



**QUARTERLY INVESTOR COMMENTARY
31 MARCH 2016**

CONTRARIUS GLOBAL EQUITY FUND

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The Fund aims to earn a higher Total Rate of Return than the average of the world's equity markets, as represented by the MSCI World Index, including the reinvestment of dividends net of withholding tax ("World Index"). It aims to achieve this without greater risk of loss, over the long-term. The Fund is an actively managed fund, and as such does not in any way seek to replicate its benchmark index, but may instead differ materially from the performance benchmark in order to achieve its objective.

CONTRARIUS GLOBAL EQUITY FUND AT 31 MARCH 2016

Total Rate of Return in US Dollars	Class	Since Inception on 1 Jan 2009	Latest 5 Years % Annualised	Latest 3 Years	Latest 1 Year % Not Annualised	Latest Quarter
Contrarius Global Equity	Investor	18.1	8.0	7.6	(3.9)	16.8
Contrarius Global Equity	Institutional	18.6	8.5	8.0	(3.5)	16.9
World Index		10.7	6.5	6.8	(3.5)	(0.3)

Past performance is not a reliable indicator of future results.

The Fund's Investor Class shares returned 16.8% for the quarter versus (0.3)% for the benchmark MSCI World Index, including reinvested net income. As we have highlighted previously, our investment philosophy is not benchmark cognisant and our portfolios would normally vary materially from the benchmark World Index. The Fund's returns are therefore likely to deviate from those of the benchmark. Investors are reminded that given the long-term, contrarian, valuation-based investment philosophy, there will be times when the Fund will materially underperform its benchmark in the short-term in order to achieve its objective of long-term outperformance.

The Fund remains overweight Materials and Technology stocks. Our bottom-up analysis of individual stocks has also uncovered further attractive opportunities among selected Energy stocks where we are also overweight. In terms of geographic exposure, the Fund continues to be significantly underweight European equities and overweight shares outside the major developed markets.

Sector Exposure 31 March 2016	Weighting (%)		Over/(Under) Weight
	Fund	World Index ¹	
Energy	15	6	8
Materials	34	5	30
Industrials	1	11	(10)
Consumer Discretionary	15	13	1
Consumer Staples	2	11	(9)
Health Care	2	13	(10)
Financials	7	20	(13)
Information Technology	24	14	10
Telecommunication Services	0	4	(4)
Utilities	0	3	(3)
Total Shares	99	100	
Net Current Assets	1	-	
Net Assets	100	100	

¹ Source: MSCI (attention is drawn to MSCI disclaimer in 'Notices')

Geographic Exposure 31 March 2016	Weighting (%)		Over/(Under) Weight
	Fund	World Index ¹	
North America	57	63	(6)
Europe	6	24	(19)
Japan	3	8	(5)
Asia ex-Japan	11	2	10
Other	22	3	19
Total Shares	99	100	
Net Current Assets	1	-	
Net Assets	100	100	

¹ Source: MSCI (attention is drawn to MSCI disclaimer in 'Notices')

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Contrarius Investment Management
Limited

SUB-INVESTMENT MANAGER
Contrarius Investment Management
(Bermuda) Limited

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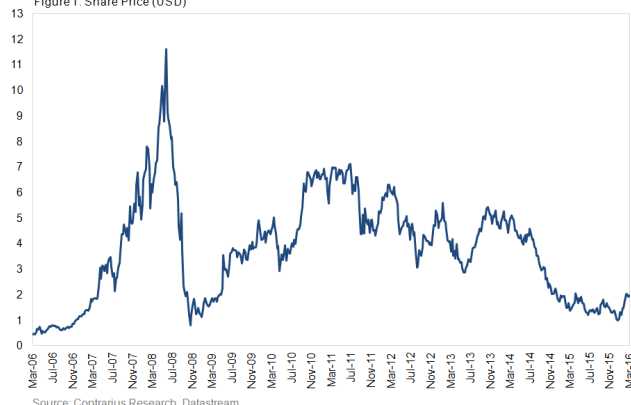
While the majority of the Fund's Materials holdings continue to be in precious metals related stocks (gold and platinum group metals), we have also found attractive investment opportunities in other selected commodity stocks. Fortescue Metals Group, an iron ore producer in Australia, is one such stock.

FORTESCUE METALS GROUP

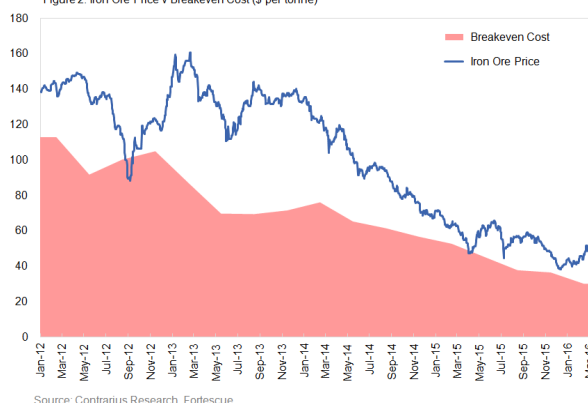
The iron ore industry is in terrible shape. A few years ago miners were struggling to satisfy booming demand from China, which sucked in more than 60% of seaborne trade. Prices started climbing from under \$20/tonne in 2003 and the extremely profitable miners invested in new projects. The iron ore rally burned out when, in 2011, it passed \$190/tonne. By the end of 2015 iron ore sold for just \$44/tonne. With China's economy slowing, and still more supply starting up, the future looks grim for the average iron ore miner.

We are bottom-up stock pickers and Fortescue Metals Group, the Fund's 4th biggest position, is not an average iron ore miner. It is one of four large and low-cost suppliers, together with BHP Billiton, Rio Tinto, and Vale. All of its operations are in Australia and more than 90% of production lands in China. Since the price of its product has fallen more than 70%, and it carries about \$6bn of net debt, it shouldn't be surprising that its shares have fallen nearly 70% (Figure 1); shares of the other three have dropped between 50% and 85%. Yet Fortescue generates a lot of cash. From July to December 2015, with an average iron ore price of \$51/tonne, it generated adjusted free cash flow of more than \$600mn on revenue of \$3,344mn in only half a year (the market cap is just \$6bn). It is unusual for a miner to be so profitable under such conditions. To see how this is possible, look at its unit costs (Figure 2). (Note that the breakeven cost accounts for both interest and the quality adjustment to make up for Fortescue's ore being lower-grade than the benchmark.)

Fortescue Metals Group
Figure 1: Share Price (USD)



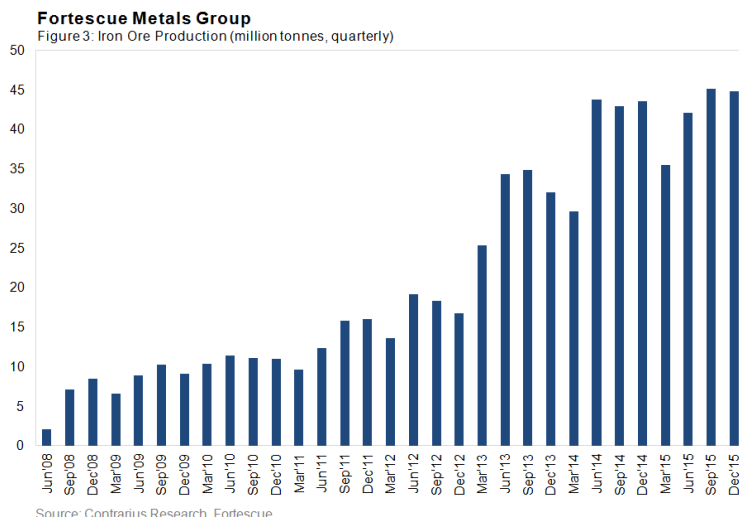
Fortescue Metals Group
Figure 2: Iron Ore Price v Breakeven Cost (\$ per tonne)



Fortescue's breakeven costs fell 73% from March 2012 until March 2016. This may be hard to believe until you consider three things that happened at the same time:

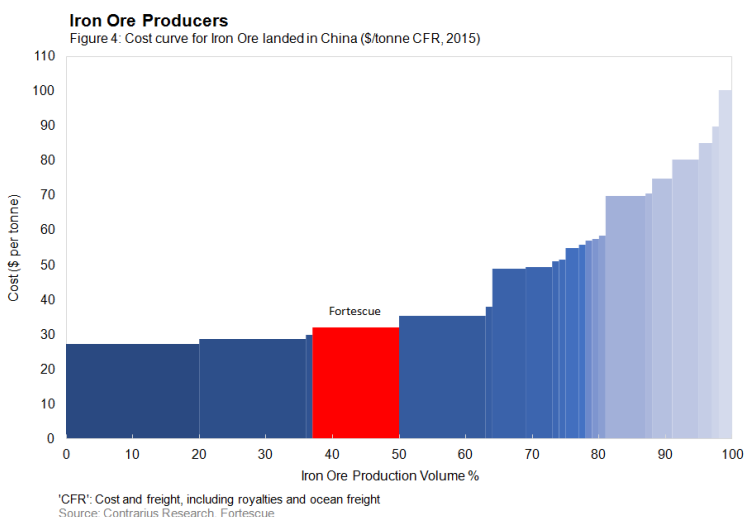
- The prices of other inputs, like oil and freight, also fell dramatically over the same period;
- Fortescue's local costs are in Australian dollars and the currency weakened about 26% against the US dollar, in which the global market for iron ore is priced;
- Production soared from an annualised rate of 58mn tonnes to 168mn tonnes as its operations ramped up (Figure 3), with sizeable fixed costs being spread over nearly triple the volume.

We estimate Fortescue's quarter-end breakeven cost to be \$30/tonne.



Commodity prices don't lurch around randomly with minds of their own (although it often seems like they do). An introductory economics class will probably cover the impact of competition on price. In a competitive market, producers will try to undercut each other in order to win more business. They keep on going until they are making only just enough profit to satisfy their investors. An investor looking into the iron ore market might see that the four big miners are very profitable and conclude that the iron ore price still has a way to fall: it is not over until miners are making only just enough profit.

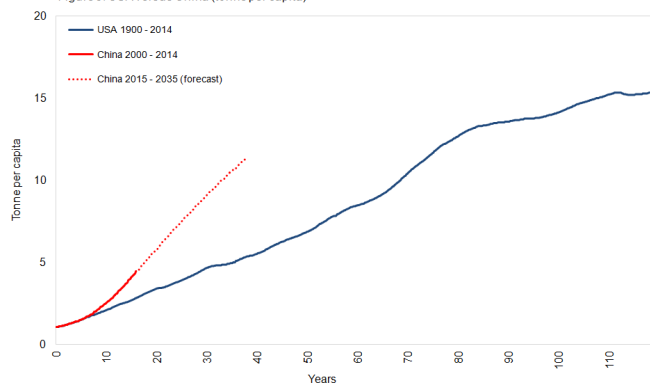
But the economics class will probably also cover supply and demand. Normally when prices are high consumers want less and manufacturers produce more; when prices are low consumers want more and manufacturers produce less. If you plot these price responses out on a chart, you can find the point where they intersect. This is the "market-clearing" price: that is, the price at which there is the best match between producers and consumers. The big four iron ore producers account for only about 60% of China's consumption. Even if they are very profitable you still need the other 40% in order to clear the market. But the cost curve of iron ore delivered to China is steep and that 40% is probably, overall, deeply loss making at current prices (Figure 4).



Some investors may counter that, as mentioned at the start, the Chinese economy is softening while supply continues increasing. That is true but misses some important details. In prior reports we have discussed how commodity cycles are, in part, caused by multi-year delays between making and implementing project decisions (see Q1 2015). From the time a new project is approved, it takes a number of years before it can deliver any ore. Recent new supply is the result of decisions made when iron ore prices were high. It is unlikely that major new projects are being approved now. Instead, we see more and more evidence of miners declaring bankruptcy, mines being shut, and projects being abandoned or delayed. The tail of new supply amounts to about 50mn tonnes each year for the next three years in the contestable seaborne market. This is significant compared to the 2015 Chinese iron ore market of about 1,200mn tonnes, but it does not compensate for the amount of supply that is estimated to be loss-making.

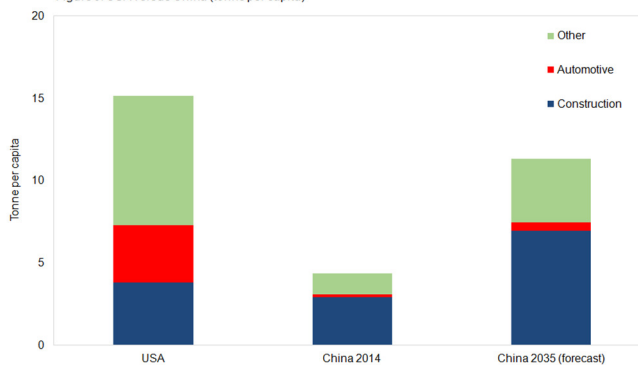
Also, Chinese economic growth may be slowing but it is probably not stopping. China is still in the early stages of development. In terms of per capita installed steel stock (cumulative steel in use), it is well behind the US, as well as regional peers like Japan, Korea, Taiwan, Hong Kong, and Singapore. Figures 5 and 6 show just how far China has to go (relative to the US): it has about 5 installed tonnes per person compared to the US's 15. India, which has a similar population to China but uses a fraction of the steel per capita, is potentially a fertile source of future demand. At current rates of production, Fortescue has around 14 years of reserves plus a further 18 years of resources. These are near the existing sites, meaning that there should be little need for further costly infrastructure. Also, transporting iron ore is expensive, giving Australian miners a geographic advantage when supplying East Asia. So Fortescue is well placed to be one of the main beneficiaries of future long-term demand.

Steel stock-in-use per capita
Figure 5: USA versus China (tonne per capita)



Source: Contrarius Research, Fortescue

Steel stock by sector
Figure 6: USA versus China (tonne per capita)



Source: Contrarius Research, Fortescue

Some analysts contend that Chinese steel demand has to fall because, when compared to the US, steel consumption relative to GDP is so high. But it is misleading to look at consumption-based metrics. When an immature economy grows rapidly, steel intensity is high. Urbanisation and vigorous domestic consumption and trade growth need a lot of investment in buildings and infrastructure. When an economy matures, the rate of urbanisation drops and domestic consumption and trade stabilise. Steel intensity falls. Infrastructure is long lasting and a country like the US has already built most of what it needs, and much of its demand is fulfilled by recycling scrap. But China still has to get steel into the ground and, because the infrastructure is on average quite young, does not generate the same level of scrap. Moreover, looking at the steepness of the curves in Figure 5, it seems that China is building out much faster than the US ever did.

In the short term, the iron ore price could do anything, including fall a lot. But we think that the steep cost curve will, in the long term, keep the market-clearing price well above Fortescue's costs. This may be little comfort to investors who worry that the market could stay weak long enough for Fortescue's debt to be a problem. But the company has a few layers of defence.

- The quarter-end price of iron ore delivered to China is about \$54/tonne and we estimate Fortescue's current breakeven costs to be about \$30/tonne. So the iron ore price would have to fall 44% from here before Fortescue breaks even. To put that in perspective, the iron ore price bottomed at \$38/tonne in December 2015.
- If the iron ore price fell dramatically, the prices of other commodities probably would too. This would bring down Fortescue's costs to some degree.
- Its infrastructure is new and so it can keep maintenance spending low for quite a long time before being under pressure to invest.
- All operations are in Australia: a stable, commodity-driven country. Because of the anticipated impact on Australia's fiscal position, the Australian dollar tends to weaken when commodities weaken. Having some costs in Australian dollars shields Fortescue, to some extent, from weakening iron ore prices.
- At a breakeven price of \$30/tonne for every month that the iron ore price remains at current levels, Fortescue clears about \$250mn that it can use to pay down debt. If the price stays at this level for about another two years, it would have net cash.
- If liquidity nonetheless did become a problem, Fortescue could sell infrastructure to raise cash. The \$18bn invested over the past seven years did not just build a few mines – it also built a railway, rolling stock, and a port. These facilities are young and valuable and, if sold, should comfortably be able to cover outstanding debt.

It seems to us that the market is overstating Fortescue's risks. It is worth noting that the founder and chairman of the board, Andrew Forrest, has an interest in a third of the company, currently worth \$2bn. He has shown extraordinary management aptitude to date and is probably highly motivated to continue to do so.

CONCLUSION

Some investors might still say that the company's estimate of sustaining capex (\$280mn per year) is too low, and that cost curves are unreliable. These are both probably true. But we believe that they miss the big picture: China and India still have a lot more building to do, supply coming online is not enough to compensate for loss-making miners, and the low-cost suppliers do not have nearly enough capacity to satisfy the market. The exact market-clearing price and breakeven cost hardly matter. If the profit gap between them is just \$5/tonne, Fortescue will be on about 10x free cash flow. With so much of the industry losing money, this gap is likely to be a multiple of that—as it currently is.

We believe that we can buy this high-quality, relatively low-risk business for an exceptional price.

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