Quarterly commentary

Kagiso Balanced Fund

December 2020

KAGISO Asset Management

This quarter's performance was primarily a result of strongly positive contributions from equities (local and global). The fund was up 12.1% this quarter, meaningfully ahead of the average of competitor funds (up 5.9%) and up 2.2% over the last year (versus 5.2% for competitors). The fund has delivered 6.0% pa over the last three years, returning 8.7% pa since its inception in 2011.

After falling further than the general market in the market crash of last year, mid-cap stocks have generally lagged larger, liquid stocks in the sharp subsequent recovery, leading to a material underperformance last year. Many of these stocks are still trading in thin volumes and at very depressed prices, amid high uncertainty regarding the lasting damage they are suffering from the current crisis. More realistic market prices are likely to emerge as these companies report results and reaffirm their prospects, which should boost fund performance given the relatively high weighting in such stocks.

Economic backdrop

A severe COVID-19 resurgence has necessitated renewed partial lockdowns across the world, which is delaying economic recovery. The successful development of vaccines has shielded the world from more negative global health and economic scenarios, but the timing of the economic recovery in different regions and the extent of further scarring (particularly in services sectors like leisure and tourism) depends critically on the effectiveness of the vaccine rollout. In addition, the immense increase in global government debt due to aggressive fiscal stimulus will retard future, long-term growth. On the whole, uncertainty remains very high.

Positively, the global economy entered the crisis in a strong position, with healthy consumer dynamics in most developed markets and a moderating, but still strongly growing, Chinese economy. Developed market consumer and corporate health appears to have been largely preserved through extensive fiscal and monetary support. Consumer indications (discretionary retail sales, vehicle purchases and housing activity) have fared better than initially expected and increased cumulative savings (from less spend under lockdowns) bodes well for future consumption under more normal conditions. Nevertheless, economic conditions will be put to the test only when fiscal support and monetary stimulus tapers off and the reality of permanent job losses manifests.

Following a rapid resumption of economic activity back to pre-crisis levels, the Chinese economy is now growing strongly. This is largely due to the successful early containment of the pandemic, government stimulus (which boosted infrastructure investment in particular) and surprisingly strong exports and manufacturing (buoyed by temporary COVID-19 related goods demand) - despite weak consumer confidence and spending. However, pre-crisis risks remain: a disruptive moderation and rebalancing of economic growth (away from fixed asset investments and towards consumption) and potential further deterioration in geopolitical relations.

The local economy is being negatively impacted by the strong resurgence of COVID-19 and will require an effective vaccine rollout to resume its recovery. The economy shows signs of permanent damage (scarring) from years of mismanagement (particularly, a very depressed labour market, unstable electricity supply and chronically low business confidence and investment) and the combined restrictions of the lockdowns. While economic revival plans are well articulated, they still rely too heavily on policy implementation from weakened state institutions and do not draw sufficiently from private sector cooperation. Economic prospects, under more normal medium-term conditions (household consumption in particular), have weakened substantially from before the crisis. It is clear that our post-crisis economic recovery will take meaningfully longer than the rest of the world due to the inherent structural weaknesses of the South African economy, with increased risk due to unsustainably high sovereign debt.

Positively, high commodity prices (in particular platinum group metals and iron ore) are significantly supporting economic outcomes and the agricultural sector is having a few good seasons.

The medium-term outlook for emerging economies is extremely varied at present, with differing exposures to volatile energy prices (importers vs exporters), the decimated tourism industry and differing impacts from the management of the pandemic and efficacy of vaccine rollouts.

Market review

Global markets were strong again this quarter (up 14.1% in US dollars), with Japan up 21.2%, France up 20.7% and the UK up 17.2%. Within emerging markets (up 19.8% in dollar terms), South Korea (up 35.0%) and Brazil (up 36.6%) outperformed. 2020 has been a very strong year for global equity markets (up 16.5% overall).

In rand terms, the local equity market was up 9.8% this quarter, with mid-caps (up 13.7% for the quarter versus large-caps up 8.9%) still significantly underperforming this year (down 14.2% for the year versus large-caps up 10.0%). Financials outperformed (up 20.1%), with listed property (up 22.2%) and banks (up 25.8%) outperforming life insurance (up 14.1%). Fortress B (up 100.7%), Redefine (up 27.2%), Capitec (up 38.1%) and Absa (up 34.2%) outperformed, while Momentum (up 1.7%), Fortress A (up 4.6%) and Santam (up 4.8%) underperformed.

Within the resources sector (up 7.9%), PGM miners (up 29.1%) outperformed, while gold miners (down 24.8%) lagged. Standout performers included Impala Platinum (up 38.8%) and African Rainbow Minerals (up 35.4%).

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Industrials (up 6.8%) lagged - primarily due to heavyweights Naspers (up 2.2%) and British American Tobacco (down 6.0%). Standout positive performers included Barloworld (up 48.2%) and MultiChoice (up 38.3%). Retailers were again mixed, with Mr. Price (up 30.9%) and The Foschini Group (up 24.8%) outperforming, while Shoprite (up 2.5%) and Spar (up 3.4%) underperformed. The hospital sector underperformed, with Mediclinic and Netcare down 7.4% and 3.3% respectively.

The local market was positive for the year (up 7.0%), with divergent sectoral performances. Resources were up 21.1%, industrials were up 14.3%, but financials underperformed (down 14.2%).

Governments in developed countries responded to the health care crisis and the resultant pausing of large parts of their economies with aggressive fiscal stimulus packages. Together with a dramatic easing of monetary policy (rate cuts, increased quantitative easing and other unconventional measures), this has tempered economic scarring from the COVID-19 crisis. The interventions, which are being sustained into the recovery phase, are providing a powerful buffer for financial markets and have led to dramatic increases in general asset prices. We expect increased volatility when fiscal stimulus inevitably wanes, if inflation emerges at last and when interest rates rise from their extremely low levels.

SA bonds returned 6.7% for the quarter, materially outperforming cash (up 1.0%). After a very poor performance from bonds in the first quarter (down 8.7%), which saw the sovereign credit rating downgrade to junk status by Moody's and resultant abnormal selling by foreign investors, bonds have recovered meaningfully - up 8.7% for the year.

The SARB seems to have reached the end of its path of easing, cutting the repo rate by 0.25% to 3.5% in July, but remaining unchanged in September and November, citing low inflation expectations and notably weak (but improving) demand conditions. In spite of recent global oil price increases, local inflation should be low in the medium term due to the reduced demand conditions.

Fund performance and positioning

Material contributors this quarter included Omnia, Altron, our PGM miner holdings (Northam Platinum and Anglo Platinum), Anglo American and Adcorp Holdings. Detractors (there were not many) included Libstar and Master Drilling.

Our global equity holdings contributed positively to performance, with standouts being Aroundtown, Bodycote, Timken, Spire Healthcare and Prudential plc. Detractors included Bayer, Inpex and Ontex.

We believe that companies with stronger balance sheets, better business models and flexible, more adaptable management teams will outperform - especially in the weaker economy in the years ahead. We are maintaining exposure to such companies, at the right price.

Our portfolios contain a diverse selection of local mid-cap holdings offering very attractive upside.

Following a change of management in 2015, Afrox adopted a new strategy that focused on resetting the cost base and shifting capital spend towards building capacity for its growth markets. Management has executed this strategy well - delivering a 14% per annum growth in earnings over the last five years. The company has excellent financial metrics with high margins, good cash conversion and consistent high returns on capital. Furthermore, Afrox has many underappreciated fundamental strengths, several material near-term growth opportunities and significant pricing power, which should support near-term earnings amid continued economic uncertainty. The Linde Group, who are aware of these attractions, recently made an attractive offer for all Afrox shares it doesn't currently own. Our clients benefitted materially from this value unlocking transaction this quarter.

Within equities, we maintain our high exposure to low-cost, growing PGM miners. We expect an acute shortage in PGM metals when global economic activity normalizes, due to structural supply impediments, demand from tightened emission regulations, increased jewellery demand and a rapidly growing hydrogen energy sector. Current share prices offer extremely attractive near-term free cash flow yields, even if commodity prices were much lower.

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 bright, long-term future. The company is thriving in the current crisis, as evidenced by recent results.

- We have more exposure to ultra-long South African government bonds than in recent years, due to highly attractive real yields on offer, despite the very weak fiscal position of the country.
- We remain guarded on corporate credit exposure, with relatively low credit exposures mainly in short-term credit instruments of well-capitalised financial sector companies.
- We remain highly selective within property and have moderately reduced exposure to offshore property.
- Our global equity exposure was increased last quarter but remains lower than the permissible limits due to the more attractive potential returns we see locally.
- We maintain a meaningful level of equity market hedging.