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

The fund finished the year with a weak quarter, resulting in the calendar year return reducing to 10.4%, underperforming the benchmark return of 13.8%. All of this underperformance came through in this last quarter and was predominantly driven by the strength of the rand given our overweight position offshore and our exposure to rand hedge stocks within our domestic equity and property allocation.

2017 proved to be a strong market for most asset classes. Equities in particular had a solid year with emerging markets the pick of the bunch. The fund started the year with an overweight position in equities and has slowly reduced this into these exceptionally strong markets. Within our offshore allocation we were also overweight global and emerging market equities, which contributed positively to our international allocation returns. Given the strong run in global markets and continued political uncertainty, we have deemed it prudent to trim back these holdings and, where possible, use some derivatives to lock in returns. As the economic outlook for most markets remains good, with Europe, Asia and the US still showing very positive underlying growth metrics, we do not believe we should be underweight equities, but given high levels of valuation it is no longer prudent to maintain a big overweight position.

Within the domestic portion of our equity allocation, while we had increased some of our exposure to local financial and industrial stocks, the majority of our exposure remained to companies with significant operations offshore. The main driver behind this remains the outlook for tepid growth locally and the expensive ratings of many domestic stocks. The strong rally in domestic stocks after the outcome of the ANC elective conference was not unexpected, but we remain firm in the belief that it is unwarranted given the massive challenges the locally economy faces. The fiscal position is dire and the low productivity of the workforce is unlikely to change given the poor educational outcomes. We have taken advantage of the recent run in domestic stocks to further lighten our exposure to these equities at what we think are exceptionally good levels. In addition to this, the fund was impacted negatively by a position in Steinhoff. The fund held a 2% position in the stock and the precipitous fall in December upon the announcement of the CEO's resignation and subsequent revelations that the annual financial statements would require restatement, negatively impacted the equity returns.

Along with SA stocks, domestic bonds have had a very strong rally at the end of the year. Given our very low exposure to government bonds this was also a detractor from our performance in the last quarter. The rally has also presented an opportunity for us to further reduce our exposure as the domestic bond market faces a number of challenges in the year ahead. SA's dire fiscal position will require much greater funding, especially as the parlous state of the finances of the state-owned enterprises becomes more evident. With debt to GDP spiralling ever higher, worsened by the prospect of free tertiary education, we do not believe current bond levels are sufficient to reward investors. As our debt rating by the various agencies moves to junk across all ratings agencies, we do not see the potential pool of investors getting any bigger. Instead, it will shrink. Importantly, this is happening in an environment where we see government bond yields in developed countries starting to rise, which will put further pressure on domestic bond yields.

Offsetting our low domestic bond position has been our high weighting in domestic property. While this did perform better in the last quarter, it has not yet responded to the election of Cyril Ramaphosa as ANC president to the same extent as the bond market. Yields on domestic property stocks remain very attractive, with many in double digit yields, with the prospect of further earnings growth. We remain overweight this particular asset class with expectations of decent returns before any capital growth. In addition to domestic names, the fund has held a big position, in excess of 3%, in Intu, a UK-listed owner of retail malls. In December, it was announced that another large UK property stock, Hammerson, would be making a takeover proposal at a significant premium. This saw the stock gain 18% for the month of December, despite the recent rand strength.

Within the offshore component outside of equities, we are also very underweight bonds with the exception of a few high-yield opportunities where we believe the credit spreads will more than compensate for adverse yield. We have increased exposure to property, adding to European retail landlords and, more recently, to a number of large US retail property owners where yields are looking very attractive and the underlying properties are high quality and defensive.

While the fund return was behind the benchmark during this period, we still delivered a pleasing double-digit return well ahead of inflation. Given the current structure and holdings of the fund, we believe we are well positioned to continue to deliver inflation-beating returns in the future and a performance ahead of benchmark, in line with our long-term track record.

Portfolio managers
Neville Chester and Pallavi Ambekar
as at 31 December 2017