

The fund was down 30.2% this quarter, underperforming other general equity funds (down 22.8% on average), 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 stocks for the fund and short-term prospects for these companies are significantly altered in most cases. Share 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 returned -3.9% pa over the last three years, ahead of the peer group average (-5.6% pa). Over the last ten years, the fund has returned 6.5% pa and it is ranked fifth since inception over 15 years ago - delivering 13.7% pa.

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.

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.

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.

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 maintain a higher than normal cash balance.

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.