

Quarterly Fund Commentary

Quarter 4 2020

Morningstar Investment Management South Africa

January 2021



Local Market Commentary

December 2020



Markets ended the final quarter of the year strongly, supported by some key economic and political developments. There was positive news on the Covid-19 vaccine front, as three major pharmaceutical companies (Moderna, Pfizer and AstraZeneca) announced that they had developed vaccines which appear to be highly effective in treating the virus. The election of a new US President also supported the risk on sentiment, with markets reacting positively to the election results. There were also expectations of diminishing political noise and a formal transition of power to the Democrats under Democratic President-elect Joe Biden. The anticipated announcement of a \$900 billion stimulus package in the United States as well as the finalisation of a Brexit deal between the United Kingdom and the European Union provided a further underpin to the risk-on sentiment.

Locally, South African President Cyril Ramaphosa announced the move to an “adjusted level 3” lockdown during December, as Covid-19 infection rates picked up across the country, particularly in Kwazulu-Natal, the Western Cape and Gauteng. Following the sharp recovery in economic growth in the third quarter of 2020, economic data appears to indicate that activity post the nationwide lockdown in Q2 continues to normalise, however, there are concerns that the impact of a slower than expected holiday season as well as the tighter lockdown restrictions may impact growth going forward.

SA’s trade surplus continued to show resilience, with strong export figures leading to a trade surplus of R37 billion for November (following a restated figure of R35 billion for October). The strength in the trade surplus is evident in the year-to-date figure for 2020 of R238 billion (to the end of November), compared to the figure of R9 billion for the same period in 2019.

South African equities reacted positively to the risk on sentiment in global markets, delivering strong performance over the quarter. The performance was broad-based; however, the large SA banks were the most significant driver of the performance of the local market. From a sector perspective, Financials (+20%), Resources (+8%) and Industrials (+7%) all ended the quarter with strong performance.

Local bonds also delivered strong performance, supported by net buying of SA bonds by foreigners in both November (R12.1 billion) and December (R19.8 billion). Medium and long dated exposures were the largest beneficiaries of the risk on environment and the return of non-residents to the local market, as investors took advantage of the attractive yields on offer in emerging market countries.

Local listed property managed to recover some lost ground, after a tumultuous first nine months of the year. Despite this, the asset class still finished the year as the worst performing local asset class, having lost over a third of its value over the calendar year. The asset class failed to recover from concerns around reduced distributions due to the Covid related lockdowns earlier in the year as well as rapidly rising debt levels for many counters.

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, it is worth highlighting that the forward-looking returns from cash appear to be less attractive given the interest rate cuts since the start of the year.

Overall, 2020 is not a year that many people will look back at with fondness. Despite the economic, health and emotional toll placed on individuals due to the global pandemic, most asset classes managed to deliver positive performance for the year. What investors need to grapple with going forward into 2021 is the apparent disconnect between economies and global markets. This disconnect provides fertile ground for valuation driven investors like ourselves, to take advantage of heading into the new year.

Global Market Commentary

December 2020



Who would have thought we'd be here, in early 2021, with peak global COVID-19 cases, a terribly weak economy, and near-record high markets. For humanity, we are gladly waving goodbye to 2020, but for markets we've endured a period of surprising benefit.

Not even the wildest of market predictions would have been right. If someone asked you how the market would perform if a global pandemic hit, causing widespread job losses and the biggest contraction in the economy for around 90 years, we doubt you'd describe today's reality.

Global stocks, corporate bonds, real estate, gold, commodities, and even bitcoin have all moved forward and delivered positive performance. In a period marked by personal fear, it seems like something closer to financial greed has prevailed.

In this regard, the final three months of 2020 was a strong one by historical standards—which did have some substantive developments. It is a clear case of market participants looking over the horizon, with the vaccine rollouts combining with a perception of greater political stability.

The wave of "good news" comes with many fascinating and constructive sub plots. One of the most interesting happened in the fourth quarter of 2020, where small-cap value stocks bucked a multi-year trend to join the winner's list. This was partly marked by President-elect Biden's victory (the so-called blue wave) but is also a vision for life after lockdowns—with the reopening of the economy considered a positive for economically-sensitive and cyclical stocks.

Company defaults and bankruptcies also remain low globally, defying the doomsayers, supported by record stimulus and the cheapest borrowing rates ever seen. This last point can't be underplayed, with corporate bond spreads tightening to the lowest levels in history, perhaps reflecting expectations that a return to economic normality is still a long way off on the horizon.

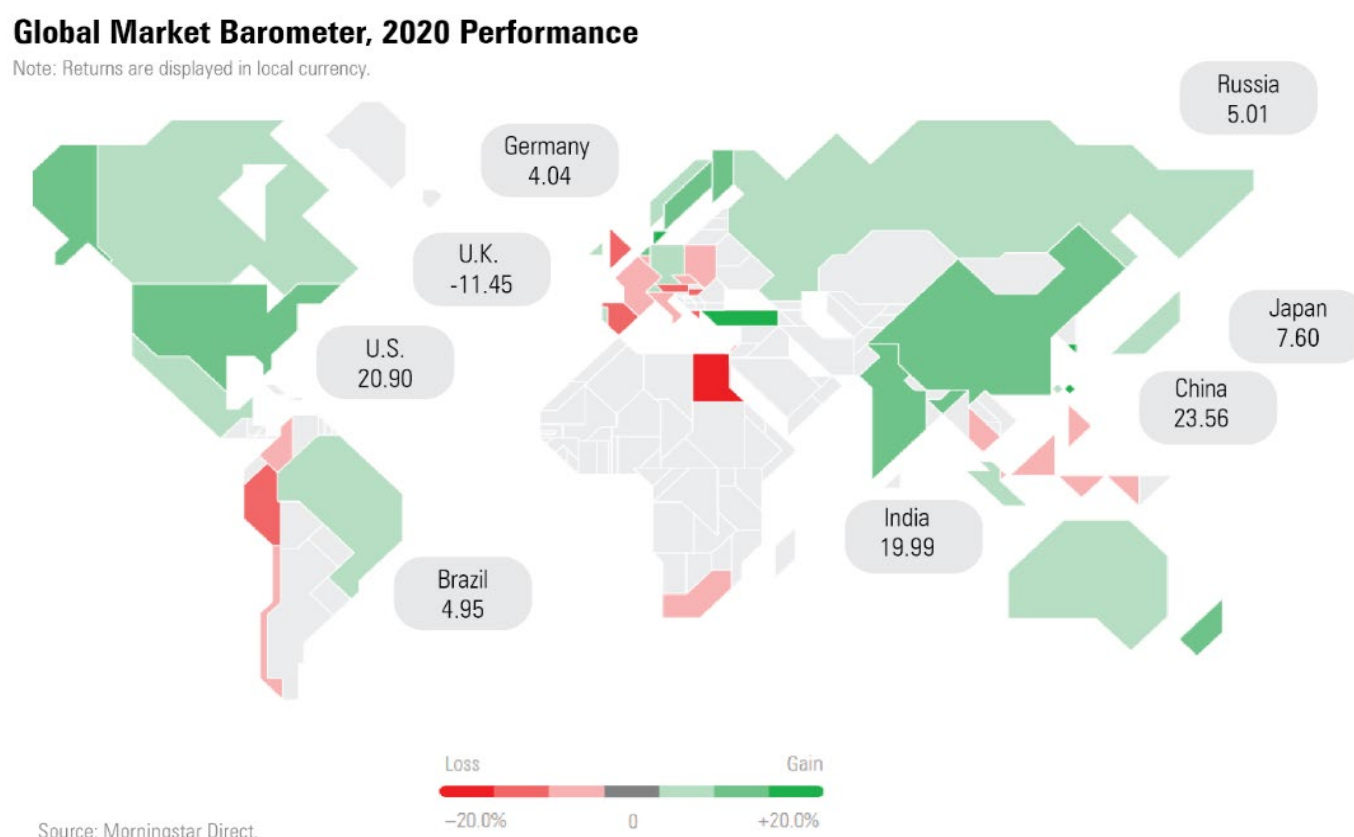
Here are some of the fourth-quarter and full-year 2020 highlights:

- ▶ Global stocks rose meaningfully in the fourth quarter, finishing 2020 with healthy overall returns given the circumstances. At year-end, the U.S. market had rallied as much as 70% from March lows.
- ▶ Dividend stocks bounced back strongly in the fourth quarter but lagged the broader market for the year. Likewise, emerging-markets stocks outperformed developed markets during the fourth quarter.
- ▶ Despite a fourth-quarter rally, energy stocks were the worst-performing sector for the fourth consecutive year. At the other end, consumer cyclical and technology stocks soared.
- ▶ Small-value stocks topped the Morningstar Style Box in the fourth quarter, but value stocks still trail growth stocks by massive margins for longer time frames.
- ▶ Among fixed income, interest-rate-sensitive bonds were one of the rare assets to fall in the fourth quarter. Meanwhile, riskier high-yield and emerging-markets bond categories performed the best.
- ▶ Inflation hedges, such as inflation-protected securities and gold, all had a strong 2020 while safe-haven currencies suffered.

Global Market Commentary

December 2020

Exhibit 1 The breadth of the strong equity performance has been noteworthy, with the fourth quarter rally pulling most global markets into positive territory.



With the big tail risks supposedly now behind us, many households continue to invest in earnest. In this regard, we seem to live in a two-pronged household dynamic, where a meaningful portion of white-collar households are saving more than ever (due to a lack of spending), while many others are finding it very tough.

Looking to the future, investors must consider the risks they can't see, or at least those they haven't given weight to. For example, inflation and how we'll ever unwind the record debt binge of 2020 could have untold consequences. Yet, above all else, investors need to weigh the valuations they are paying, as we've seen extreme divergences that presents both an opportunity and a risk.

As Warren Buffett once said, "Only when the tide goes out do you discover who's been swimming naked". We remain confident that our positions are in the best interests of our clients—acknowledging tomorrow's challenges and working towards a prosperous 2021 with good financial decision making.

Southwood Balanced Portfolio Update

December 2020



Moderately aggressive investors will be pleased with returns generated in the fourth quarter of 2020. All major local asset classes managed to generate positive returns, contributing to the performance of the Portfolio over the quarter.

The Southwood Balanced Portfolio returned 7.3% for the quarter and has generated a return of 8.4% 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

Local equity allocations were a significant contributor to the performance of the Portfolio, as the global risk on environment proved very supportive of emerging market equities over the quarter. Financials (+20%) were the most significant driver of the performance of the local equity market over the quarter, followed by Resources (+8%) and Industrials (+7%). Local bonds have a significant allocation within the Portfolio. This includes allocations to corporate bonds, government bonds as well as inflation linked bonds. In a reversal of the recent trend, it was medium and long dated exposures that performed the strongest over the quarter, which assisted the performance of bond funds. Short-dated exposures also generated positive returns over the quarter, supported by the stable repo rate. Offshore equity, bond and cash allocations faced a headwind from a stronger rand, as the local currency was significantly stronger against most major developed market currencies over the quarter. Strong hard currency returns from global equity markets were largely negated by rand strength, which meant that global equities in rand terms ended the quarter largely flat. A small allocation to local cash in the Portfolio managed to deliver stable positive returns, however, these allocations did place a slight drag on performance as all other local asset classes delivered strong performance over the quarter.

Fund Selection

The contribution from fund selection was mixed over the quarter.

PSG Equity had a great quarter after a very difficult start to the year. The fund outperformed its peers and its benchmark. The fund benefitted from the rally we saw in the fourth quarter of the more cyclical and "value" companies. Performance over the quarter was driven by the fund's exposure to Basic Materials (Glencore, AECI and The Mosaic Co.), Financial Services (Discovery) and Industrials (Super Group).

Nedgroup Investments Core Bond delivered strong performance in the fourth quarter of the year. This was largely driven by positive performance from long dated SA government bonds, particularly in the >12 year area of the curve. Foreigners returned to the SA bond market in the final quarter of the year, with non-residents purchasing a net amount of R12.1 billion and R19.8 billion of SA bonds in November and December respectively. This, along with a contraction in the SA sovereign credit spread, pushed yields lower across different maturities, leading to positive price moves in many cases (due to the inverse relationship between bond yields and prices).

The Ninety One Global Franchise FF had yet another challenging quarter, lagging peers and failing to post a positive return. Whilst local currency (ZAR) returns were affected negatively by a significantly stronger rand over the quarter, the fund's exposure to non-bank financial counters such as Moodys Corporation (-11,6%) and S&P Global (-19,6%) was amongst the key detractors from performance whilst the likes of ASML Holdings (16,5%) and Bookings Holdings (14,7%) were amongst the top contributors to performance. This fund generally protects capital in down markets owing to its exposure to quality counters and can consequently lag during periods of market recovery due to its relatively lower exposure to high beta and cyclical counters.

Coronation Strategic Income managed to deliver positive performance over the quarter, despite lagging peers slightly. The fund's allocation to long dated SA government bonds drove performance, as foreigners returned to the SA bond market as net buyers in November and December and the SA sovereign credit spread reduced slightly. Local listed property allocations in the fund also drove performance, as the asset class rebounded slightly after a tumultuous start to 2020. Offshore allocations in the portfolio acted as a headwind to performance over the quarter, largely due to rand strength against most major currencies.

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

Summary

We are pleased that the Portfolio ended the year on a strong note, delivering decent returns in the final quarter of the year. Despite the challenging market environment in 2020, the Portfolio also managed to generate decent inflation beating returns over the calendar year. 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 Global Cautious Portfolio Update

December 2020



The portfolio gained 6.7% in the last quarter of 2020 as most asset prices continued to recover from the pandemic-induced trough at the end of Q1. Despite the onset of a further wave of COVID-19 infections and renewed economic lockdowns in many countries, there appeared to be a growing sense of optimism among investors supported by the approval of several vaccines. This had a particular impact on companies that are more sensitive to economic conditions, lifting their share prices considerably in November. Many of these companies had previously appeared unusually good value, compared to their peers, when viewed from a long-term perspective. Our investment process enabled us to identify these holdings and add them to the portfolio. Consequently, our portfolios had greater exposure to these companies and benefitted from other investors latterly adopting a more optimistic view of the future.

The one-year return of 10.1% is reassuring given the large swings in market prices over 2020. This reminds us of the importance of taking a long-term view when investing and demonstrates that periods of investor pessimism provide opportunities to enhance future returns. The returns since inception remain an attractive 6.5% annualized. It is important to remember that given the cautious nature of the portfolio, this return has been delivered with a modest risk profile.

Asset Allocation

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 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 prospects and are therefore likely to lag as the gravity of valuation overcomes the excessive optimism of investors in the fashionable parts of the market.

However, as share prices continue their recovery, the choice of good value investment opportunities has become more limited and hence it is more important than usual to have sufficient research capacity to cover the widest possible range of investment options and the courage to purchase assets that are out of favour with other investors. Fortunately, our investment team of almost 100 people supported by over 500 analysts across the Morningstar group is well equipped to find these opportunities as we run valuation models on over 300 asset classes and groups of assets.

One example of how we achieve this is via the portfolio's exposure to UK companies. The UK has lagged other markets over the last few years due to concerns about BREXIT and the high exposure to unpopular industries such as energy and banking. While there are good reasons to be concerned about the economic impact of BREXIT and the long-term returns from traditional sources of energy, these concerns appear to be over-represented in the price of companies listed in the UK. Consequently, by investing in the UK we can access some of the most attractively priced companies across global capital markets, most of which derive the majority of their sales and profits outside the UK. In an environment where opportunities are narrowing, we expect more investors to become enthusiastic about the positions we have already added to portfolios, lifting prices, and delivering returns for our investors. When investing in undervalued companies time is your friend as the longer you hold your investments the more likely it is that prices will converge with fair value. This situation is reversed when holding expensive assets and consequently we continue to have less exposure to expensive assets such as US companies in general and the big US technology companies in particular, where we believe that prices are far ahead of a reasonable expectation of the fair value of these businesses.

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 strong returns. All the fixed income holdings also managed to deliver positive returns. From an equity perspective, Fidelity Emerging Markets and Ninety One GSF UK Equity Alpha were the most significant contributors to the performance of the portfolio, driven by strong positive moves in both emerging markets and UK 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 December, with the major change being the removal of iShares Europe Equity Index, which was replaced by Schroder ISF Euro Equity.

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

December 2020



The portfolio gained 11.2% in the last quarter of 2020 as most asset prices continued to recover from the pandemic-induced trough at the end of Q1. Despite the onset of a further wave of COVID-19 infections and renewed economic lockdowns in many countries, there appeared to be a growing sense of optimism among investors supported by the approval of several vaccines. This had a particular impact on companies that are more sensitive to economic conditions, lifting their share prices considerably in November. Many of these companies had previously appeared unusually good value, compared to their peers, when viewed from a long-term perspective. Our investment process enabled us to identify these holdings and add them to the portfolio. Consequently, our portfolios had greater exposure to these companies and benefitted from other investors latterly adopting a more optimistic view of the future.

The one-year return of 13.0% is reassuring given the large swings in market prices over 2020. This reminds us of the importance of taking a long-term view when investing and demonstrates that periods of investor pessimism provide opportunities to enhance future returns. The returns since inception remain an attractive 8.4% annualized. It is important to remember that given the moderate nature of the portfolio, this return has been delivered with a strong focus on risk.

Asset Allocation

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 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 prospects and are therefore likely to lag as the gravity of valuation overcomes the excessive optimism of investors in the fashionable parts of the market.

However, as share prices continue their recovery, the choice of good value investment opportunities has become more limited and hence it is more important than usual to have sufficient research capacity to cover the widest possible range of investment options and the courage to purchase assets that are out of favour with other investors. Fortunately, our investment team of almost 100 people supported by over 500 analysts across the Morningstar group is well equipped to find these opportunities as we run valuation models on over 300 asset classes and groups of assets.

One example of how we achieve this is via the portfolio's exposure to UK companies. The UK has lagged other markets over the last few years due to concerns about BREXIT and the high exposure to unpopular industries such as energy and banking. While there are good reasons to be concerned about the economic impact of BREXIT and the long-term returns from traditional sources of energy, these concerns appear to be over-represented in the price of companies listed in the UK. Consequently, by investing in the UK we can access some of the most attractively priced companies across global capital markets, most of which derive the majority of their sales and profits outside the UK. In an environment where opportunities are narrowing, we expect more investors to become enthusiastic about the positions we have already added to portfolios, lifting prices, and delivering returns for our investors. When investing in undervalued companies time is your friend as the longer you hold your investments the more likely it is that prices will converge with fair value. This situation is reversed when holding expensive assets and consequently we continue to have less exposure to expensive assets such as US companies in general and the big US technology companies in particular, where we believe that prices are far ahead of a reasonable expectation of the fair value of these businesses.

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 strong returns. All the fixed income holdings also managed to deliver positive returns. From an equity perspective, Fidelity Emerging Markets and Dodge and Cox Worldwide US Stock were the most significant contributors to the performance of the portfolio, driven by strong positive moves in both emerging markets and US 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 December, with the major change being the reduction in the allocation to iShares Europe Equity Index and the introduction of Schroder ISF Euro Equity.

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

December 2020



The portfolio gained 15.8% in the last quarter of 2020 as most asset prices continued to recover from the pandemic-induced trough at the end of Q1. Despite the onset of a further wave of COVID-19 infections and renewed economic lockdowns in many countries, there appeared to be a growing sense of optimism among investors supported by the approval of several vaccines. This had a particular impact on companies that are more sensitive to economic conditions, lifting their share prices considerably in November. Many of these companies had previously appeared unusually good value, compared to their peers, when viewed from a long-term perspective. Our investment process enabled us to identify these holdings and add them to the portfolio. Consequently, our portfolios had greater exposure to these companies and benefitted from other investors latterly adopting a more optimistic view of the future.

The one-year return of 16.9% is reassuring given the large swings in market prices over 2020. This reminds us of the importance of taking a long-term view when investing and demonstrates that periods of investor pessimism provide opportunities to enhance future returns. The returns since inception remain an attractive 10.4% annualized.

Asset Allocation

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 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 prospects and are therefore likely to lag as the gravity of valuation overcomes the excessive optimism of investors in the fashionable parts of the market.

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Risk Warnings

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