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Researching Capital Markets and Financial Services

ETF Insights.

Prepared for clients of EasyEquities

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Satrix Quality SA ETF (JSE:STXQUA)

17.03.2023

Fund suitability

This ETF suits investors who want passive exposure to quality equities over a long-term investment horizon.

Fees

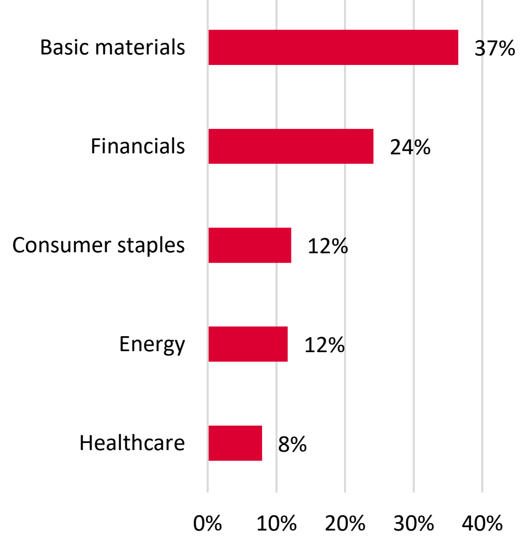
The fund has a total investment cost of 0.67%.

Alternative funds

No alternative funds

"Return on equity measures how much net profit a business generates in relation to shareholder capital invested in a company."

Top 5 sector allocation (%)



This week's pick is the Satrix Quality SA ETF. It tracks the performance of the S&P Quality South Africa Index. To be included in the index, companies must score favourably across three quality ratios calculated by S&P Dow Jones Indices – **return on equity** (ROE), the **accruals ratio** and the **financial leverage** ratio.

Return on equity measures how much net profit a business generates in relation to shareholder capital invested in a company. Financial leverage has to do with debt, which implies that high-quality companies often have less debt and higher free-cash flow to fund the company's growth or to pay dividends. The accruals ratio measures the quality of earnings – in other words, cash flow growth must be higher than net profits, as cash flow is a better indicator of profitability and financial strength than profit.

Share weights are determined as the product of the quality score for each company and its float-adjusted market capitalisation, which excludes non-tradeable shares. The ETF is slightly expensive, with an estimated total investment cost of 0.67%.

Our focus on quality in this week's ETF analysis takes place against a volatile market backdrop. The recent downturn of the JSE All Share index has erased the gains from earlier this year as the market is down 0.7% year-to-date . The latest real GDP figure (Q4 2022) – which indicated a 1.3% drop in quarterly output (exceeding expectations of a 0.4% decline) - confirmed market suspicions of SA's increasingly strained macroeconomic condition. Also, the 59% nose-dive of Transaction Capital's share price this week spooked the local equities market.

The mini-bus taxi financier (and majority owner of used car trader WeBuyCars) issued a trading update on Monday indicating that due to economic pressures facing the SA taxi business, it had to convert an existing intercompany loan of R2bn from the group holding company into equity. It also increased its bad debt provisions for the SA Taxi business by R1.8bn, taking provision (expected loss) coverage from just over 4% to approximately 15%. As such, we think the developments at Transaction Capital lay bare the difficult economic environment SA companies operate in.

Globally, equities have similarly not been spared - a "mini banking crisis" involving SVB Bank (tech-focused) and Silvergate Bank (cryptocurrency) in the US dominated headlines in recent days. In addition, Swiss-giant Credit Suisse reported to the market (earlier this week) that it had found a "material weakness" in its financial reporting, prompting its majority shareholder (Saudi National Bank) to stop supplying further funding to the bank.

We will focus here on SVB Bank. Its share price plummeted as much as 77% (8-10 March) following news of a liquidity issue at the bank resulting from substantial losses on its bond portfolio. Banks typically lend depositing client funds to borrowing clients to generate profits. Deposits are also invested in capital markets to generate returns.

Importantly, interest rates and bond prices have an inverse relationship, which means that bonds have generally been under pressure as interest rates in the US increased. As a result, the losses SVB made on its bonds negatively affected its financial position, which prompted a spike on deposit withdrawals from bank account holders. US authorities have since intervened to prevent further contagion in the banking industry by guaranteeing the deposits of all clients at the institutions under threat.

However, there is emerging evidence of executives at SVB Bank lobbying lawmakers to relax regulations related to liquidity and capital adequacy. The resultant undue risk from changes in regulation (2018) and downfall of the bank points to the potential losses shareholders incur due to poor management decision-making at companies.

As such, while a quality investing strategy includes buying shares in companies with strong competitive advantages and healthy financials, recent developments in the global banking space point to a tricky task in equity investing, which is evaluating management teams.

This generally includes researching their capital allocation records. The best teams spend capital on the best performing assets within a business and have incentives linked to the positive long-term performance of companies. We also believe that sustainable and positive financial performance provides some insight into the management of a business.

Pharmaceutical retailer Clicks, which is one of the top five companies in the ETF, is a useful example. It's ROE peaked at 48% in FY22 from 38% in FY18. It had manageable leverage with a debt:equity ratio of 0.5 in FY22 (lease liabilities only).

The retailer also grew operating cash flow (+20.3% compounded annually) ahead of headline earnings (14%) over the same period. This translated into a 14.6% annual increase in dividends to R6.37/share in FY22 – a good result for the quality investor. As always though, we think that the Satrix Quality SA ETF should be considered as part of an overall portfolio.

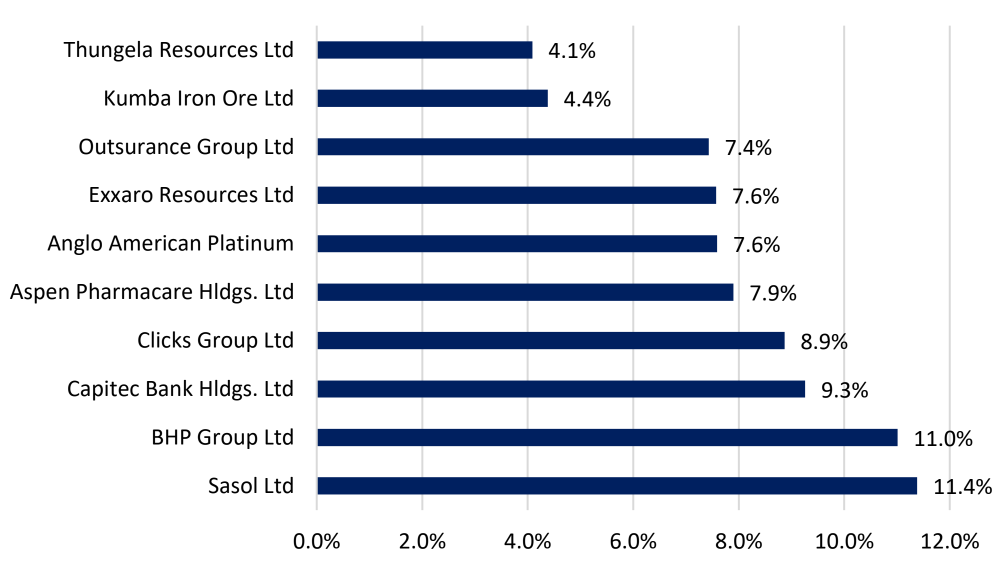
Investment term of the week: return on equity (ROE)

Calculated as net profit over shareholder's equity, it measures the percentage of net profit generated from shareholder capital invested in a company for a year. A higher ROE given a stable level of shareholder's equity indicates that the company's profitability is improving.

Investment approach and portfolio composition

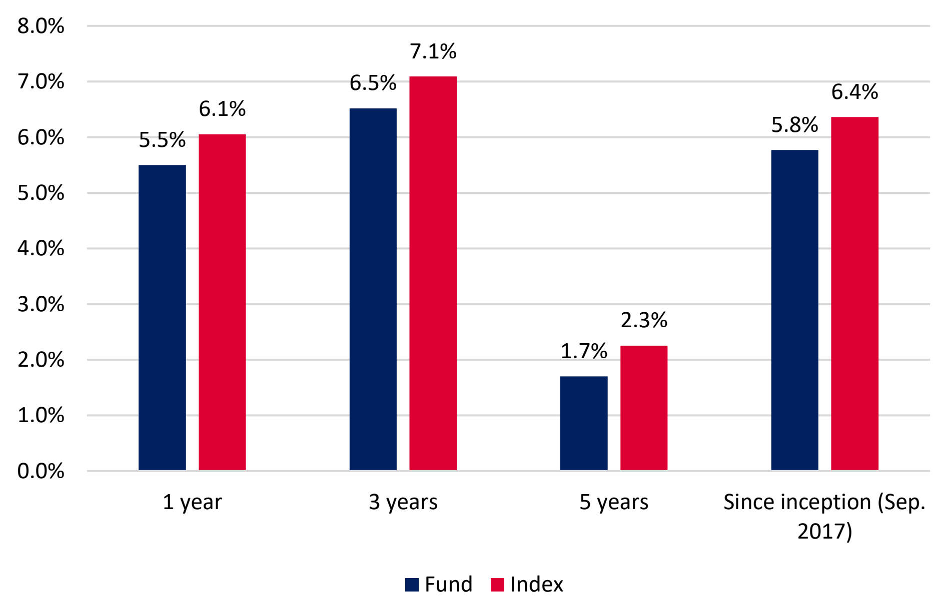
The Satrix Quality SA ETF tracks the performance of the S&P Quality SA index before fees and expenses.

Top holdings (%)



Performance

Fund and index performance to end-January 2023 (annualised for periods longer than one year; with dividends reinvested).



Fund information: 31 January 2023

Launched on	26 September 2017
Trading symbol (JSE)	STXQUA
Total assets	R59m
Total investment cost	0.67%
Risk rating	High
Benchmark	S&P Quality SA Index

Market data: 17 March 2023

Spot price	R7.42
One-year high	R9.18
One-year low	R6.80
Average monthly volume	240,827
Estimated dividend yield	5.1%

Source: Infront, yahoo finance