costs of good habits are in the present, while the costs of bad habits are in the future. It's all about delayed versus instant gratification, which relates to our ancient brain.

Clear professes that many habits occur at a decisive moment that then sets you up for a productive day or an unproductive one. He refers to gateway habits – small steps that influence the big steps thereafter. You can only run a marathon if you start with putting on your running shoes, for example.

One can cut out bad habits through increasing the odds that you will do the right thing in future by making the bad habit difficult in the present. An example of this is when gamblers voluntarily add themselves to the banned list at a casino to prevent future gambling sprees. Good habits should be made easy (putting your running clothes out the night before) and bad habits difficult. This is where technology comes in as a useful tool, through for instance limiting your own social media browsing with a website blocker, or setting up a debit order to enforce your saving habit.

The author then focuses on habit tracking, which forces you not to break the chain and to make it obvious what your progress is, such as setting up a reward for every time you pass up on a cappuccino. Humans like seeing their own visible progress.

In the final section of the book, Clear focuses on how habits relate to genes and personality types, since habits are easier to form if they align with your personality and skills. The Goldilocks Rule and how that relates to habits is also introduced (i.e. working on challenges of just manageable difficulty). The difference between great athletes and everyone else often just boils down to who can handle the boredom of training every day, doing the same drills over and over. Habit formation is therefore not about how long it takes to establish, but about how many repetitions it takes. For Clear, habits are the backbone of any pursuit of excellence.

The book concludes that small, positive habits don't simply add up – they compound. The words of the famous investor Charlie Munger are therefore very apt: "The first rule of compounding: never interrupt it unnecessarily". ■

Miranda joined Prudential in January 2016 as Regional Sales Manager. She is currently responsible for the management of retail distribution in the Gauteng region. With more than 20 years' industry experience, Miranda has served in a range of roles including: business development, manager research, portfolio management and asset consulting to large pension funds. She holds an MSc (Engineering) degree and is a CFA Charterholder.

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