QUARTERLY INVESTOR COMMENTARY
30 JUNE 2018

CONTRARIUS GLOBAL EQUITY FUND

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 ("MSCI World Index", "Benchmark"). 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 30 JUNE 2018

Total Rate of Return in US Dollars	Class [1]	Since Inception on 1 Jan 2009	Latest 5 Years	Latest 3 Years	Latest 1 Year	2018 Year-to-date	Latest Quarter
		% Annualised			% Not Annualised		
Contrarius Global Equity	**Investor**	**20.3**	**15.1**	**17.9**	**40.9**	**14.7**	**13.9**
MSCI World Index		11.3	9.9	8.5	11.1	0.4	1.7
Average Global Equity Fund		9.3	7.9	6.5	9.1	(0.8)	0.7

Past performance is not a reliable indicator of future results. The Fund's share prices fluctuate and are not guaranteed. Returns may decrease and increase as a result of currency fluctuations. When making an investment in the Fund, an investor's capital is at risk.

[1] *Performance of other fee classes are available on our website.*

The Fund's Investor Class shares returned 13.9% for the quarter versus 1.7% 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. 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 Consumer Discretionary, Energy, and Materials stocks. In terms of geographic exposure, the Fund continues to be overweight shares in North America and shares outside the major developed markets.

Sector Exposure 30 June 2018	Weighting (%) Fund	World Index [1]	Over/(Under) Weight
Energy	22	7	16
Materials	15	5	11
Industrials	0	11	(11)
Consumer Discretionary	39	13	26
Consumer Staples	6	8	(2)
Health Care	1	12	(11)
Financials	1	17	(16)
Real Estate	0	3	(3)
Information Technology	14	19	(4)
Telecommunication Services	0	3	(2)
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 30 June 2018	Weighting (%) Fund	World Index [1]	Over/(Under) Weight
North America	84	64	19
Europe	7	23	(16)
Japan	0	9	(8)
Asia ex-Japan	3	2	2
Other	5	3	2
Total Shares	**99**	**100**	
Net Current Assets	1	-	
Net Assets	**100**	**100**	

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

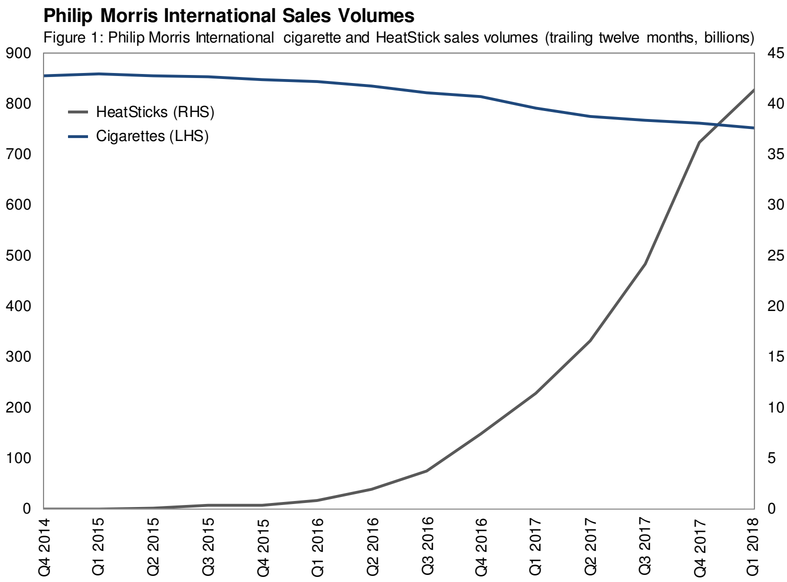
Philip Morris International

Sometime in the first half of the 1800s a German merchant emigrated to England and took the name Bernard Morris. He passed his trading skills to his son, Philip, who opened a "Tobacconist and Importer of Fine Seegars" on Bond Street, London, in 1847. He surely could not imagine the next 170 years of drama bearing his name. In the latest instalment, Philip Morris International (PMI), one of the world's biggest tobacco companies, made a full-page New Year resolution in UK newspapers to quit smoking.

Cigarettes are often considered the quintessential "consumer staple". Profits crept up and up, through wars, reshuffling of the global economic order, regulation, taxation, litigation, and consumer fashions. Even after per-capita consumption started declining in the US 50 years ago, the industry continued its steady beat: tax increases; declines in wealthy countries; growth in poorer countries; price increases all 'round. The product itself has been mostly oblivious to technology: Mr Morris would easily recognise today's cigarettes. The fears that drove PE ratios into single digits during the period of aggressive US litigation in the 2000s, ending in 11-digit settlements, proved unfounded. Cigarette makers have come to be seen as bond-like.

In investing circles, the folly of claiming that "this time is different" is so clichéd that even joking about it is trite. What is a contrarian to do? Here's a taster for why the bond-like era may be over:

Global volumes peaked around 2010-2012 and have been falling steadily since. Japanese cigarette volumes fell 4% in Q4 but PMI's volumes there *grew* 47%. That is thanks to its smokeless "heat not burn" (HNB) iQOS cigarette, which is now the second biggest brand in Japan, and which we expect to outsell PMI's combustibles there during this year. "Reduced-Risk Products" account for 13% of group revenue despite still being market tested. It is by far the most successful tobacco-based smokeless cigarette. Could a cigarette maker actually be a "growth" company?



Source: Philip Morris International

Reduced-Risk Products

Price increases only get you so far, otherwise if US volumes continued falling 5% annually the last pack of cigarettes in the US would fetch about $40 billion around the year 2500. RJ Reynolds invented "heat not burn" in 1989, but the experience was reportedly so poor that even its executives would not use it. The smokeless cigarette category eventually took off with e-cigarettes, which use a nicotine liquid rather than tobacco. US sales of e-cigarettes amounted to $1.7 billion in 2017, and grew 68% in the most recent 12 months (116% in the June 2018 quarter). But e-cigarettes don't taste, smell, look, or feel like the cigarettes that are so ingrained in smokers' habits.

Tobacco burns in air at about 800°C. The higher the temperature of a chemical reaction, the more energy is available to break molecular bonds, leading to more vigorous reactions. The symmetry and reactivity of the carbon atom (as well as hydrogen, oxygen, and nitrogen) that make it the foundation of life also mean that burning organic material produces a kaleidoscope of chemicals. But the nicotine solution in tobacco leaf distils at about 250 °C, long before the leaf burns. Cigarette smoke is roughly 50% water and glycerine, the rest being particulates and thousands of other chemicals. In contrast, vapour from HNBs is about

90% water and glycerine, with negligible particulates and a reduction in toxicants of more than 90%. The vapour also carries aromatic compounds, making it smell and taste like tobacco.

Regulation 1: A Big Ship to Turn

Two regulatory concerns stymy the conversion of smokers to HNBs: (1) the risk that normalising the act of apparently smoking will be a "gateway" for a new generation of smokers; (2) the dearth of clinical data on the long-term health effects for humans. The gateway risk prompted the *World Health Organisation* (WHO) to recommend prohibiting smokeless cigarettes, and at least 27 countries have done so.

Both of these concerns were evident when the advisory panel to the *US Food and Drug Administration* (FDA) recommended rejecting PMI's (more than 2 million page) application to market HNBs as "reduced risk". The panel concluded that PMI:

1. Did not prove that switching to iQOS cuts the risk of humans contracting disease;
2. Did not demonstrate a tangible reduction in harm;
3. Assumed a complete switch, which is unlikely;
4. Did not demonstrate that consumers would accurately understand the risks.

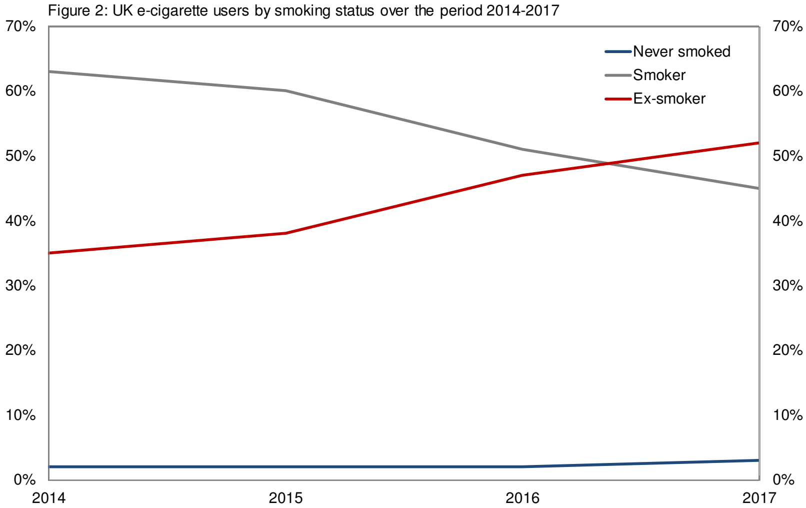
One advisory panel member said: "… it *suggests*, it *implies*… I could not say under oath that what we've seen *demonstrates*". The panel did agree that iQOS lowers exposure to harmful chemicals (indeed, the FDA itself showed this), but wants more data, especially in humans rather than lab animals.

In theory, the FDA wants to embrace "reduced-risk products" (RRPs). The US Tobacco Control Act (2009) explicitly provides a pathway for doing so, and the FDA has said that getting nicotine to people in less harmful ways is a core mission. Speaking of nicotine, the FDA commissioner said: "We must recognise the potential for innovation to lead to less harmful products… the bigger problem is the delivery mechanism".

There's been more activity from other credible regulators, health agencies, and NGOs (including such heavyweights as *Public Health England* (PHE), the UK's *National Institute of Clinical Excellence*, the *US Surgeon General*, and the *Royal College of Physicians*). Between them they have claimed that: there is evidence that RRPs can be a useful tool for reducing consumption or quitting; they are highly likely to be less harmful than cigarettes; they reduce exposure to carcinogens and other dangerous chemicals; the chemical products of combustion cause great harm; there is a spectrum of risk and consumers are poorly informed about the relative hazards; the evidence that e-cigarettes are a route to smoking is lacking; and nicotine alone presents little hazard.

Current E-Cigarette Users

Figure 2: UK e-cigarette users by smoking status over the period 2014-2017



Source: Action on Smoking and Health

The FDA's exacting burden-of-proof may be appropriate for its own purposes. It is the final arbiter (in the US) on the safety of all things ingestible, and is notoriously unforgiving on new drug applications. After all, it has had to withstand decades of potent lobbying, distortion of data, misrepresentation of science, and litigation from the very well-funded industries that it regulates. The history of medicine is littered with lessons for students of statistics about correlation not being causation, and other tricky inference errors. Indeed, the tobacco industry itself once used these techniques to undermine the public health message. The anti-smoking juggernaut built over sixty years is a big ship to turn. But investing is a probabilistic enterprise. We believe that investing always entails uncertainty—if we waited for near-certainty then we would miss every good opportunity. On the data so far, the odds seem to be in PMI's long-term favour.

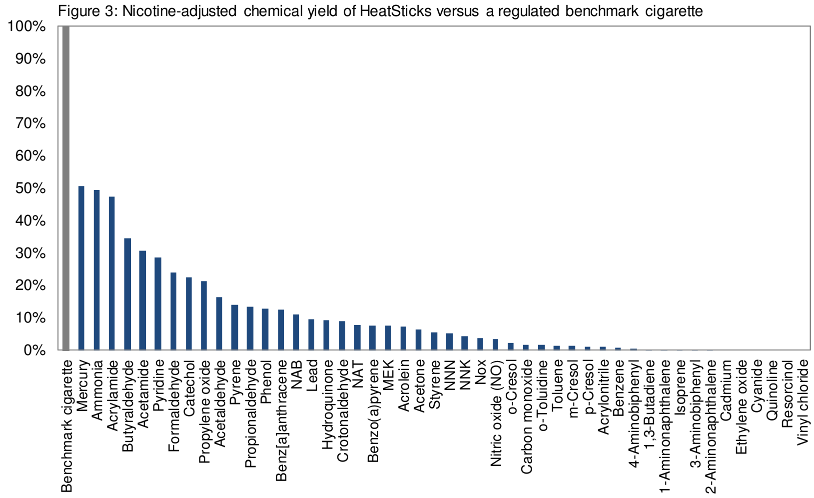
The Evidence So Far

Quitting doesn't just halt a health decline, it actually does much to reverse it. A review by the Cochrane Collaboration (the gold standard of evidence-based medicine) concluded that there is evidence that nicotine e-cigarettes improve the long-term probability of quitting, and that there is no evidence of incremental harm to smokers who use them.

PMI's FDA application for iQOS showed improved indoor air quality (only nicotine and acetaldehyde above baseline levels); a 90% reduction in human cell toxicity, 100% reduction in bacterial mutations, and an 85% reduction in mouse mutations, *in vitro*; reduced lung inflammation, atherosclerosis, and emphysema similar to cessation, *in vivo*; minimal production of solid particulates; many biological markers converging on cessation levels; and nicotine delivery similar to cigarettes (key for smoker acceptance).

Toxicity of HeatSticks

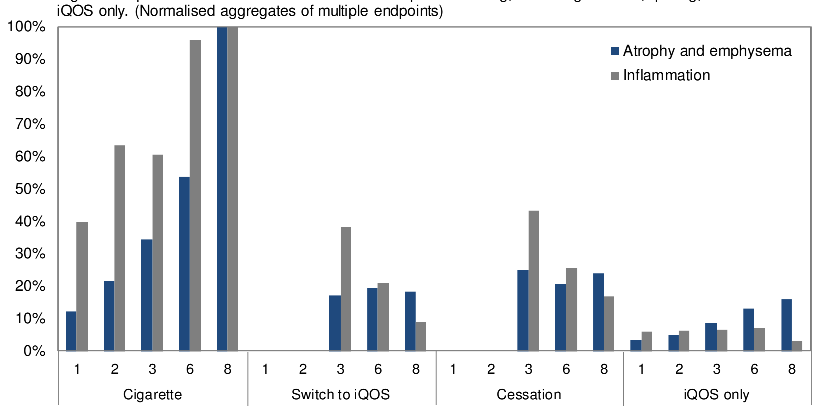
Figure 3: Nicotine-adjusted chemical yield of HeatSticks versus a regulated benchmark cigarette



Sources: US FDA, PMI Research & Development, Contrarius Research

Side-effects Using iQOS Compared To Cigarettes

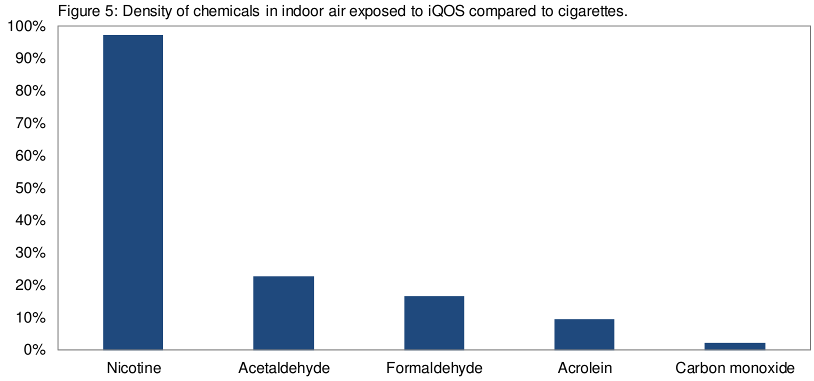
Figure 4: Impairment and inflammation in mice. Compares smoking, switching to iQOS, quitting, and iQOS only. (Normalised aggregates of multiple endpoints)



Sources: *Toxiocological Sciences*, 149(2) 2016, 411-432, Contrarius Research

Indoor Air Quality Compared to Cigarettes

Figure 5: Density of chemicals in indoor air exposed to iQOS compared to cigarettes.



Sources: *Toxicological Sciences*, 149(2), 2016, 411-432, Contrarius Research

Regulation 2: The Ship is Turning!

The real issue seems to be e-cigarettes, whose popularity has rocketed, especially amongst the youth. More e-cigarettes are flavoured as fruit than as tobacco. On the website of JUUL, the industry leader, you can buy crème brulee "pods". The FDA has said it is "extremely concerned", but until recently it could not easily regulate because, according to a ruling based on the Family Smoking Prevention and Tobacco Control Act (2009), e-cigarettes that do not make health claims were outside of its scope.

This seems to be shifting quickly. The *American Academy of Pediatrics* is suing the FDA for delaying regulation, saying that not all alternative nicotine products are equal and "people don't look for cures for diseases by word of mouth". In April and May of this year, the FDA asked the major e-cigarette brands to turn over marketing and research documentation. We believe that tighter control of e-cigarettes is inevitable.

On the other hand, control of HNBs is likely to relax as many concerns resolve themselves. The reservations that smokers would not completely switch ignores the "dose-response relationship" found in almost all pharmacological interventions. The required long-term human clinical data can be generated only by long-term human use. The current consensus seems overwhelmingly to be that HNBs release a fraction of the carcinogens and other toxins, with a corresponding impact on biological disease markers. This is not proof of any clinical outcome, but it does hint at which way the wind is blowing.

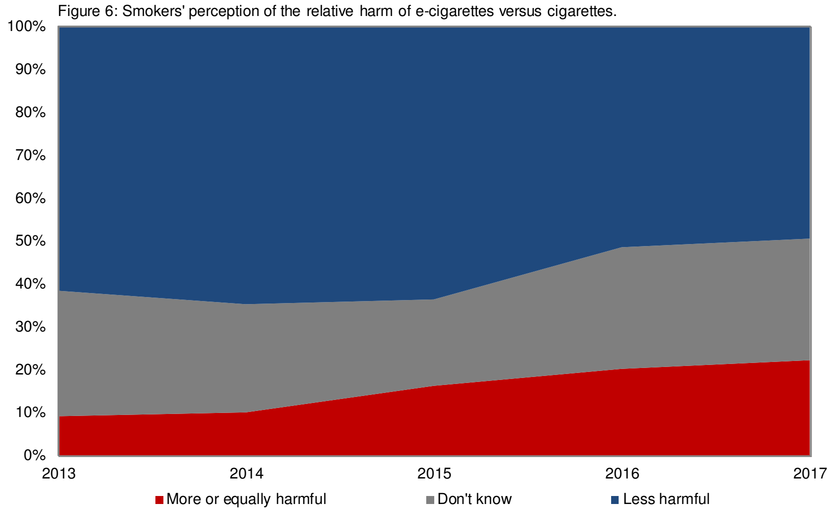
Consumer Sentiment

The anti-smoking drive has largely equated nicotine and smoking. Many people think that smokeless cigarettes are as risky as smoky ones, and the number is actually *increasing*. PHE estimates that fewer than 10% of UK adults understand that most of the harm is not from nicotine, and blames the way studies are conducted and reported for causing unnecessary concern.

The recent FDA advisory presumably did not help. Nonetheless, acceptance of RRPs is gaining momentum, and we expect adoption to grow significantly from here as public awareness improves.

Smokers' Perception Of Harm From E-Cigarettes

Figure 6: Smokers' perception of the relative harm of e-cigarettes versus cigarettes.



Source: Action on Smoking and Health, Contrarius Research

Competitive Position

Nicotine replacement products have mostly failed because the nicotine hit is too small or too slow. E-cigarettes have done better, but are still quite a departure from the smoking ritual, and can have unpleasant "chemical" aftertastes. HNBs go further by retaining the taste and smell of tobacco.

iQOS is a 3-part system: consumable sticks ("heatsticks"), an electronic pen-like holder to heat the tobacco, and a battery pack about the size of a pack of cigarettes to charge the pen. The pen's charge lasts 14 puffs or six minutes. A pack of heatsticks is akin to a pack of cigarettes.

The next generation of HNBs currently being tested, called TEEPS, hews even more closely to the smoking ritual. This is a tobacco "cigarette" but with a carbon tip that, when lit, becomes a glowing ember that heats the tobacco in the stick to sub-combustion temperatures.

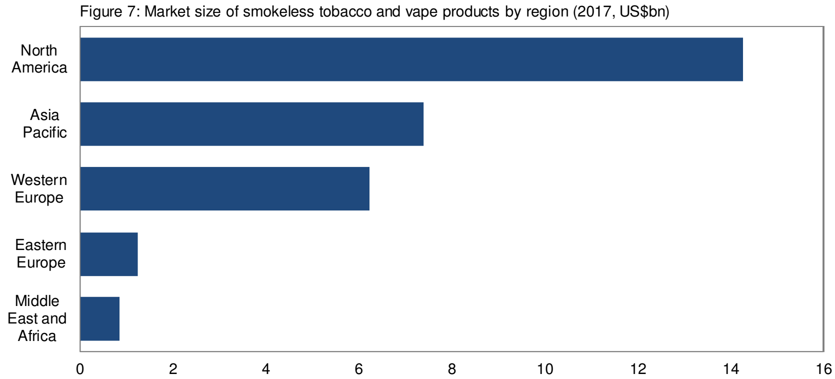
These are highly engineered products. The R&D amounts to billions of USD, and the clinical testing requirements are onerous. Only the most technically astute and well-funded companies are likely to be competitive.

RJR invented HNBs but was not able to capitalise on its early start. British American Tobacco and Japan Tobacco have since launched their own but PMI is the clear leader. And history has shown that in this industry incumbents are hard to unseat.

Despite already being 13% of revenue, RRP's are a tiny portion of the inhaled nicotine market in PMIs territories and it currently gets no revenue from the biggest market, the US. In 2008, Philip Morris Inc. split into a US and a non-US business, Altria and Philip Morris International, respectively, with cross-licensing agreements. PMI has four types of RRP in its stable: the two tobacco platforms (iQOS and TEEPS) are owned by PMI, and there are two non-tobacco platforms owned by Altria. Each company has the right to market the unowned platforms in its territories. Since PMI has no presence in the US, any royalties from the sale of iQOS and TEEPS in the US would be incremental to the current business. It is notable that the US tobacco market is highly concentrated, with Altria's Marlboro brand being close to half of it.

Market Size of Smokeless Tobacco and Vape Products

Figure 7: Market size of smokeless tobacco and vape products by region (2017, US$bn)



Source: Bloomberg

The Economics of RRPs

Taxes are a key tool of tobacco control, and the WHO recommends that they make up at least 70% of the retail price of cigarettes. This is because taxes both discourage smoking and raise funds to offset the public health burden. If HNBs are less harmful, then taxes should be lower for both of those reasons: to encourage switching; and because the public health burden is smaller. The tax wedge leaves ample space to undercut cigarettes at retail and still make considerable profit. On average, PMI prices RRPs 17% below cigarettes at retail. Smokers buy the devices (currently discounted to cost or less) but the tax gap is wide enough that PMI could fully absorb the cost of the device and still be more profitable.

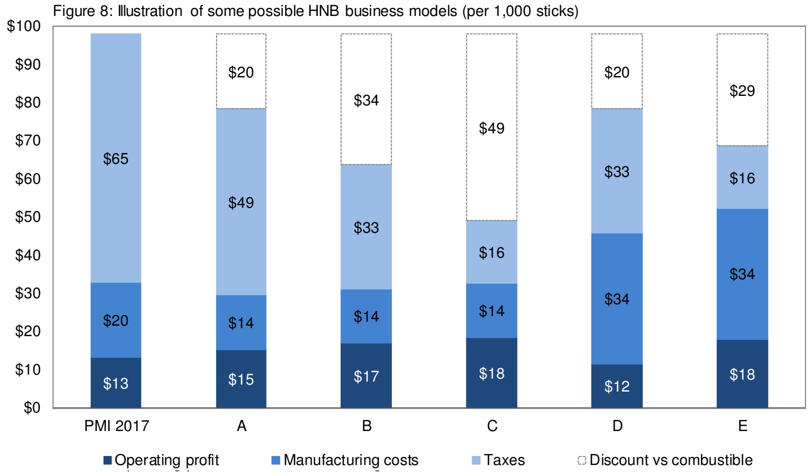
Net revenue per stick may come down from here because iQOS launched at the premium end. But so should units costs as volumes approach those of cigarettes. iQOS "heatsticks" use less raw materials than cigarettes and so should be cheaper to produce. We estimate that the device currently costs about $100 to make and distribute, and one device is sold for roughly every 3,000 sticks. Device sales are likely inflated due to the rapidly increasing adoption, but this number suggests an amortised cost of about 3c per stick, which should come down substantially as technology improves and the operation scales up.

Some investors expect governments to tax HNBs at similar rates to cigarettes, and cite Japan as an example where the difference is small. This is possible, but Japan intends to increase taxes on cigarettes further, which will widen the gap again. Taxes have a disproportionate impact on the poor for two reasons: they have less money; and they smoke more. In the US, 34% of those who earn less than $30,000 smoke, and they spend 14% of their income on cigarettes; whereas 12% of those who earn more than $60,000 smoke, and they spend 2% of income. Making RRPs more affordable would presumably also disproportionately benefit the poor, which may give the idea political cachet.

Figure 8 considers possible HNB business models, and compares them to PMI's 2017 results, to illustrate how HNBs can be both more affordable for the consumer and more profitable for the company. We don't know the eventual pricing model—the permutations are endless and it will depend on how the tax environment evolves. But it would seem rather self-defeating for tax policy to make RRPs commercial infeasible.

Possible HNB Scenarios

Figure 8: Illustration of some possible HNB business models (per 1,000 sticks)



PMI 2017: PMI's actuals for 2017
A: Discount of 20%. Taxes at 85% of combustible. Smoker covers device cost.
B: Discount of 35%. Taxes at 50% of combustible. Smoker covers device cost.
C: Discount of 50%. Taxes at 25% of combustible. Smoker covers device cost.
D: Discount of 20%. Taxes at 50% of combustible. Absorb device cost.
E: Discount of 30%. Taxes at 25% of combustible. Absorb device cost.

Sources: Contrarius Research for estimates and illustrations, Philip Morris International for 2017 actuals.

Investor Sentiment

PMI has underperformed the market by 40% since last June. A few possible reasons for this come to mind:

Interest rates: The stable cash generation may have attracted bond investors. The share may be falling with bonds as interest rates rise. If the share register is replacing "bond investors" with "equity investors", then you might expect the share to react sharply if PMI reports growth in future.

Slowing growth: Japanese iQOS sales in the most recent quarter were less than expected. Memories are short: this "disappointment" is in the context of an extraordinary reception in Japan that few investors predicted. Growth curves are rarely smooth, and new technologies have early adopters.

Japan is a special case: Japan prohibits liquid nicotine e-cigarettes, so there is no smokeless alternative to HNBs, which surely spurs Japanese sales. This is true, but we are not expecting PMI to hit 18% market share after two years in every market. That would be astonishing. Instead, we expect more gradual but steady gains as regulators and consumers become more accepting and even supportive.

Falling margins: Seventy percent of PMI's R&D is these days dedicated to RRPs. It has fully converted a major Greek factory, is doing the same with a major Romanian factory, and is building new factories from scratch for this purpose. These investments are costly, as are clinical trials, educating regulators and the public, and rebuilding its marketing efforts. The long-term benefits are big, but in the meantime margins should be expected to fall.

Increasing regulation on RRPs: Most people would say that high oil prices are bad for airlines since fuel is one of the biggest costs, but it is more nuanced than that. Yes, costs go up. But for any one company what matters more is whether it suffers more or less than its competitors. High oil prices expose the less astute operators, or those with the less efficient planes, which tends to thin out the competition, boosting margins for the survivors. Similarly, tighter regulation on RRPs—although costly in isolation—should benefit the survivors. We expect that PMI, as the industry leader and with its tremendous cash generation, will come out ahead.

Conclusion

The total number of smokers and cigarettes consumed will probably continue dropping. That, though, hides the striking mix shift that we expect from combustible to smokeless products. The Japanese example may be exaggerated but, together with the rapid penetration of e-cigarettes in a number of countries, it shows how quickly a supposedly staid sector can evolve when conditions are right (iQOS has captured 7% of the South Korean market in 9 months). It is hard to predict (let alone time) regulatory changes, but the signs are pointing in PMI's favour. There is lots of opportunity for innovative regulators to encourage switching: for example, letting manufacturers replace the grotesque imagery on packs with adverts for HNBs; or allowing HNBs in places were smoking is banned. We like the idea of a company priced lower than the market when its growth prospects are above average, even though shifting a regulatory and societal monolith should be expected to take some time. We believe that, for long-term investors, Philip Morris International is hardly a "cigar-butt investment".

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Performance (net, per calendar year, since inception)	Fee Class	Currency	Best Performance		Worst Performance		Inception
			Year	%	Year	%	Date
Contrarius Global Equity Fund	Investor Class	US$	2009	94.5	2015	(17.4)	01-Jan-09
	Institutional Class	US$	2009	95.1	2015	(17.0)	01-Jan-09

These are the best and worst performing calendar years each specified fee class has experienced since inception, demonstrating the variability of performance. Annual figures for all calendar years since inception are also available on www.contrarius.com. South African residents interested in receiving a Prospectus or other information on these funds should contact the authorised representative for those funds, Contrarius Investment Services (South Africa) (Pty) Ltd at clientservice@contrarius.co.za. Contrarius Investment Services (South Africa) (Pty) is a member of the Association for Savings & Investment South Africa.

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