Quarterly commentary

Kagiso Balanced Fund

March 2020

KAGISO Asset Management

The fund was down a disappointing 21.0% this quarter, underperforming the average of competitor funds (down 13.5%), amidst a huge market crash, as the Covid-19 crisis stalled economic activity across the world. Clearly we were not expecting this crisis when selecting assets for the fund. Asset prices are very volatile, with visibility on the outlook so low, and relative fund performance is dramatically different from day to day.

A major contributor to the underperformance in March was our local mid-cap holdings, which are trading very little at the moment as holders are not inclined to sell at such low prices, but small marginal sellers dramatically negatively impact prices. Additionally our large PGM miner exposure was particularly severely marked down.

The fund has delivered -0.3% pa over the last three years and has returned 6.33% pa since its inception in 2011.

Material unforeseen shocks have dramatically changed the economic outlook

1. The 2019 Covid-19 outbreak began negatively affecting Chinese economic activity early in the year.
2. Covid-19 spread worldwide and was declared a global pandemic, with unprecedented negative economic repercussions resulting from the necessary containment measures.
3. The oil price crashed in March due to aggressive supply increases by Saudi Arabia - a very large, low-cost producer, targeted at higher cost competitors. The crash was particularly severe as demand is extremely weak due to the dramatic decrease in global travel resulting from Covid-19 lockdowns.
4. Locally, our economy entered 2020 in a weak recessionary state with very low confidence and increasingly acute fiscal pressures. Decisive actions to control the spread of Covid-19 in South Africa, while highly commendable and successful thus far, are resulting in devastating damage to the fragile economy.
5. There has been an extremely sharp depreciation in the rand. This is due to South Africa's weak economic fundamentals amplified by the effects of the lockdown on the economy and large fund outflows following the Moody's sovereign rating downgrade to junk status. Global companies, listed on the JSE Securities Exchange, materially outperformed in rand terms as a result.

There is extreme uncertainty around how these economic shocks will evolve, which is forcing the contemplation of a wide range of probable scenarios, ie visibility is very poor. This is vastly different to (and more negative than) the envisioned outlook prior to these shocks.

Market review

Global markets were materially weaker this quarter (down 20.9% in US dollars) with the UK (down 28.8%), Germany (down 26.6%) and France (down 27.8%) underperforming. Within emerging markets (down 23.6% in dollar terms), South Africa (down 40.3%), Brazil (down 51%) and Russia (down 36.3%) underperformed.

In rand terms, the local equity market was down 21.4% this quarter, with mid-caps (down 35.5%) materially underperforming large caps. Industrials (down 6.3%) outperformed primarily due to the high exposure to very large global companies, ie Naspers (up 11.5%), Reinet (up 2.5%) and British American Tobacco (up 2%). Retailers were particularly weak (Massmart, Truworths, Woolworths and Pepkor were all down over 40%).

Resources were down 24.4%, with general miners down 18.3% and PGM miners particularly weak (down 44.1%). Standout underperformers included Impala Platinum (down 46.4%) and Northam Platinum (down 43.9%), while Assore (up 12%) and Anglo Gold Ashanti (up 1.3%) outperformed. Sasol (down 87.8%) was particularly weak.

Financials were down 39.4%, with listed property (down 47.6%) and banks (down 42.7%) very weak. Hammerson (down 70.0%), Fortress B (down 69.6%), Redefine (down 68.7%) and Nedbank (down 61.4%) were particularly weak. Santam (down 5.2%) and the JSE (down 8.3%) outperformed.

Developed country governments have responded to the health care crisis and the resultant pausing of large parts of their economies with very aggressive fiscal stimulus packages. These recent measures, together with a dramatic easing of already extremely accommodative monetary policy (through rate cuts and increased quantitative easing) will most likely temper the permanent economic damage from the crisis. The interventions are also providing a powerful buffer to financial markets for the time being.

SA bonds returned -8.7% for the quarter (in March registering the worst ever monthly performance (-9.7%), materially underperforming cash (up 1.7%). South Africa's sovereign credit rating was downgraded to sub-investment grade by Moody's at the end of the quarter. The SARB took three emergency measures in March, affecting the fixed interest markets:

- the policy rate was cut by 1% to 5.25%;
- they began an unprecedented secondary market purchase program for government bonds; and
- introduced proposals to temporarily relax liquidity and capital requirements, and accounting standards, for the banking sector.

In spite of recent material currency weakness, the precipitous fall in the oil price, benign food inflation and the likely inflation dampening effects from much reduced demand means that local inflation will likely be low in the medium term.

The fund has underperformed in the short term

Our equity funds have underperformed benchmarks over the first quarter of 2020, owing primarily to:

- The underperformance of our PGM holdings, despite very healthy PGM commodity prices in rand terms.
- Sharp falls across much of our diverse mid-cap holdings, which have occurred in a low volume environment, characterised by extremely large bid-offer spreads. We believe a more realistic and better assessment of prices will manifest in normal liquidity conditions, and indeed, some of our mid-cap holdings have recovered meaningfully since quarter end.
- Global holdings exposure to quality cyclicals as well as US banks. These positions underperformed considerably in the quarter but have subsequently materially rebounded.

Equity market hedging contributed positively to performance over the quarter, as did instrument selection within bonds.

Given the material change in prospects for most economic participants across the world, envisaged cashflows from many of our holdings will not emerge as previously expected. These shocks were clearly unforeseen and we could not have been positioned optimally in advance. What we can do is assess the new environment as best as possible and adapt the portfolios appropriately, in line with our investment philosophy.

It is of paramount importance to keep in mind that the month of March has seen extremely high levels of market volatility and apparent performance appears materially different from day to day. In the face of such uncertainty on so many levels and with heightened volatility, it is not useful to consider performance in the short term.

Material detractors this quarter were our PGM miner holdings (Northam Platinum and Royal Bafokeng Platinum), Sasol, Curro and AECI. The key positive contributor was Naspers.

Our global equity holdings detracted from performance with key negative contributors being M&G Plc, Aroundtown, Citigroup, Spire Healthcare and Goodyear Tire & Rubber Company. The key positive contributor was JD.com.

Portfolio actions and positioning

Immediate actions

At the outset of the current market turmoil, our initial focus was to systematically assess (across stocks under coverage) the financial strength and balance sheet resilience of each business and the likely near-term cashflow impacts of the economic shocks. We aimed to identify companies that were particularly vulnerable to the Covid-19 containment measures so that we could reduce exposure if prices were not reflecting our concerns.

We took the following actions in portfolios:

- Accounting for liquidity and what was already priced into stocks - exposures were lightened in more vulnerable holdings.
- In a number of the more liquid stocks held, where prices were slower to fall - we also lightened somewhat.
- We maintained our equity market hedges.

Our actions raised unusually high cash exposure in the fund and it is our view is that there will be opportunities to deploy this cash in the weeks ahead as the shocks take their toll on company results. In addition, given the poor visibility, we believe it is prudent not to rush into increasing equity exposure again unless there is very material upside on offer (on revised potential scenarios) or we gain greater clarity on how the future is likely to unfold.

Subsequent actions

Our team has been systematically focused on assessing stocks under coverage across a range of possible scenarios – vastly different from previous base cases. Team debates and research efforts have been focused on understanding how the business environment has changed, with many likely casualties and consequent attractive opportunities for survivors, even in a weak economy.

Current positioning

- We maintain our high exposure to low-cost, growing PGM miners and we remain confident of a return to an acute shortage in PGM metals when global activity normalises – due to structural supply impediments and growing demand from tightened emission regulations. With the depreciated currency meaningfully reducing dollar cash costs, current share prices offer extremely attractive near-term free cashflow yields, even with commodity prices much lower than at present.
- Our diverse selection of mid-cap holdings offered very attractive upside prior to the recent crash. Based on revised assumptions and sharply lower share prices, the upside is now even greater in many cases. Given the liquidity issues discussed above, our sense is that the diversified underlying fundamental drivers of these companies (many of which are actually well positioned to navigate the crisis due to benefits from a weaker currency and defensive end markets) has not yet reflected in their weak performance to date.
- We have been buying a number of new holdings based on our assessment of company prospects and sharp falls in share prices. These include MTN and Sanlam.
- We maintain a very high weighting in Naspers where the group balance sheet is strong and the underlying exposure to online Chinese economic activity (via Tencent) has a very bright long-term future and the company is thriving in the current crisis.
- We have more exposure to South African government bonds than in recent years due to very attractive real yields on offer, despite the very weak fiscal position of the country.
- Credit spreads had compressed meaningfully in the domestic market prior to the crisis and we were very circumspect about exposure to corporate credit, where spreads were not adequately compensating for the additional risk. We remain guarded with relatively low credit exposures, mainly in preference shares and short-term credit instruments.

- We remain highly selective within property and have moderately reduced exposure to offshore property.
- Our global equity exposure remains far lower than permissible limits due to the more attractive potential returns we see locally as well as the very weak rand.
- We maintain a higher than normal cash balance with a view to deploying this into risky assets at appropriate entry points.
- We maintain a meaningful level of equity market hedging.

We believe that the current crisis will lead to a high level of financial stress for many companies, especially those with weaker balance sheets, low or zero revenue for a period, high fixed costs, weak negotiating power with suppliers or clients and poor management. This will inevitably lead to permanent losses of capital, which we are actively trying to avoid through our considerable research efforts.