Quarterly commentary

Kagiso Protector Fund
March 2021

KAGISO Asset Management

The fund was up 9.1% this quarter, outperforming its (CPI + 4%) benchmark of 2.0% and returning 11.2% pa over the last three years. Since its inception in 2002, the fund has returned 9.9% pa.

After falling further than the general market in the market crash of last year, mid-cap stocks have commonly 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 reposition their prospects, which should boost fund performance given the very high weighting in mid-cap stocks.

Economic backdrop

Rapid rollout programs of very effective vaccines are underway in the USA, the UK and Israel, with other rich countries accelerating after slow starts. This increases the probability of a faster return to more normal activity in those regions, limiting further scarring in services sectors (particularly tourism and leisure). Unfortunately, several less wealthy nations are enduring another Covid-19 surge, accompanied by very slow vaccine rollout programs. This is delaying their economic recoveries. It appears that the rate of vaccine rollouts is insufficient to quell the virus worldwide and, with mutations arising where the virus is raging, it's likely that negative economic effects are likely to endure for an extended period. Uncertainty remains 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 and ongoing fiscal and monetary support. In the USA, the level of fiscal support has increased further this year and will be a positive and enduring boost for the global economy. Consumers have fared better than initially expected and increased cumulative savings (from less spend during lockdowns and direct forms of fiscal stimulus) bodes well for future consumption under more normal conditions. Nevertheless, enduring economic conditions may be visible 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 once again 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). This is despite continued lackluster 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.

Due to relatively moderate lockdown restrictions the local South African economic recovery was not meaningfully derailed by the strong second wave of Covid-19 infections. Nevertheless, a much more effective vaccine rollout will be needed to continue the recovery in services sectors. Positively, continued high commodity prices (particularly platinum group metals and iron ore) are significantly supporting economic outcomes and the agricultural sector is very buoyant. The economy shows signs of permanent economic damage (scarring) from years of state mismanagement (particularly, a very depressed labour market, unstable electricity supply, weakened and tax-hungry municipalities and chronically low business and investment confidence) and the restrictions of the lockdowns.

While economic revival plans are well articulated, they still rely too heavily on implementation from weakened state institutions and do not draw sufficiently on private sector co-operation. Although on a strong recovery path from very low levels, it is clear that a full 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. Economic growth prospects, under more normal medium-term conditions (household consumption in particular) have weakened substantially relative to before the crisis.

The medium-term outlook for emerging economies is extremely varied at present, with differing exposures to volatile energy prices (importers vs exporters), strong commodity prices, the decimated tourism industry and differing impacts from the management of the pandemic and efficacy of vaccine rollouts. Due to recovering domestic demand and some signs of increased inflation, policy interest rates are beginning to normalize higher from extraordinarily low crisis levels.

Market review

Global markets were strong again this quarter (up 5.0% in US dollars), with the USA up 6.2%, France up 5.3% and the UK up 6.1%. Within emerging markets (up 2.3% in dollar terms), South Africa (up 12.3%) and Russia (up 5.0%) outperformed, while Turkey (down 20.2%) and Brazil (down 10.6%) lagged. Over the last twelve months global equity markets have recovered very strongly from the March 2020 lows (up 54.8% overall).

In rand terms, the local equity market was up 13.1% this quarter, with mid-caps (up 9.4% for the quarter versus large-caps up 13.2%) still underperforming since the start of 2020 (down 6.4% versus large-caps up 19.8%). Resources outperformed (up 18.8%), PGM miners (up 29.4%) outperformed again, while gold miners (down 0.9%) lagged. Standout performers included Sasol (up 58.4%) and Anglo American Platinum (up 49.1%).

Industrials were also strong (up 12.4%) - primarily due to Naspers (up 17.0%). Standout positive performers included Motus (up 53.7%) and telecommunication stocks MTN (up 44.3%) and Telkom (up 37.9%). Retailers were generally strong, with Massmart (up 30.9%) and Truworths (up 29.8%) outperforming. Brait (down 30.0%), Clicks (down 4.9%) and Multichoice (down 3.8%) all lagged.

Financials underperformed (up 2.3%), with listed property (up 6.4%), banks (up 2.8%) and life insurance (down 1.0%). Hammerson (up 33.7%), Coronation (up 26.9%), Capital and Counties (up 21.7%) and Investec plc (up 20.0%) outperformed, while Discovery (down 13.7%), Liberty (down 4.9%) and Santam (down 4.3%) underperformed.

Extremely high developed market fiscal and monetary stimulus, which are being sustained (and in the case of the USA increased) into the recovery phase, are providing a powerful support 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 -1.7% for the quarter after a strong recovery in the second half of 2020. Cash returned 0.9% for the quarter. Global emerging market bonds traded weaker following rising US treasury yields. Markets are increasingly discounting rising inflation in the US, post the large fiscal stimulus aimed at supporting a pandemic hit economy, although US real yields are still negative. Foreigners continued to be net sellers of SA bonds this year.

The SARB remains content to maintain its very accommodative monetary policy, given low inflation expectations and very weak demand conditions, keeping the repo rate at 3.5% at the March meeting. Local inflation will be benign over the medium-term, given the weak economy and stronger rand, despite rising oil prices and higher food inflation.

Fund performance and positioning

Excellent equity stock selection (locally and globally) was the main positive contributor to performance. Hedging activities, however, detracted from performance in this period. Material contributors this quarter included Naspers, our PGM miner holdings (Royal Bafokeng Platinum and Anglo Platinum), MTN and Telkom. The only meaningful detractor was Brait. Hedging activities, however, detracted from performance in this period in line with our hedging strategy.

Our global equity holdings contributed positively to performance, with standouts being Inpex, Johnson Matthey, Siemens, Prudential and Kinder Morgan. Detractors included Ontex, Aroundtown and Siemens Energy.

It's very evident that companies with stronger balance sheets, better business models and flexible, more adaptable management teams are outperforming in the recovery period and we believe the outperformance will be even more pronounced 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.

Altron has been significantly reconfigured over the past five years, with 2020 culminating in the unbundling of their UK ICT-services company, Bytes Technology Group. Substantial value has been created for Altron shareholders by this turnaround and the separation of Bytes UK. The workplace is rapidly evolving, with distributed teams, new business models and complex security issues resulting in evolving software requirements. With a deep understanding of the technologies available, Bytes UK can sell the appropriate software licenses to corporate customers to meet their developing software needs. Its primary focus is on cloud and security products, including providing advice regarding updates or optimisations to existing software and helping to manage license compliance and renewals. It is well positioned to capitalise on the demand for software solutions stemming from the continued evolution of the workplace and will deliver solid earnings growth. Our clients have substantially benefited from our holding in Altron over the past five years and we were supportive of the recent unbundling.

Within equities, we maintain our high exposure to low-cost, growing PGM miners. We expect a sustained acute shortage in PGM metals when global economic activity normalises, due to structural supply impediments, demand from tightened emission regulations, increased jewellery demand and a rapidly growing hydrogen energy sector. Current share prices offer 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 listed property and have moderately reduced exposure to offshore property.
- Our global equity exposure has increased over the last six months 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.

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