

Quarterly Fund Commentary

Quarter 1 2021

Morningstar Investment Management South Africa

April 2021



Local Market Commentary

March 2021



The first quarter of 2021 marked the 1-year anniversary since the first Covid-19 induced lockdown in South Africa, which started on the 27th of March 2020. Interestingly, it also marked the 1-year anniversary of the trough of the fall in the FTSE/JSE All Share Index on Covid-19 related fears, with the SA equity index delivering a staggering 54% return for the 1-year period ending on the 31st of March 2021! This once again highlights the importance of staying invested through market cycles, with those focused on trying to play the perilous game of timing markets often ending with subpar returns from their portfolios.

The theme of the quarter was largely one of divergent returns from equity and bond markets. Equity markets continued to climb higher during the quarter, reaching all-time highs in some cases across the globe. This came largely on the back of economic data reflecting the recovery from the Covid-19 pandemic continuing to surprise on the upside. Progress continued to be made on vaccine rollouts across the globe, despite significant divergence in the success of these programmes for specific countries (none more so than at home here in South Africa).

Movements in global fixed income markets were slightly more concerning, as yields moved higher (moving prices lower), led by US Treasuries, as global bonds ended the first quarter with their worst return in decades. The uptick in global bond yields appears to be connected to inflation expectations, with fixed income markets pricing in higher inflation in the medium term, which is likely to lead to interest rate increases from the US Federal Reserve (Fed) and other major central banks. This, despite the Fed's insistence that they will continue to keep monetary policy accommodative as the US economy continues its recovery from the shock of the Covid-19 pandemic.

SA markets followed a similar theme to the global narrative, with the local equity market reaching an all-time high in the quarter and the local bond market ending the quarter in negative territory. This, despite positive news on lower-than-expected inflation, a reduction in government bond auctions, a lower-than-expected budget deficit and a stronger rand. In a reversal of the recent trend, foreigners exited the local bond market during the quarter, selling around R36 billion worth of bonds in the first three months of the year. The performance from the local equity market was largely driven by strong performance from commodity counters, with Resources (+19%) faring better than Industrials (+13%) and Financials (+4%) over the quarter.

On the 24th of February, Finance Minister Tito Mboweni tabled the 2021/2022 Budget in Parliament. The minister announced that revenue is expected to be around R100 billion ahead of expectations, largely due to tax collections from the mining sector coming in higher than expected due to booming commodity prices, coupled with a recovery in VAT. South African President Cyril Ramaphosa announced on the 28th of February that the country will move to a level 1 lockdown, to aid a resumption of economic activity amidst the decline in daily Covid-19 cases. The South African Reserve Bank's Monetary Policy Committee (MPC) announced during March that it will leave the repo rate unchanged at 3.5%. This was the fourth consecutive meeting where the MPC decided to leave the rate unchanged, however, unlike recent meetings, the decision was unanimous, with all five members voting to keep rates on hold.

Despite the disappointing returns from fixed income markets, local investors will largely be pleased with returns generated in the first quarter of 2021. As global economies continue their recovery from the restrictions put in place to halt the spread of the Covid-19 virus, major governments and central banks across the globe have pledged to continue to provide monetary and fiscal support. This, in turn, has supported the prices of financial assets, and equities in particular. As always, we will continue to seek out opportunities in markets using our valuation driven approach, as we aim to deliver on clients' investment objectives over the long term.

Global Market Commentary

March 2021



Important Perspective

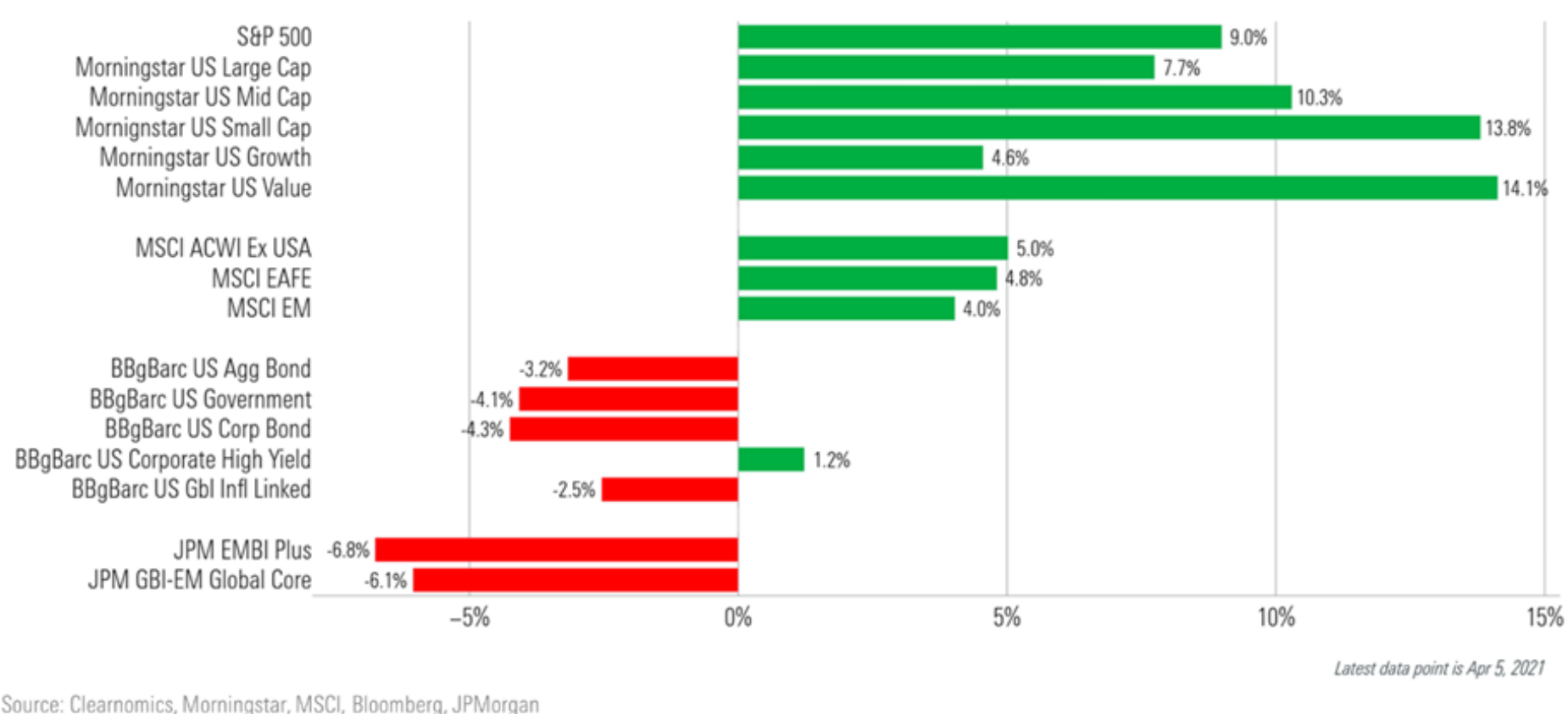
What a difference a quarter of a year makes. After a dramatic 2020, we have seen the green shoots of “reflation”, with several significant developments co-existing. The major market influences are a) inflation expectations are higher with central banks, for now, willing to let prices rise, b) economic growth forecasts increasing following solid vaccine progress, c) company reporting broadly exceeding expectations, d) geopolitical tensions and systemic risks softening, and e) investors conditioned by strong returns through good news and bad.

This culminated in strong returns for equities but weak returns for bonds in the first quarter. Among equities, the corners of the markets that had been hot—in some cases for years—turned cold. In fact, we saw a remarkable change with value stocks at the top of the leaderboard, buoyed by energy and financial companies, and technology stocks landed in the unusual position of worst performers. Smaller companies, more likely to have their fortunes tied to the strength of the economy, were among the best performers. Dividend-payers, which struggled in 2020, also saw a first-quarter recovery.

In the bond market, dormant expectations for inflation began to emerge, leading to losses across interest-rate-sensitive sectors of the market even as central banks committed to easy-money policies. The first-quarter bond sell-off hit government bonds the hardest, followed by safer core and corporate bonds. Only high-yield bonds managed to end the quarter just in positive territory.

In the background, the yield curve (which looks at the effective interest rate for governments over different time periods) steepened severely from three months ago on expectations for stronger economic growth. For example, the 10-year yield in the U.S. has risen by 1.04% since last year, reaching pre-pandemic levels near the end of the first quarter. But it wasn’t just U.S. Treasuries that were hit hard—U.K. government bonds also saw a 7.2% decline and government bonds lost 6.2% globally.

Exhibit 1 The first quarter of 2021 saw equity market strength and bond market weakness.



Global Market Commentary

March 2021



Longer-Term Perspective

On a year-over-year basis, a more compelling story emerges as the scope of the bounce back from the depth of last year's brutal bear market becomes clear. From where it ended in the first quarter of 2020, stocks are up significantly.

Meanwhile, under the hood of the stock market, we continue to see significant changes in leadership. Perhaps most notable is the recent strength in value stocks, which have been lagging significantly in recent years. Still, the longer-term performance gaps in preference of growth stocks remains wide. While losing the least in the bear market, wide-moat stocks have lagged in the recovery.

At a sector level, despite the dismal quarter, consumer cyclical stocks have gained the most of any sector from a year ago, rising over 100% from last March. Utilities have been the slowest to recover, only gaining 19% in the same period.

Turning to bonds, the decline in government bonds has muted total returns for more cautious investors, while corporate bonds have done slightly better. Over the past year, though, high-yield and emerging-markets bonds have staged the largest recovery, with high-yields bonds up approximately 24% and emerging-markets bonds recording double-digit returns.

Southwood Balanced Portfolio Update

March 2021



Moderately aggressive investors will be pleased with returns generated in the first quarter of 2021. The strong performance was largely generated by the returns from local and global risk assets, as equities continued to move higher in reaction to positive economic news.

The Southwood Balanced Portfolio returned 7.7% for the quarter and has generated a return of 36.3% 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 delivered strong returns over the quarter, largely driven by the performance of mining counters which moved sharply higher in reaction to movements in major commodity prices (excluding gold). Resources (+19%) and Industrials (+13%) delivered strong performance, while Financials (+4%) generated positive performance despite lagging the other sectors slightly. Offshore equity allocations contributed positively to performance, as both developed and emerging equity markets delivered decent returns for investors. Cyclical sectors including Financials and Energy performed strongly over the quarter, as economies continued to recover from the Covid-19 induced restrictions in 2020 and early 2021. Local bonds faced a headwind from rising yields over the quarter in reaction to expectations of higher inflation and interest rates over the medium term, which acted as a headwind for certain fixed income instruments. Local cash allocations in the Portfolio managed to deliver stable positive returns, which was a positive contributor to performance in an environment of rising yields. A small allocation to offshore bonds detracted from performance over the quarter, as global bond markets had their worst start to a year in decades in reaction to yields moving sharply higher on the back of rising inflation expectations.

Fund Selection

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

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 Glencore (+24%) and Imperial logistics (+29%) also delivered decent performance during the month.

The Ninety One Global Franchise FF had yet another challenging quarter, posting a positive return but lagging its peers. Currency was a tailwind for returns over the quarter as the rand weakened relative to the dollar. Part of this Fund's underperformance comes from its meaningful exposure to quality defensive counters which have lagged in the current leg of the reflation trade that has largely benefitted cyclical counters that were hit the hardest during the Covid-19 sell-off. Exposure to counters such as Charles Schwab (23,9%) and ASML (25,6%) contributed to performance whilst the likes of Checkpoint Software (-15,3%) and Verisign (-7,7%) were amongst the key detractors.

Nedgroup Investments Core Bond delivered disappointing performance over the quarter, as SA government bonds faced a headwind from rising global bond yields in reaction to increases in medium term inflation expectations. The increase in yields (moving prices lower) came despite positive news on lower-than-expected inflation, a reduction in government bond auctions, a lower-than-expected budget deficit and a stronger rand. The fund has significant exposure to medium and long dated bonds which are more sensitive to changes in interest rates.

Summary

We are pleased that the Portfolio managed to deliver strong performance in the first quarter of 2021. 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

March 2021



The portfolio was largely flat for the first quarter of 2021. Equity asset prices continued to recover from the pandemic-induced trough at the end of the first quarter of 2020. 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 distribution of several vaccines and a further economic stimulus package in the US. This combination of strengthening economic growth supported by significant stimulus, including direct payments to families in the US and an ongoing commitment to low interest rates from the US Federal Reserve has induced a degree of euphoria in the actions of some investors, leading to speculative trading and extreme price volatility in some companies, most notably Game Stop. Such optimism among investors tends to lead to inflated prices, lowering future expected returns and increasing the potential for a sharp fall in prices. Concerns about inflation accompanied this growing economic optimism among investors, leading to a sharp rise in government bond yields and negative returns from government bonds.

The one-year return of 18.6% is unusually large, as it reflects the recovery from the COVID-19 induced lows of March 2020. The sharp swings we have seen in market prices remind us of the importance of taking a long-term view when investing and also demonstrates that periods of investor pessimism provide opportunities to enhance future returns, while exaggerated optimism often comes before a decline in prices. The returns since inception remain an attractive 6.2% 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

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

However, it is important to note that the choice of good value investment opportunities has become more limited over the last quarter and consequently the prudent management of risk has become more important. We are therefore placing more emphasis on the robustness of the portfolio to a range of market outcomes. This is done by modelling the impact of these scenarios on the portfolios and considering how the structure can be improved with the lowest impact on expected returns. As other investors are increasingly discounting positive economic scenarios, the opportunity cost of building more robust portfolios has declined. We plan to take advantage of the more attractive pricing to increase our exposure to government bonds and defensive equities. These are assets that are likely to act as a small drag on returns while investors remain optimistic, but should provide an important level of protection in the event that sentiment among investors becomes more negative. Notwithstanding the planned increase in defensive assets, we continue to see some value in more cyclical companies and markets that have been out-of-favour over most of the last year, such as banks and those that dominate UK equities. In this way, the portfolio is beginning to resemble a 'bar bell', with more emphasis on attractively priced defensive and economically sensitive assets and lower exposure to more highly priced assets that require a benign economic environment.

Fund Selection

The rise in bond yields was especially relevant for cautious investors. While portfolios benefitted from the fact that we continue to hold less government bond exposure than is typical, the dominance of bonds within portfolios drove both absolute and relative returns over the quarter. As bond yields have risen, these assets have become more attractive. However, yields remain well below the level that we would regard as offering a fair return and hence we continue to have a lower than usual exposure to this part of the market.

From a fund selection perspective, all equity funds in the portfolio managed to generate decent returns over the quarter. Those funds with a fixed income bias struggled, as corporate and sovereign bonds came under pressure due to rising yields.

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

There were no changes to the portfolio in the first quarter of 2021.

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

March 2021



The portfolio gained 2.6% in the first quarter of 2021, supported by further gains in equity prices that continued to recover from the pandemic-induced trough at the end of the first quarter of 2020. 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 distribution of several vaccines and a further economic stimulus package in the US. This combination of strengthening economic growth supported by significant stimulus, including direct payments to families in the US and an ongoing commitment to low interest rates from the US Federal Reserve has induced a degree of euphoria in the actions of some investors, leading to speculative trading and extreme price volatility in some companies, most notably Game Stop. Such optimism among investors tends to lead to inflated prices, lowering future expected returns and increasing the potential for a sharp fall in prices. Concerns about inflation accompanied this growing economic optimism among investors, leading to a sharp rise in government bond yields and negative returns from government bonds.

The one-year return of 34.2% is unusually large, as it reflects the recovery from the COVID-19 induced lows of March 2020. The sharp swings we have seen in market prices remind us of the importance of taking a long-term view when investing and also demonstrates that periods of investor pessimism provide opportunities to enhance future returns, while exaggerated optimism often comes before a decline in prices. The returns since inception remain an attractive 8.5% annualised. It is important to remember that given the balanced nature of the portfolio, this return has been delivered with a very 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 future prospects and which are consequently likely to lag, as the gravity of valuation overcomes the excessive optimism of investors in the fashionable parts of the market.

However, it is important to note that the choice of good value investment opportunities has become more limited over the last quarter and consequently the prudent management of risk has become more important. We are therefore placing more emphasis on the robustness of the portfolio to a range of market outcomes. This is done by modelling the impact of these scenarios on the portfolios and considering how the structure can be improved with the lowest impact on expected returns. As other investors are increasingly discounting positive economic scenarios, the opportunity cost of building more robust portfolios has declined. We plan to take advantage of the more attractive pricing to increase our exposure to government bonds and defensive equities. These are assets that are likely to act as a small drag on returns while investors remain optimistic, but should provide an important level of protection in the event that sentiment among investors becomes more negative. Notwithstanding the planned increase in defensive assets, we continue to see some value in more cyclical companies and markets that have been out-of-favour over most of the last year, such as banks and those that dominate UK equities. In this way, the portfolio is beginning to resemble a 'bar bell', with more emphasis on attractively priced defensive and economically sensitive assets and lower exposure to more highly priced assets that require a benign economic environment.

Fund Selection

The strong returns from businesses more exposed to economic growth were especially relevant for balanced investors, as we have previously orientated portfolios towards these type of companies as we believe that other investors were too pessimistic about the probability and impact of a strong economic recovery and hence were undervaluing economically sensitive companies such as financial and energy businesses.

From a fund selection perspective, all equity funds in the portfolio managed to generate decent returns over the quarter. Those funds with a fixed income bias struggled, as corporate and sovereign bonds came under pressure due to rising yields.

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

There were no changes to the portfolio in the first quarter of 2021.

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

March 2021



The portfolio gained 4.9% in the first quarter of 2021, supported by further gains in equity prices that continued to recover from the pandemic-induced trough at the end of the first quarter of 2020. 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 distribution of several vaccines and a further economic stimulus package in the US. This combination of strengthening economic growth supported by significant stimulus, including direct payments to families in the US and an ongoing commitment to low interest rates from the US Federal Reserve has induced a degree of euphoria in the actions of some investors, leading to speculative trading and extreme price volatility in some companies, most notably Game Stop. Such optimism among investors tends to lead to inflated prices, lowering future expected returns and increasing the potential for a sharp fall in prices. Concerns about inflation accompanied this growing economic optimism among investors, leading to a sharp rise in government bond yields and negative returns from government bonds.

The one-year return of 53.3% is unusually large, as it reflects the recovery from the COVID-19 induced lows of March 2020. The sharp swings we have seen in market prices remind us of the importance of taking a long-term view when investing and also demonstrates that periods of investor pessimism provide opportunities to enhance future returns, while exaggerated optimism often comes before a decline in prices. The returns since inception remain an attractive 10.9% annualised.

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

However, it is important to note that the choice of good value investment opportunities has become more limited over the last quarter and consequently the prudent management of risk has become more important. We are therefore placing more emphasis on the robustness of the portfolio to a range of market outcomes. This is done by modelling the impact of these scenarios on the portfolios and considering how the structure can be improved with the lowest impact on expected returns. As other investors are increasingly discounting positive economic scenarios, the opportunity cost of building more robust portfolios has declined. We plan to take advantage of the more attractive pricing to increase our exposure to defensive equities. These are assets that are likely to act as a small drag on returns while investors remain optimistic, but should provide an important level of protection in the event that sentiment among investors becomes more negative. Notwithstanding the planned increase in defensive assets, we continue to see some value in more cyclical companies and markets that have been out-of-favour over most of the last year, such as banks and those that dominate UK equities. In this way, the portfolio is beginning to resemble a 'bar bell', with more emphasis on attractively priced defensive and economically sensitive assets and lower exposure to more highly priced assets that require a benign economic environment.

Fund Selection

The strong returns from businesses more exposed to economic growth were especially relevant for equity investors, as we have previously orientated portfolios towards these type of companies as we believe that other investors were too pessimistic about the probability and impact of a strong economic recovery and hence were undervaluing economically sensitive companies such as financial and energy businesses.

From a fund selection perspective, most equity funds in the portfolio managed to generate decent returns over the quarter. The largest contributor to the performance of the portfolio was Dodge and Cox Worldwide US Stock, with the fund's overweight exposure to cyclical areas of the market including Financials and Energy acting as a tailwind. The largest detractor from performance was Franklin US Opportunities, which struggled during the quarter due to overweight positions in Technology companies.

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

There were no changes to the portfolio in the first quarter of 2021

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

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