Quarterly commentary

Kagiso Protector Fund
September 2019

The fund was up 1.5% this quarter, slightly underperforming its (CPI +4%) benchmark of 1.8%. This quarter's performance was due to a positive contribution from local and foreign equities, as well as bonds. The fund has returned 7.5% pa over the last three years, behind its benchmark (9.2% pa), but is ranked first in its category over this period. Since its inception in 2002, the fund has returned 9.7% pa.

Economic backdrop

Global economic growth, though still healthy, has decelerated further from the high rates of recent years largely due to a continuing moderation in Chinese growth. Growth expectations have continued to retreat this quarter as business confidence has deteriorated with accelerating US protectionism, particularly in the global manufacturing sector (especially Europe and Japan). Consequently, key central banks have abruptly ended their tightening and begun loosening monetary policy and signaling more accommodation, should economic activity deteriorate. Trade activity continues to weaken due to the ongoing trade dispute between the US and China and this seems to be dampening business confidence.

US economic growth has been strong this year, but weaker manufacturing production (due to trade tensions) and the tapering off of fiscal stimulus support is now leading to a moderation back to trend. In Europe, manufacturing and export related activity is very weak, particularly in Germany, affected by slower Chinese growth and a contracting global automotive market. Japan's recent economic resilience is somewhat due to pre-emptive consumption ahead of an impending consumer tax hike.

Overall growth in China continues to moderate as the government acts to rebalance the economy and reign in credit excesses and as export growth is affected by trade tensions. Infrastructure investment and manufacturing related growth is most affected, although the economy is somewhat shielded by domestic stimulus.

Emerging market currencies were weaker this quarter as many countries continued along the path of aggressive rate cutting. India, Indonesia and Eastern Europe continue to outperform, but growth has eased in line with global growth. Indian growth in particular has been dampened by unexpected tax rises and a clampdown on the shadow banking sector. Previous laggards (South Africa, Russia and Turkey) have seen sequential growth off very low levels.

Locally, there was a moderate recovery in growth in the second quarter as the severe electricity-supply disruptions of the first quarter abated. Nevertheless, the South African economy continues to deliver a very weak performance, with persistently low business confidence, contracting fixed investment and lackluster consumption growth amidst a steadily deteriorating labour market. Continued progress in governance improvements (strengthening of corruption fighting institutions and improving corporate governance and senior leadership at SOCs) is being accompanied by frustratingly slow economic policy action in the face of a deteriorating fiscal position.

Market review

SA bonds returned 0.7% for the quarter - underperforming cash (1.8%). This brings the year-to-date performance of SA bonds to 8.4%, with cash returning 5.5%. Emerging market local currency bonds enjoyed notably strong foreign inflows again this quarter, however, South Africa did not participate, with foreigners selling our bonds over the period. Despite an increasingly fragile fiscal picture we continue to believe longer dated bonds offer attractive returns, due to well-anchored inflation prospects and very substantial implied real yields.

Aside from administered prices, domestic inflationary pressures remain subdued due to sharply lower wage settlements and generally absent demand-pull price pressures as a result of the weak economy. Moderate pressure from a weaker currency is beginning to impact food and goods inflation. The MPC held the policy rate unchanged at 6.5% at the September meeting, describing the inflation forecast risks as balanced.

Global markets were only moderately higher in the last quarter in US dollars (up 0.7%) with the USA (up 1.7%) and Japan (up 2.8%) offsetting declines in France (down 1.4%), Germany (down 3.8%) and the UK (down 2.2%). Emerging markets (down 4.1% in dollar terms) were weak, particularly South Korea (down 4.8%), India (down 5.2%) and South Africa (down 12.4%).

In rand terms, the local equity market was negative this quarter (down 4.6%) with the resources sector (down 7.3%) underperforming. Diversified miners were weak, while gold and platinum miners were strong again (up 12.4% and 25.8% respectively). Standout performers included Northam Platinum (up 40.9%), Impala Platinum (up 36.6%) and Harmony Gold (up 36.4%).

Financials were down 6.8%, with Discovery (down 23.5%) and the banks (down 7.8%) being particularly weak. Listed property was also weak (down 4.5%), with Intu Properties (down 38.6%) the worst.

Industrials (down 2.1%) outperformed. Large companies, including MTN (down 8.0%) and Richemont (down 4.1%), underperformed, while British American Tobacco (up 13.7%) was strong.

For several years, extreme, unconventional monetary stimulus in the form of price agnostic asset purchases have distorted asset prices across the globe. Global bond yields have retreated to very low levels (pricing in exceedingly low levels of future long-term inflation), corporate bond credit spreads are depressed, and equity prices are high, especially in large cap stocks and sectors where growth prospects are well appreciated.

US bond yields are moderately higher than the record low levels of 2016, accompanied by tentative signs of wage led rising inflation (although yields in other developed markets are now back down to record lows). Recent trade tensions between the US and its key trading partners appear to have negatively impacted the global growth outlook and central banks are now undertaking pre-emptive

Fund performance and positioning

Excellent local stock selection, fixed interest instrument selection, hedging activities and our allocation to global stocks were the main contributors to performance. Our exposure to local property was a moderate detractor. Strong local equity contributors this quarter included Northam Platinum, Clover, Royal Bafokeng Platinum and AECI. Key detractors included Sasol, Libstar, African Rainbow Minerals and Curro.

Our global equity holdings contributed positively to performance with key contributors being Umicore, Ontex, Wells Fargo and Sekisui Chemical. Prudential, Evonik and Siemens underperformed.

Despite a global backdrop of reasonable, but weaker, economic growth, risks of negative trade disruptions (as Chinese economic growth continues to trend lower) and a local market facing a very weak economy - we remain positive on the outlook for our stock holdings, given very attractive market ratings relative to our assessment of their prospects.

Our decision to increase exposure to both local and global equities towards the end of 2018 (due to substantially weaker prices), together with excellent local stock selection this year, has led to material outperformance.

With the outlook for the South African economy being weak in the medium term, we continue to hold material positions in unpopular or neglected areas of the SA equity market where we find idiosyncratic investment cases that offer improving prospects, not wholly dependent on the economy performing. We have high exposure to mid-cap industrial stocks where we see compelling stock-specific potential, coupled with low market prices. Over two thirds of our SA equity exposure across our funds lies outside of the top 50 largest shares. Additionally, we continue to maintain a small hedge against our equity exposure, especially in our lower risk funds.

We maintain a position well below maximum permitted limits in offshore markets, mostly because of the very exciting expected returns we see in our South African holdings and somewhat due to the relatively weak rand at present. Our global stock picks are widely diversified across (mostly) developed markets, have somewhat of a quality cyclical orientation and stand to benefit from a less negative economic environment than is reflected in their very low share prices.

An example of a compelling midcap idea is Datatec, where we expect a continued strong contribution to fund performance as it completes a major corporate restructuring. The company's has two operating businesses. Logicalis is a global leader in information technology managed services and Westcon is a global information technology hardware distributor. In 2017, Datatec sold its US and Latin American Westcon operations (roughly half of Westcon) for an attractive price, unlocking material value. The company returned around R4 billion to shareholders via a special dividend last year and over R1 billion, or roughly 20% of its market capitalisation after the deal, via an additional share buyback program. After the Westcon partial sale, Datatec retained the very large central cost base of the former (larger) Westcon group. Management are making good progress in reducing these costs, as planned, and turning around the remaining business. We expect the residual Westcon group to return to profitability over the next few months. This turnaround is revealing a substantially more valuable company than was implied by the share price 18 months ago. Ultimately, we expect further value to be unlocked via a sale of one or both of its remaining businesses.