Quarterly Fund Commentary

Quarter 3 2020

Morningstar Investment Management South Africa

October 2020

Local Market Commentary
September 2020

SOUTHWOOD FINANCIAL PLANNING cc

Markets continued to climb higher in the third quarter, despite concerns around a resurgence in Covid-19 infections and continued setbacks in the search for a vaccine. Global central banks and governments continue to be accommodative, with low interest rates and committed stimulus providing significant support to financial markets. This is most notably evident from US Federal Reserve Chair Jerome Powell's comments during August at the annual Fed symposium in Jackson Hole, where he announced that the Fed would switch to inflation targeting, which appears to support the "lower interest rates for longer" narrative. The US Presidential Election scheduled for the 4th of November also took centre stage during the quarter, with US President Donald Trump and Democratic nominee Joe Biden exchanging blows ahead of the much-anticipated election.

South African equities underperformed global markets during the quarter, despite ending marginally higher. Resources (+6%) ended the quarter with strong performance, while Industrials (-2%) and Financials (-2%) ended in the red. The strong performance from the Resource sector was largely driven by platinum counters, which moved sharply higher during the quarter.

Local bonds ended the quarter largely flat, with short dated exposures continuing to benefit from the stable repo rate and long dated exposures continuing to underperform, weighed down by concerns around South Africa's deteriorating fiscal position. The South African Reserve Bank (SARB) cut the repo rate by another 25 basis points at the July Monetary Policy Committee (MPC) meeting, bringing the policy rate to a level of 3.5%, its lowest in close to 50 years.

Local listed property continued to struggle, weighed down by valuation write-downs and negative earnings growth related to the knock-on effects of the Covid-19 related lockdown. Property counters initial requests to retain more than 25% of distributable earnings to reduce debt failed to materialize, however, asset disposals and South Africa's transition to alert level 1 lockdown on the 21st of September should provide further clarity on the sector's distribution prospects.

Local cash provided a stable return for investors over the quarter. We continue to be mindful of the role that cash plays in a portfolio in terms of providing protection in the event of market declines, however, we are aware that the forward-looking returns from cash appear to be less attractive given the interest rate cuts since the start of the year.

SA's Q2 2020 GDP data was released during September, indicating a 17.1% year-on-year decline in GDP for the second quarter as the hard lockdown took its toll on the local economy. South African Reserve Bank Governor Lesetja Kganyago announced the Monetary Policy Committee's decision to leave the repo rate unchanged at 3.5%. The decision was split, with 2 of the 5 MPC members favouring an interest rate cut. SA headline CPI fell to a year-on-year figure of 3.1% to the end of August (from 3.2% in July), close to the bottom end of the target range of between 3% and 6%.

In summary, the third quarter was largely positive for investors. All major asset classes (besides local listed property) managed to deliver positive returns, which led to decent performance for investors over the quarter. The final quarter contains some key political and economic events, including the Medium-Term Policy Statement from Finance Minister Tito Mboweni in late October and the US Presidential Election in early November. We would encourage investors to continue to focus on their long-term goals rather than get distracted by short-term market moves. Patient, valuation focused investors are likely to be rewarded with above average returns going forward.

Global Market Commentary
September 2020

Important Perspective

Imagine waking up as an investor from the 1980s, 1990s or 2000s. How would you make sense of today's dynamics? You would see debt levels at all-time highs, economic output at multi-decade lows, widespread job losses, a global pandemic halting most human interactions… yet global stock prices are at or near record highs. If you are left scratching your head, you're not alone.

A meaningful part of the narrative is attributable to record levels of committed stimulus. Let's not forget that interest rates are sitting down at all-time lows for the foreseeable future (at least, that's what market participants are expecting, with the Federal Reserve hinting that rates will remain low until 2023).

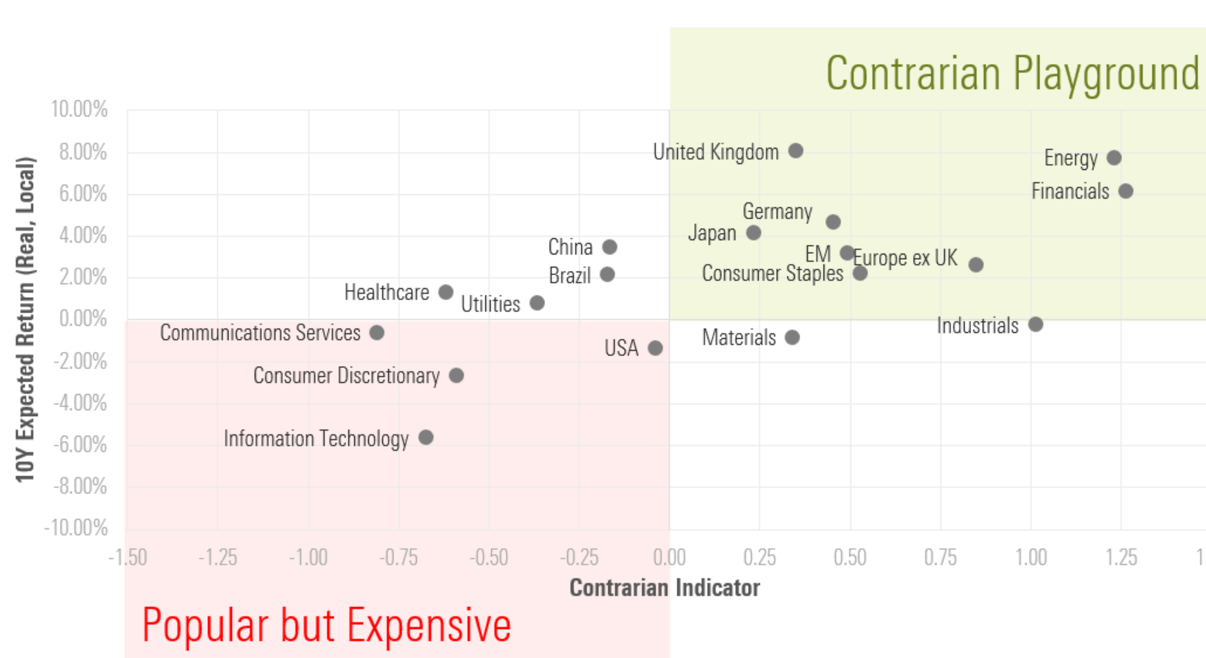
The challenge, of course, is that investors are also required to climb a wall of worry. Here are just a few current investor concerns: U.S. election nerves, Brexit negotiations, the vaccine waiting game, inflation uncertainty, US/China tensions, political division, and the potential for a rise in corporate defaults. Offsetting this, some participants—including professional and retail investors—appear buoyed by vaccine progress and a growing expectation for a 2021 recovery.

Key Developments

Looking within equities, all is not equal. What we've witnessed lately—and Q3 saw an extension of this—is diversity of outcome, with "new world" growth demanding a curiously high premium while "established" businesses fall off the radar of investors (this is true across developed and emerging markets). Understanding this dispersion has become one of the biggest talking points among investors.

To get practical, we offer the graphic below, which shows how prevalent this dispersion currently is. Ultimately, it is unpopular stocks that tend to outperform popular stocks in the long run, as validated in several academic studies. Therefore, while 2020 has so far proven to be an outlier in this sense, it is the contrarian investor that has the upper hand probabilistically. This popularity/unpopularity conundrum should not be understated in these extreme times.

Exhibit 1 Global Equity Markets are Split Between the Popular and the Unloved (Where Contrarians Find Opportunity)



Source: Morningstar Investment Management. Data as of August 31st, 2020. Expected return estimates are annual valuation-implied inflation-adjusted performance over the next full market cycle (about five to 10 years). Contrarian indicator combines several inputs, including flows, positioning and sentiment. For illustrative purposes only.

Speaking of popularity, interest in ESG (environmental, social and governance) investing continues at pace. This has been undoubtedly supported by sector performance differences, with ESG-friendly sectors generally doing better than some of the "dirtier" industries such as energy (obviously not all of the energy sector is "dirty", but the composition is an important factor here).

Defensive Considerations

Looking for risk offsets, it is the typical safe-haven assets that investors are looking towards. Gold, despite all its faults, has taken a lion's share of the headlines in this space. Yet, unsung heroes in times of stress—such as cash and longer-dated bonds—continue to play their role as defensive ballast. Remember that the pledges by central banks to keep rates low has provided some comfort for fixed-income investors, despite the low yields.

Turning to bond holdings, it has really been about balancing credit risk versus the extra return that you can achieve. This spread between riskier holdings (such as lower-quality corporate bonds) and safer exposures (such as government bonds, which tend to offset equity risk) saw a big spike in early 2020, but has narrowed once again, as corporate bankruptcies have remained low to date. Emerging-markets debt remains an area of interest given the high relative yields on offer.

Circling the investment landscape, we can't forget the importance of currency, which is one of the first places investors express their geopolitical views. This space continues to be important from a risk management perspective, too, although a lot of negative news is still seemingly priced into riskier currencies. In fact, we've seen procyclical currencies (those that tend to do well in a growing economy) improve more recently, perhaps acknowledging the extent by which investors sought safety.

Our Message to Clients

Taken together, balancing capital growth and capital preservation is undoubtedly demanding at present. This requires a steady hand. There are the simple things to get right, such as keeping costs low, focusing on the long term, and diversifying the return/risk drivers. But to excel in today's environment, it also requires advanced analytical and behavioural skill. We continue to drive this agenda in earnest, for the benefit of all investors, and thank you for entrusting us.

Southwood Balanced Portfolio Update

September 2020

SOUTHWOOD FINANCIAL PLANNING cc

Moderately aggressive investors will be pleased with returns generated in the third quarter of 2020. Both local and global equities delivered positive performance, however, global equity allocations were the primary driver of portfolio performance.

The Southwood Balanced Portfolio returned 2.5% for the quarter and has generated a return of 3.9% over the past year.

The Portfolio remains diversified in terms of its exposure to different asset classes and we remain confident in its ability to deliver inflation beating returns over the long-term independent of the market environment.

Asset Allocation

SA equity allocations, which make up the bulk of the Portfolio, contributed positively to performance over the quarter, however, there was a significant divergence in the performance of the underlying equity sectors. Resource allocations (particularly platinum) delivered strong performance, while financials and industrials did not fare as well. Naspers (-6%) placed a drag on the performance of local equities over the quarter, particularly for benchmark aware SA equity managers, largely due to its significant weight in local equity indices. Offshore equities faced a headwind from a stronger rand, however, the performance of global equity markets, particularly US equities, more than compensated for rand strength over the quarter. US equities continue to be driven higher by strong performance from the so called FAANG stocks – namely Facebook, Apple, Amazon, Netflix and Google (Alphabet). Emerging and developed market equities delivered strong performance, with the former delivering slightly better performance, supported by upward price movements in major commodities including platinum, gold, and copper. Local bonds are the next significant allocation within the Portfolio. This includes allocations to corporate bonds, government bonds as well as inflation linked bonds. Short dated allocations to both nominal bonds and inflation linked bonds generated decent returns during the quarter, supported by the recent interest rate cuts from the South African Reserve Bank (SARB). Long dated exposures did not fare as well, as concerns around South Africa's fiscal issues continued to be front of mind for investors. Local cash allocations in the Portfolio managed to deliver stable positive returns, with cash ending the quarter as the second best performing local asset class behind bonds. We continue to be mindful of the role that cash plays in a portfolio in terms of providing protection in the event of market declines, however, we are aware that the yield on offer from local cash has decreased significantly since the start of the year, largely due to the interest rate cuts of 3% in 2020.

Fund Selection

All of the funds in the portfolio managed to deliver a positive return for the quarter.

Ninety One Equity delivered decent performance relative to peers, despite significant exposure to both Naspers (-6%) and Prosus (-4%). The fund's allocation to Impala Platinum (+29%) delivered strong performance over the quarter, largely on the back of decent price performance from the underlying commodity. The fund's exposure to Firstrand (+8%) was also a contributor, as the SA banks held up relatively well compared to other SA financials exposures.

PSG Equity delivered strong performance relative to peers, as the fund's benchmark agnostic approach and preference for unfavoured areas of the market (particularly local small and mid cap shares) led to outperformance over the quarter. Large cap financial and industrial counters delivered poor performance during the quarter relative to resources. Significant exposure to counters including Discovery (+22%) and AB Inbev (+7%) also delivered decent performance during the quarter.

Ninety One Global Franchise Feeder Fund underperformed its benchmark and peers over the third quarter. Stock selection was a mixed bag over the quarter. The fund's positions in Healthcare (BD and Roche) and Information Technology (VeriSign and ASML) detracted from performance. While the positions in Consumer Staples (Estee Lauder, Unilever, Phillip Morris and Nestle) were positive contributors they weren't able to out weight the negative contribution from stock selection.

On the other hand, the Nedgroup Core Bond Fund had a challenging quarter. Long duration was a detractor from performance, as we saw the short end of the curve outperforming the long end during the third quarter. The short end remained in favour due to prospects of a stable repo rate, the expectation of interest rate cuts has diminished. Investors have been selling in the +12 year maturity space as concerns around fiscal health remain front of mind.

There were no changes to the underlying funds over the third quarter.

Summary

We are pleased with the returns generated for investors in the third quarter, despite the noisy market environment. Positive performance from allocations to both local and global growth assets drove performance during the quarter. The Portfolio continues to be allocated to a diverse range of attractively priced local and global asset classes and we are confident that it will be able to deliver on its objective over the long-term.

MORNINGSTAR®

Morningstar Global Cautious Portfolio Update
September 2020

The portfolio gained 3.5% in the third quarter as most asset prices continued to recover from the trough at the end of Q1. However, this recovery is becoming increasingly uneven with some assets, such as UK equities, UK government bonds, and the USD falling in price over the quarter. In general, these price movements are a continuation of trends that have dominated capital markets over the last year and continue to drive the relative returns of this portfolio when compared to peers. Most significant for cautious investors is the fact that we hold less government bond exposure than is typical as we are concerned that bonds currently represent an unattractive risk/reward profile.

In the context of the large swings in asset prices, both the year-to-date return of 3.2% and the one-year return of 6.4% appear reassuring and provide us with a reminder of the unpredictability of short-term market moves. In contrast, the returns since inception remain an attractive 5.4% annualised. It is important to remember that given the cautious nature of the portfolio, this return has been delivered with a very modest risk profile.

Asset Allocation

Despite the ongoing turmoil in markets, the equity exposure of the portfolio remains near the middle of its long term range. However, we believe that the portfolio is positioned to deliver above average returns relative to peers over the long term by investing in those assets with the most attractive prices relative to a reasonable expectation of their future return. Conversely, we have less exposure to assets that appear expensive relative to their future prospects.

The best examples of the former are UK and emerging market equities. Both of these have lagged over the last few years due to broader geo-political concerns, such as the impact of BREXIT, turmoil within the energy market and US trade policy. While each of these is important, their impact on individual businesses is uncertain and encourages investors to overreact in an effort to reduce that uncertainty. This negativity creates opportunities for those who are prepared to take a longer-term perspective and accept the short term uncertainty that accompanies low prices. In contrast, assets that appear to provide predictable growth, such as US technology companies are valued very highly by investors who are projecting current certainty and growth rates of these companies far into the future. With such optimism baked into the price of these assets, it is easy for investors to be disappointed, leading to a future fall in prices.

However, over the last year, this approach has not delivered superior returns as expensive assets have become more expensive and cheap assets have become relatively cheaper, a trend that has been accelerated by the COVID-19 pandemic. This naturally raises the question of whether this strategy remains the best approach to investing for the long term and if so, what is the best way to position a portfolio to capture those long term returns?

When answering this it is important to note that the key drivers of investment returns depend on the time period over which one measures them. Short term returns tend to be dominated by investor sentiment, medium term returns by the price one pays for the investment and very long term returns by the growth and income generated by the asset. In recognition of the fact that our portfolios are geared towards investors with a 5-10 year investment horizon, our investment approach is designed to access the returns from changing valuations, with some focus on the longer term growth and income generation.

Short term investor sentiment that drives asset prices away from a reasonable assessment of their fair value is therefore a source of future returns as it provides an opportunity for us to purchase assets that are unusually cheap and sell those that have become expensive. Occasionally, these shorter-term trends are especially strong leading to surprisingly wide gaps in the valuation of assets, which act as a headwind for the returns of the portfolio. The wider the gap in valuations, the stronger the headwind and the higher the potential for future returns as the headwind becomes a tailwind.

It is fair to say that the headwind has been especially strong over the last year, leading to historic gaps in the valuation of assets. It is during this period that it is most tempting to believe that valuations are no longer important and that we have entered a new era in investment when assets may remain expensive in perpetuity. We have experienced similar periods before, most notably the TMT boom in the late 1990s and the credit / housing boom in the early part of this century. In each case, valuations reasserted themselves, but in each case, it took longer than most people expected.

It is for this reason that we have retained exposure to these expensive assets, reducing slowly as the prices become more extreme and ensuring that the portfolio remains well diversified across a large number of assets. Consequently, while the extreme dislocation in valuations has led to some underperformance, it has been limited by our investment approach.

We would therefore expect to more than make up the lost ground as the sentiment of investors change. Such changes are unpredictable but often rapid and hence it is important for the portfolio to be positioned ahead of such a change. A good example of such a change is provided by the recent rise in bond yields and the fall in the US dollar.

Fund Selection

The asset exposure of the portfolio was the main driver of returns over the quarter, with the equity holdings having a pronounced impact on returns in a period when most equity markets delivered a positive return. Most of the fixed income holdings also managed to deliver positive returns, however, Franklin US Government Bond ended the quarter marginally lower. From an equity perspective, Fidelity Emerging Markets and iShares North America Equity Index were the most significant contributors to the performance of the portfolio, driven by strong positive moves in both US and emerging market equities.

Taken together, we remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with expectations.

Recent Changes

The portfolio was restructured during September, with the major change being the removal of the Satrix Europe (Ex-UK) Equity Tracker, which was replaced by iShares Europe Equity Index.

Summary

Looking forward, we remain confident that the line-up will help us deliver positive outcomes. We continue to focus on risk-adjusted returns—not just returns—and have a constructive view on our ability to navigate different market pathways going forward. That is, we believe the portfolio is sensibly positioned (given what we can and can't know), with a selective yet diversified approach and ample cash to capture future opportunities.

Morningstar Global Balanced Portfolio Update
September 2020

The portfolio gained 5.3% in the third quarter as most asset prices continued to recover from the trough at the end of Q1. However, this recovery is becoming increasingly uneven with some assets, such as UK equities, UK government bonds, and the USD falling in price over the quarter. In general, these price movements are a continuation of trends that have dominated capital markets over the last year and continue to drive the relative returns of this portfolio when compared to peers. Most significant for moderate investors is the fact that we hold less US equity exposure than is typical as we are concerned that this market currently represents an unattractive risk/reward profile.

In the context of the large swings in asset prices, both the year-to-date return of 1.6% and the one-year return of 7.5% appear reassuring and provide us with a reminder of the unpredictability of short-term market moves. In contrast the returns since inception remain an attractive 6.5% annualised. It is important to remember that given the relatively cautious nature of the portfolio, this return has been delivered with a modest risk profile.

Asset Allocation

Despite the ongoing turmoil in markets, the equity exposure of the portfolio remains near the middle of its long term range. However, we believe that the portfolio is positioned to deliver above average returns relative to peers over the long term by investing in those assets with the most attractive prices relative to a reasonable expectation of their future return. Conversely, we have less exposure to assets that appear expensive relative to their future prospects.

The best examples of the former are UK and emerging market equities. Both of these have lagged over the last few years due to broader geo-political concerns, such as the impact of BREXIT, turmoil within the energy market and US trade policy. While each of these is important, their impact on individual businesses is uncertain and encourages investors to overreact in an effort to reduce that uncertainty. This negativity creates opportunities for those who are prepared to take a longer-term perspective and accept the short term uncertainty that accompanies low prices. In contrast, assets that appear to provide predictable growth, such as US technology companies, are valued very highly by investors who are projecting current certainty and growth rates of these companies far into the future. With such optimism baked into the price of these assets, it is easy for investors to be disappointed, leading to a future fall in prices.

However, over the last year, this approach has not delivered superior returns, as expensive assets have become more expensive and cheap assets have become relatively cheaper, a trend that has been accelerated by the COVID-19 pandemic. This naturally raises the question of whether this strategy remains the best approach to investing for the long term and if so, what is the best way to position a portfolio to capture those long term returns?

When answering this it is important to note that the key drivers of investment returns depend on the time period over which one measures them. Short term returns tend to be dominated by investor sentiment, medium term returns by the price one pays for the investment and very long term returns by the growth and income generated by the asset. In recognition of the fact that our portfolios are geared towards investors with a 5-10 year investment horizon, our investment approach is designed to access the returns from changing valuations, with some focus on the longer term growth and income generation.

Short term investor sentiment that drives asset prices away from a reasonable assessment of their fair value is therefore a source of future returns, as it provides an opportunity for us to purchase assets that are unusually cheap and sell those that have become expensive. Occasionally, these shorter-term trends are especially strong, leading to surprisingly wide gaps in the valuation of assets, which act as a headwind for the returns of the portfolio. The wider the gap in valuations, the stronger the headwind and the higher the potential for future returns as the headwind becomes a tailwind.

It is fair to say that the headwind has been especially strong over the last year, leading to historic gaps in the valuation of assets. It is during this period that it is most tempting to believe that valuations are no longer important and that we have entered a new era in investment when assets may remain expensive in perpetuity. We have experienced similar periods before, most notably the TMT boom in the late 1990s and the credit / housing boom in the early part of this century. In each case, valuations reasserted themselves, but in each case, it took longer than most people expected.

It is for this reason that we have retained exposure to these expensive assets, reducing slowly as the prices become more extreme and ensuring that the portfolio remains well diversified across a large number of assets. Consequently, while the extreme dislocation in valuations has led to some underperformance, it has been limited by our investment approach.

We would therefore expect to more than make up the lost ground as the sentiment of investors change. Such changes are unpredictable but often rapid and hence it is important for the portfolio to be positioned ahead of such a change. A good example of such a change is provided by the recent rise in bond yields and the fall in the US dollar.

Fund Selection

The asset exposure of the portfolio was the main driver of returns over the quarter, with the equity holdings having a pronounced impact on returns in a period when most equity markets delivered a positive return. Most of the fixed income holdings also managed to deliver positive returns, however, Franklin US Government Bond ended the quarter marginally lower. From an equity perspective, Fidelity Emerging Markets and iShares North America Equity Index were the most significant contributors to the performance of the portfolio, driven by strong positive moves in both US and emerging market equities.

Taken together, we remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with expectations.

Recent Changes

The portfolio was restructured during September, with the major change being the removal of the Satrix Europe (Ex-UK) Equity Tracker, which was replaced by iShares Europe Equity Index.

Summary

Looking forward, we remain confident that the line-up will help us deliver positive outcomes. We continue to focus on risk-adjusted returns—not just returns—and have a constructive view on our ability to navigate different market pathways going forward. That is, we believe the portfolio is sensibly positioned (given what we can and can't know), with a selective yet diversified approach to help investors reach their goals.

Morningstar Global Growth Portfolio Update
September 2020

SOUTHWOOD FINANCIAL PLANNING cc

The portfolio gained 7.9% in the third quarter as most asset prices continued to recover from the trough at the end of Q1. However, this recovery is becoming increasingly uneven with some assets, such as UK equities, UK government bonds, and the USD falling in price over the quarter. In general, these price movements are a continuation of trends that have dominated capital markets over the last year and continue to drive the relative returns of this portfolio when compared to peers. Most significant for adventurous investors is the fact that we hold less US equity exposure than is typical as we are concerned that this market currently represents an unattractive risk/reward profile.

In the context of the large swings in asset prices, both the year-to-date return of 1.0% and the one-year return of 10.0% appear reassuring and provide us with a reminder of the unpredictability of short-term market moves. In contrast, the returns since inception remain an attractive 7.7% annualised.

Asset Allocation

Despite the ongoing turmoil in markets, the equity exposure of the portfolio remains near the middle of its long term range. However, we believe that the portfolio is positioned to deliver above average returns relative to peers over the long term by investing in those assets with the most attractive prices relative to a reasonable expectation of their future return. Conversely, we have less exposure to assets that appear expensive relative to their future prospects.

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However, over the last year, this approach has not delivered superior returns, as expensive assets have become more expensive and cheap assets have become relatively cheaper, a trend that has been accelerated by the COVID-19 pandemic. This naturally raises the question of whether this strategy remains the best approach to investing for the long term and if so, what is the best way to position a portfolio to capture those long term returns?

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Fund Selection

The asset exposure of the portfolio was the main driver of returns over the quarter with the equity holdings having a pronounced impact on returns in a period when most equity markets delivered a positive return. Turning to the underlying investments, fund selection was largely positive, with Fidelity Emerging Markets and Franklin US Opportunities being the most significant contributors to performance and Ninety One UK Equity Alpha being the most significant detractor.

Recent Changes

The portfolio was restructured during September, with the major change being the removal of the Satrix Europe (Ex-UK) Equity Tracker, which was replaced by iShares Europe Equity Index.

Summary

Looking forward, we remain confident that the line-up will help us deliver positive long-term outcomes. We continue to focus on risk-adjusted returns—not just returns—and have a constructive view on our ability to navigate different market pathways going forward. That is, we believe the portfolio is sensibly positioned (given what we can and can’t know), with a selective yet diversified approach to help investors reach their goals.

Risk Warnings

Morningstar Investment Management South Africa Disclosure

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