

Please note that the commentary is for the retail class of the fund.

The last quarter of 2017 continued to bring good news and strong returns to equity investors around the world. A combination of surprisingly strong economic data points (especially in regions like Europe and China), and a relatively benign outlook on interest rate normalisation in the US fueled equity markets to new highs. Investor euphoria built even stronger when the US legislative forums agreed to a radical reform of the US tax system, one of the cornerstones of the Trump administration's efforts to kick start growth in the US economy. The headline corporate federal tax rate is proposed to drop from 35% to 21%, in return for introducing a territorially based tax system. This will result in multinational US companies paying a bit more tax on their non-US earnings in return for the drastic reduction in domestic tax rates. At the time of writing this report, much of the detail remains unclear, but it does not take away from the fact that this is a significant event that in the short term will lead to a jump in the earnings of the S&P 500 of around 7-10%, and in the longer term could propel the US economy onto a higher growth path.

Global equity markets returned 5.7% over the quarter, and a very strong 24.0% over calendar 2017. The S&P 500 ended the year with a positive return in every month - a historic first. In addition to the factors mentioned above, inflationary pressures around the world continued to surprise on the downside and global central bank liquidity remained at close to peak levels throughout the year. This Goldilocks scenario culminated in very low volatility levels, with the cost of protection on equity markets continuing to make new lows as we speak.

Emerging markets had a blowout year, producing 37.3%, with China registering the strongest performance of 54.3%. Within developed markets, performances were closely bunched together, with Europe and Japan marginally outperforming the US. This was primarily as a result of the weaker US dollar as the US performed better than most other markets in local currency terms. The US dollar weakened by 14% against the euro over 2017. Over the longer term, the US equity market has however performed significantly better than any of the other developed equity markets.

While the performances of the various sectors over the quarter didn't divert much, healthcare continued to lag, as did utilities and telecommunication services. Energy stocks benefited surprisingly little from a strong rebound in the oil price, resulting the energy sector (+6.9%) being the worst performing subsector on the MSCI All Country World Index over 2017. Energy is probably the one sector (outside of real estate) that stand to benefit the least from the tax reform. Information technology was the standout winning sector, with an annual return of 41.8%. Other notable laggards were telecommunication (+8.1%) and utilities (+14.1%).

The fund performed well against this backdrop. It returned 24.9% for 2017, which should be viewed against a strong performance in 2016, meaning that alpha for the two-year period now amounts to 2.4% p.a. Over three years and since inception, the fund performed more or less in line with our benchmark given the very challenging first year of the fund's existence.

The biggest positive stock contributor this quarter was L Brands, a position that we have previously discussed in detail. It bounced back spectacularly from highly oversold levels, but subsequent to quarter-end sold off in response to poorer than expected Christmas trading numbers. Other strong contributors over the quarter included Fox (on the back of a proposed takeover by Disney), Amazon, Spirit Airlines (a low-cost US airline introduced into the portfolio a few quarters ago), Naspers, and Intu (after announcing a merger with Hammerson).

By far the biggest detractor was Altice NV, a new position in the fund that was severely punished by the market for producing poor trading numbers (especially in its French operation), leading to concerns about Altice's ability to service its reasonably high debt levels. Other disappointments included Allergan (loss of patents and an adverse court outcome), Newell Brands (poor trading update), and CVS Caremark and Walgreens (both punished due to fears that Amazon will enter the retail pharmacy market).

Over the last year Fortress remained our biggest positive contributor following its takeover by Softbank. Estácio and JD.com added significantly to performance, as did most of our other alternative asset managers (Apollo, KKR and Carlyle). Our internet positions including Amazon, Naspers and Facebook benefited from the strong uplift in the sector. The biggest detractors over 2017 were Altice NV (discussed above), Allergan and the retail pharmacy stocks Walgreens, CVS Caremark and Rite Aid (also on the back of Amazon-related concerns discussed above). Put options to protect the fund from a significant drawdown cost the fund 28 basis points over the 12-month period.

The US tax reform is a game-changing event, and investors should expect the portfolio to change once the details of the programme have been fleshed out. During the last quarter our decision to increase the fund's exposure to US cable stocks Comcast, Charter and even Altice NV was partially influenced by the fact that this sector will be a prime beneficiary of the proposed changes. The sector is almost exclusively focused on the US domestic market, provides for tax at the maximum rate, and is a significant investor in capital equipment, which will receive preferential tax deductions in terms of the current proposals. While the outcome of the tax reform initiative remained uncertain until just before Christmas, some of these stocks have reacted strongly before and after the bill has been passed. We will continue to assess investment opportunities with an open mind, but are also conscious of the fact that in a competitive environment like the US, there is a chance that at least some of the benefits of the tax reform will be competed away.

Portfolio managers
Louis Stassen and Neil Padoa
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