

PORTFOLIO MANAGER COMMENTARY

The first quarter of the year was a strong one for global equity markets, and financial stocks in particular. During the period the fund returned 11.9% against the index return of 12.8%. Over 1, 3 and 5 years the fund (and index) has produced 17.7% (20.2%), 24.3% (24.8%) and 7.3% (5.1%) in annualised returns. While quite acceptable in absolute terms, the disappointing trend in medium term relative returns has not escaped our attention. This is the first time that we can recall slipping below the three-year benchmark, albeit by a small margin. It may be worth noting that this has not prompted a dramatic rethink or altered approach. The way we go about analysing stocks and constructing portfolios hasn't changed - we perform detailed fundamental analysis, interact regularly with company managements, regulators, and competitors, and continually review, question and challenge our investment views. We continue to believe that the portfolio is appropriately positioned.

Encouraging macroeconomic data and optimism that the worst-case scenario being priced into many equity markets would not eventuate contributed to a strong global equity rally in the first quarter of 2012. Two rounds of LTRO (effectively the European equivalent of US quantitative easing) was a significant contributor to this. The injection of cash into the system restored some confidence in European banks, and this reflected in the share prices of financial stocks, pushing the MSCI financials 18.3% (in US dollar terms) during the quarter. SA listed financial stocks followed suit, with banks returning 15.6% and insurers 13.6% (in rand terms).

All of the large financial institutions with the exception of Investec reported results during the quarter. The banks continue to deliver in line with the expectations built into our investment case, and are clearly past the trough of the earnings cycle. Earnings growth exceeded 20%, driven by improved credit losses, moderate asset growth and some margin expansion as a result of asset repricing. The capital positions of all four big banks are strong, and the prospect of a return of excess as the impact of Basel III become clearer remains. As the interest rate cycle inevitably moves upwards these businesses should benefit from improved endowment earnings, and despite having declined notably, impairments have some further scope for improvement. Life insurance companies also reported results not dissimilar from expectations, although it was evident that the middle-lower end of the market is performing ahead of the upper-middle market amongst the traditional players. Excess capital and the prospect of its return, once regulatory uncertainty is resolved, is a consistent theme in this sector too.

The fund's holdings in Discovery, African Bank, Standard Bank and Nedbank contributed to quarterly performance. Offsetting this were underweight positions in Sanlam and Old Mutual, and overweight positions in MMI, Capital Shopping Centres and Capital & Counties (both of which suffered from a 3% strengthening in the rand against sterling). No significant changes were made to the portfolio during the quarter. Small reductions were made to the fund's holdings in FirstRand (price performance) and ABSA (some questions over their asset growth strategy and concerns about numerous senior management departures). These funds were deployed to increase exposure to Investec and Old Mutual, and establish a new position in Brait.

While the US is showing some signs of recovery and a 'slowing' in Chinese growth to 7% - 8% is now considered acceptable, much uncertainty still hangs over Europe. The consensus not too long ago suggested that the worst was behind us. Now there is more caution, with concerns focused on Spain as we write. A renewed hawkishness on Europe is likely to reflect in financial company share prices given that they are at the epicentre of this crisis. This in turn is likely to impact on the ratings of South African financial shares, although as we have highlighted before many of the drivers are quite distinct from those of the global stocks. We continue to see value in the portfolio's investments, with banks trading on forward p/e multiples of 10x, and 1.75x p/book with attractive earnings growth prospects, and insurers ranging between a 15% discount to EV to a par rating for Discovery.

Portfolio managers

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