Quarterly commentary

Kagiso Stable Fund

June 2020

KAGISO Asset Management

The fund was up 2.5%, ahead of its (CPI + 2%) benchmark of -0.2%. This was mainly as a result of our allocation to local equities and positive performance from our yield assets. The fund has returned 2.8% pa over the last three years, behind its benchmark of 5.9% pa. Since its inception in 2011, the fund has returned 6.6% pa.

After falling further than the general market in the first quarter, mid-cap stocks have generally lagged larger, liquid stocks in the sharp subsequent recovery, leading to a very material underperformance for the year to date. Many of these stocks are trading in thin volumes and at very depressed prices, amidst 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, though up strongly this quarter, it has lagged its benchmark for the year to date.

Economic backdrop

Efforts to reopen global economies are cautiously underway and it appears that the most severe scenarios concerning global health and economic outcomes may have been averted. However, a considerable amount of uncertainty remains regarding countries where the pandemic is still accelerating and the extent of subsequent waves post the unlocking phase. The immense increase in global government debt balances due to aggressive fiscal stimulus will most likely hamper future, long-term growth. Uncertainty remains very high.

Positively, the global economy entered the crisis in a buoyant position, with healthy consumer dynamics in most developed markets and a moderating, but still robustly growing, Chinese economy. Developed market consumer health appears to have been preserved thus far through extensive fiscal and monetary support and increased savings rates (from less spend under lockdown). Early consumer indications (discretionary retail sales and vehicle purchases) have been better than initially feared. However, their sustainability will be put to the test once fiscal support tapers off and the extent of permanent job losses are evident.

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

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

Locally, growth weakened further in the first quarter prior to the COVID-19 lockdown, following the very weak 2019 economic performance. The sharp decrease in fixed capital formation, from an already low base, is particularly concerning. Our very weak economy has been severely (and potentially permanently) damaged due to the extended lockdown. Economic prospects for the near-term (household consumption in particular) have weakened substantially. It is now 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.

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

Market review

Global markets were materially stronger this quarter (up 19.5% in US dollars), with Germany up 27.0% and the USA up 20.5%, but with the UK and Hong Kong lagging (up 9% and 4.7% respectively). Within emerging markets (up 18.2% in dollar terms), previous laggards South Africa and Brazil were stronger in the period.

In rand terms, the local equity market was up 23.8% this quarter, with mid-caps (up 15.4% for the quarter and down 25.5% year to date) again underperforming large caps (up 24.2% for the quarter and up 0.4% year to date). Resources outperformed (up 40.6%) with gold miners up 68.0% and PGM miners up 62.1%. Standout performers included Sasol (up 258%), African Rainbow Minerals (up 67.8%) and Northam Platinum (up 67.4%).

Industrials (up 17.1%) were strong, primarily due to Naspers (up 23.9%), with other large global companies also buoyant (British American Tobacco up 11.9% and Richemont up 14%). Standout performers included KAP (up 66%), Aspen (up 55.2%) and Telkom (up 44.3%). Retailers were mixed, with Truworths (up 36.1%) and Mr Price (25.4%) outperforming, while Massmart (down 16.5%), Pick and Pay (down 15.8%) and Shoprite (down 14.7%) underperformed.

Financials were up 13.0%, with listed property (up 20.5%) and life insurance (up 19.1%) outperforming banks (up 7.5%). Redefine (up 39.7%), Resilient (up 35.4%), Discovery (up 34.1%) and Coronation (up 32.6%) outperformed. Capco (down 13.8%), Capitec (down 2.4%) and FirstRand (down 1.9%) underperformed.

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 will likely temper the permanent economic damage from the crisis. The interventions are providing a powerful buffer to financial markets for the time being.

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SA bonds returned 9.9% for the quarter (more than erasing the previous quarter's losses), materially outperforming cash (up 1.5%). This strong recovery followed the sovereign credit rating downgrade to junk status by Moody's at the end of the prior quarter, which triggered abnormal selling by foreign investors.

The SARB continued on its path of easing, cutting the repo rate by a further 1.5% this quarter to 3.75%, citing a continued decline in inflation expectations and very weak demand conditions. In spite of currency weakness, 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
The primary contributors to performance this quarter was our allocation to yield assets and to local equities. Our exposure to risk assets is accompanied by significant downside protection, the cost of which caused a meaningful drag on performance this quarter (after adding to performance last quarter).

Material contributors this quarter included our PGM miner holdings (Northam Platinum and Royal Bafokeng Platinum), Naspers, African Rainbow Minerals, MTN and some of our mid-cap holdings (particularly Metair, Curro and Omnia). Key detractors were Adcorp, RECM, Calibre and Master Drilling.

Our global equity holdings contributed positively to performance, with standouts including M&G plc, Siemens, Brightsphere, Dupont De Nemours and SKF. Detractors were Ontex Group, Associated British Foods and Wells Fargo.

We believe that there will be casualties among local companies, where: balance sheets are weaker, the pandemic permanently affects prospects and management teams do not adapt well to the new environment. Companies with stronger business models and management teams will outperform, especially in the weaker economy in the years ahead. We are attempting to maintain exposure to such stronger companies at the right price.

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

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 benefits from a weaker currency and defensive end markets) have not yet reflected in their weak performance to date. Some examples include:

- ICT company, Datatec, derives the vast majority of its cashflows from outside South Africa and has a strong balance sheet. The company is benefiting from increased demand for its products and services due to the pandemic disruptions to office work environments. We continue to see material value from their cost cutting programme, market share gains and likely corporate actions.
- South African food producer, Libstar, operated as an essential service during lockdown. Its strong balance sheet and relatively defensive end markets should see it navigate the COVID-19 crisis period well. Longer-term, their strong retailer relationship, their focus on the faster growing private label market and their track record of successful innovation and category building (eg Lancewood Cheese) should result in continued good returns on investment and cash generation.
- AECI is a diversified explosives and chemicals manufacturer, supplying products and services to a broad spectrum of customers globally. While parts of the chemical business are exposed to the SA industrial sector, which is under severe pressure, the business is well diversified with offsetting exposures in fast growing markets such as water treatment, plant and animal health and high value mining chemicals. The explosives business commands a large share of the SA market and growth opportunities (mainly outside of South Africa), remain attractive. Added to this, the company recently announced a restructuring of its chemical business, which will deliver significant cost savings over the next 18-months. Together with synergies expected from recent acquisitions, the business is well placed to deliver healthy medium-term earnings growth.

Within equities, 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 economic activity normalizes, due to structural supply impediments and growing demand from tightened emission regulations. With the weaker currency meaningfully reducing dollar cash costs, current share prices offer extremely attractive near-term free cashflow yields, even were commodity prices to be much lower than at present.

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.

Our actions in the first quarter raised an unusually high cash balance that has been deployed into certain new positions. Meaningful purchases were: FirstRand, Oceana, MTN and Telkom.

- We have a high exposure to South African government bonds due to very attractive real yields on offer.
- We remain guarded on corporate credit exposure, with relatively low credit exposures, mainly in preference shares and short-term credit instruments of well-capitalised corporates.
- We remain highly selective within property and have moderately reduced exposure to offshore property.
- We maintain a very high level of equity market hedging, given the very strong markets and substantial lack of visibility regarding prospects for economic recovery.