Quarterly commentary

Kagiso Protector Fund
September 2020

KAGISO Asset Management

The fund was up 0.6% this quarter, underperforming its (CPI + 4%) benchmark of 2.4% and returning 2.8% pa over the last three years. Since its inception in 2002, the fund has returned 8.9% pa.

After dropping further than the general market in the first quarter, mid-cap stocks have generally lagged larger, liquid stocks in the sharp subsequent recovery. This has led to their very material underperformance for the year to date. Many of these stocks are trading in thin volumes 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 reposition their prospects. Given that the fund holds a high weighting in mid-cap stocks, we expect a material portfolio outperformance from this source in the months ahead.

Economic backdrop

Efforts to reopen global economies are cautiously underway and it appears that the most severe scenarios concerning global health and economic outcomes have been averted. However, a considerable amount of uncertainty remains around the resurgence of Covid-19 in many regions, necessitating the resumption of restrictions. The immense increase in global government debt balances due to aggressive fiscal stimulus will hamper future, long-term growth and uncertainty remains high.

Positively, the global economy entered the crisis in a buoyant position, with healthy consumer dynamics in most developed markets and a moderating, but strongly growing Chinese economy. Developed market consumer health appears to have been largely preserved thus far through extensive fiscal and monetary support and increased savings rates (less spend under lockdown). Early consumer indications (discretionary retail sales and vehicle purchases) have fared better than initially presumed and in many regions housing activity is now at healthy levels, partially due to changing consumer needs resulting from remote working. However, consumer expenditure sustainability is being put to the test as fiscal support tapers off and permanent job losses begin to bite.

The Chinese economy has had a remarkably quick resumption of economic activity, with many key economic indicators above pre-crisis levels and continuing to improve, especially automotive purchases and online retail sales. However, the path of a return to trend growth that is vital for a return of global growth to higher levels, is unlikely to be smooth as:

- consumer confidence is still shaken (evidenced in increased savings rates);
- the capacity and appetite for further debt-fuelled infrastructure stimulus appears diminished; and
- there are risks to manufacturing and export growth from weak (though improving) global trade and possible further deterioration in geopolitical relations.

Although recovering sharply from the second quarter economic activity trough, the local economy is showing signs of permanent damage following years of mismanagement and the extended lockdown (particularly, a very depressed labour market and chronically low business confidence). Economic revival plans are well articulated, but still rely too heavily on policy implementation from weakened state institutions that do not draw sufficiently from private sector cooperation. On a positive note, there is now evidence of anti-corruption action from strengthened state bodies, which may serve to revive confidence somewhat. Economic prospects, under more normal medium-term conditions (household consumption in particular) have weakened substantially due to weak pre-Covid conditions. It is clear that South Africa's post-Covid economic recovery will take substantially longer than the rest of the world due to the inherent structural weaknesses of the economy, with increased risk caused by unsustainably high sovereign debt, chronic unemployment and poor human capital development.

The medium-term outlook for emerging economies is extremely varied at present, with differing exposures to low energy prices (importers versus exporters), the decimated tourism industry, varying pandemic-related impacts and exposure to the more buoyant Asian regions.

Market review

Global markets were strong again this quarter (up 8.0% in US dollars), with Germany up 8.1% and the USA up 8.9%, but with the UK and Hong Kong lagging (flat and down 2.6% respectively). Within emerging markets (up 9.7% in dollar terms), South Korea (up 13.5%) and India (up 15.1%) outperformed.

In rand terms, the local equity market was up 0.7% this quarter, with mid-caps (up 1.3% for the quarter versus large-caps up 0.7%) continuing to underperform considerably this year (down 24.5% year to date versus large-caps up 1.1%). Again, resources outperformed (up 5.7%), with standout performers being the PGM miners (up 21.7%).

Industrials (down 2.4%) underperformed primarily due to Naspers (down 6.4%). The telecommunications sector was mixed, with MTN (up 6.3%) outperforming, while Telkom (down 9.8%) underperformed. Retailers were also mixed, with Shoprite (up 30.3%) and Spar (up 10.5%) outperforming, while Pick n Pay (down 7.9%), Mr Price (down 7.7%) and Truworths (down 7.4%) underperformed.

Financials were marginally higher (up 0.5%), with listed property (down 14.1%) and life insurance (down 6.5%) underperforming banks (up 6.2%). Fortress B (down 49.2%), Redefine (down 27.2%), Capco (down 23.4%) and Liberty (down 14.1%) underperformed, while PSG Group (up 26.5%), Discovery (up 22.4%) and FirstRand (up 8.3%) outperformed.

Governments in developed countries responded to the healthcare 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 the economic damage from the crisis. The interventions have provided a powerful buffer to financial markets up to this point, but we expect increased volatility when fiscal stimulus inevitably wanes, when inflation emerges at last and when interest rates rise from the current extremely low levels.

SA bonds returned 1.5% for the quarter, outperforming cash (up 1.2%). After a markedly poor performance from bonds in the first quarter (down 8.7%), which was accompanied by the sovereign credit rating downgrade to junk status by Moody's and material selling by foreign investors, bonds have recovered meaningfully over the last six months (up 11.5%).

The SARB seems to have reached the end of its easing cycle, cutting the repo rate by 0.25% to 3.5% in July and leaving it unchanged in September - citing the stubbornly low inflation expectations and significantly weak (but improving) demand conditions. In spite of currency weakness, this years' local inflation should be very low in the medium term due to the fall in the oil price, benign food inflation and the inflation-dampening effects from reduced demand.

Fund performance and positioning
An excellent selection within local equities and bonds was the main positive contributor to performance, although hedging activities detracted from performance in this period.

Material local equity contributors this quarter included Northam, the Foschini Group, Omnia, and Master Drilling. Key detractors were Telkom, Libstar, Naspers and Adcorp.

We believe that there will be distress among local companies whose balance sheets are weaker and whose management teams do not adapt to the new environment, therefore permanently affecting prospects. Companies with better business models and stronger management teams will outperform, especially in the weaker economy in the years ahead. We are endeavoring to maintain exposure to such leading companies at the right price.

We maintain a position below maximum permitted limits in offshore markets, mainly due to the higher expected returns we see in our South African holdings.

- 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 regarding corporate credit exposure, with holdings mainly in short-term credit instruments of well-capitalised corporates.
- We remain highly selective within listed property.
- We maintain a meaningful level of equity market hedging.

Our diverse selection of local mid-cap holdings offered very attractive upside prior to the recent crash. Based on revised, post-crisis assumptions and sharply lower share prices, the upside is now even greater in many cases. Given the liquidity issues mentioned 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 the benefits of a weaker currency and defensive end markets) have not yet reflected, judging by their weak performance to date.

An example of this is Curro, which is South Africa's largest provider of private schooling, offering a range of schools to meet different income levels. Schooling is a capital-intensive business where infrastructure is built in anticipation of future demand. Newly built schools typically accept learners at entry level grades and fill up over time as learners progress through grades. Curro is emerging from a period of rapid growth and many of its schools are not yet mature. We expect profitability and cash flow to improve rapidly as the utilisation of these investments in new schools improves. The prevailing weak economy is a risk to private and public schools, where significant support is provided by middle to upper income parents. However, it is our view that Curro is well positioned to endure the current constraints of parents' ability to pay school fees, to gain market share from struggling competing schools and to continue to capitalise on the large opportunity for quality, affordable education in South Africa.

Within equities, we maintain our high exposure to low-cost, growing PGM miners. We remain confident of a return to an acute shortage in PGM metals when global economic activity normalises, due to structural supply impediments and growing demand from tightening emission regulations. With the weaker currency meaningfully reducing dollar cash costs, current share prices offer extremely attractive near-term free cash flow yields, even if commodity prices move much lower than at present as we expect.

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.