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

Macro overview

The final quarter of 2018 unfortunately saw the downtrend already prevailing in most stock markets accelerate to even bigger losses. Where emerging markets suffered the most in the first half of the year, the developed world and specifically the US suffered the sharpest declines in the final months of 2018. The S&P 500 lost 13.5% in the quarter, resulting in a negative 4.4% return for the year. The FTSE 100, weighed down by the Brexit uncertainty, lost 11.7% in the quarter and was down 14.0% over the full year.

Although the global economy performed reasonably well, stock markets were negatively affected by the unpredictability of US President Donald Trump and his tweets relating to Federal Reserve policy, the trade war with China, the US government shutdown over the issue of funding the Mexican border wall and, of course, the Brexit debacle drawing inevitably closer in the UK.

The negative investor sentiment spilled over to South Africa, where the mood was already bleak as a result of a very weak economy, major problems exposed in the SOEs as well as the uncertainty around the land issue. The rate hike by the Reserve Bank further dulled investor sentiment.

The JSE SWIX declined by 4.0% over the quarter, taking the year's loss to 11.6%. The property index suffered another 4.0% decline in the final quarter, resulting in a substantial 25.3% loss for the full year. Bonds were the best-performing asset class, returning a positive 2.7% for the quarter and 7.7% for the year.

The fund's relatively high exposure to bonds helped to offset the negative returns from risky assets, resulting in a positive return of 2.0% for the year. The five-year return of 6.1% per annum (p.a.) is slightly ahead of inflation but failed to meet the target of exceeding inflation by 3%. Over the past 10 years, the fund has returned a commendable 9.8% p.a. - significantly ahead of inflation, which ran at 5.4% p.a. over the period and has therefore exceeded its targeted return.

Looking forward to 2019, we are certainly more optimistic about the potential stock market returns. The ratings of many stocks have adjusted downward and the earnings base for domestic companies is particularly low. A little good news and some top-line growth can lead to strong earnings growth and improved ratings for many of the shares we are invested in.

We have consequently been adding to JSE-listed equities, taking the fund's exposure to 19.5% at year-end - the highest level it has been all year. We added to a range of stocks, including British American Tobacco, Standard Bank, FirstRand, Shoprite and others. As far as Naspers is concerned, we used the extreme volatility in the share price to trade it actively, resulting in it being both one of our bigger buys and sells for the quarter.

An interesting feature of our fund is that the effective exposure to global assets was reduced during the year to end the 12-month period with a relatively low exposure of 21.8% (including a 4.9% currency future, which reduces the effective global currency exposure to just shy of 16.9%), of which 11.6% was in equities. The rand is a very volatile currency and also very difficult to predict. Our investment stance of adding to domestic assets while reducing global exposure was therefore driven by the fact that we see better value in the local market (stocks and bonds) and was not based on a rand currency view. We expect our bond holdings, with a yield of close to 10%, to be a key building block in the coming year to help us achieve our targeted return.

Cash has now outperformed this fund, and most balanced funds, even over a five-year period. It is therefore understandable that investors will question the relevance of staying invested in balanced funds. In our view, cash will not deliver inflation plus 3% in the long term. One therefore requires exposure to some risk assets where the potential return is far higher. Returns from the equity sector has, however, been poor and, on top of that, we have failed to add alpha over the past number of years. It is the low earnings base, combined with low ratings, that makes us much more optimistic about future returns from our equity investments and is the reason we have increased our exposure recently.

In summary, the portfolio carries an almost 50% exposure to domestic bonds, including inflation-linked bonds, at an expected real yield of close to 5%. The fund's weighting to domestic equities has been increased into price weakness and we are finding many stocks that now offer very good value. The fund's global exposure has been trimmed to make space for the more attractive local assets.

Portfolio managers
Charles de Kock and Pallavi Ambekar
as at 31 December 2018