It was a disappointing year, with the industrial sector declining meaningfully by 17.6% and the fund underperforming its benchmark to end the year at -20%. In the fourth quarter of 2018, the fund was down 6.3% -marginally above the benchmark -6.5%. Over 10 years the fund has averaged 16.0%, slightly beating the benchmark. Since inception, the fund has delivered a compound annual return of 16.5%, which is 2.7% above its benchmark.

Over the year, investor sentiment in South Africa deteriorated as Ramaphoria evaporated and structural concerns reasserted themselves as the dire state of many state-owned enterprises (SOEs) was further revealed. Most sit with inflated wage bills from overstaffing and years of above-inflation pay increases. The job cuts required to rein in costs are a tough call for a divided governing party facing an election in the next few months. Following the election, we are hopeful that a stronger mandate for the incumbent will enable more decisive reform. Eskom remains a significant problem, with its strained balance sheet and years of poor maintenance, resulting in the reoccurrence of load-shedding in an economy already struggling to grow. Positively, there has been progress on governance, with SOE boards being reconstituted and underperforming management teams being replaced. In addition, third-quarter GDP figures indicated a return to growth, although a further hurdle came in the form of the South African Reserve Bank's surprise repo rate increase of 25 basis points (bps) in November. This action was premised on a depreciating rand, persistent electricity price increases and a high oil price, which has subsequently declined. Food inflation also looks set to rise in 2019, with maize prices spiking in response to a poor rainy season in key planting areas.

The JSE Capped SWIX All Share Index ended 2018 down 10.9% (down 3.8% in Q4) as the euphoria of the first quarter subsided, resulting in both weak equity markets and a marked deterioration in the currency, down 13.8% for the year. The rand was one of the weakest currencies globally. Worldwide markets were also weak as fears of trade wars and slowing global growth momentum plagued sentiment.

We have the fortunate dilemma of seeing attractive value in both the offshore shares and domestic industrial shares, given the increased upside to our estimates of fair values after a year of market declines. The portfolios core building blocks remain in place, with significant positions in offshore stocks, including Naspers, British American Tobacco, Richemont and MTN. All of these companies have faced various challenges over the past year.

Earlier during the year, MTN was hit by claims from the Central Bank of Nigeria (CBN) and the Nigerian Attorney General for capital repatriation of US$8 billion and US$2 billion in back taxes. The share reacted violently to the news flow, with sharp declines and priced in a severe outcome with seemingly no value placed on the Nigerian operations. The actions of the Nigerian bodies attracted international attention as the investment climate was broadly undermined. The fund added to its position at this time. The issue of repatriation has subsequently been resolved for a notional amount of US$52 million. Despite resolution, shaken investor confidence means MTN continues to trade well below our opinion of fair value as we view investors as placing an excessive discount on African operations.

British American Tobacco (BTI), a major holding in the fund, ended the quarter at -27.4% and the year at -43.4%. The company significantly increased its exposure to the US market with its 2017 acquisition of Reynolds, and since then, US tobacco companies have been plagued by a barrage of negative regulatory developments. The Food and Drug Administration seeks to clampdown on tobacco levels in conventional cigarettes and reduce flavoured tobacco, particularly menthol, where BTI is the market leader. In addition, the market is facing structural change as reduced-harm offerings, such as vaping, could result in an accelerated volume decline in combustible cigarettes. New entrants (particularly Juul in the US market) have managed to establish good distribution channels and gain market share through a well-designed product with youth appeal. The share has been punished in response to these factors and the high levels of gearing from the Reynolds acquisition. Trading on 7.6 times its forward earnings and with a dividend yield of 9%, we believe the share offers exceptional value. BTI's healthy free cash flow conversion, and the likelihood that any regulatory change will take a few years to implement, will support balance sheet de-gearing. Given the ongoing negative news flow (regulatory developments, rise of e-cigarettes), there seems to be little price support, despite the valuation underpin. Ultimately, we believe fundamentals will reassert themselves.

Naspers remains a large holding in the fund, given the compelling opportunity set latent in this business. We remain cognisant of the inherent risk in Tencent, particularly given its size and dominance within a single, centrally-controlled market such as China. During the past year, delays in Chinese gaming licences have proved a headwind. Despite this, we expect strong growth to continue. Tencent is building a payments business in a financial services market segment many times larger than the gaming market as well as growing rapidly in areas such as cloud services and advertising. Within Naspers, streamlining of the portfolio continues, with more focused investment in core pillars such as the rapidly-growing food delivery businesses. A planned unbundling of the MultiChoice business in 2019, as well as a potential offshore listing of some of the internet assets further underpin management's commitment to reduce the discount to fair value.

Domestically, we believe earnings bases are low as cost bases have been trimmed and companies have faced several years of tough economic conditions with little volume. The food retailers owned by the fund are a good example. Rising food inflation and a (hopefully) stronger economy should provide food retailers and producers with the ability to raise prices and recover cost increases. A little bit of volume should deliver positive operating leverage given the lean cost bases.

Performance attributions over the past three years have been boosted by our holdings in Pick n Pay, Netcare, Naspers, Spar, and Barloworld, while British American Tobacco, Mediclinic and Steinhoff have been detractors. During the quarter, our overweight positions in Netcare, Pepkor, Clover, Cartrack and Rhodes Food Group, as well as our underweight position in Richemont all contributed to performance.

Portfolio activity during the quarter included building positions in Shoprite and Rhodes Food Group as well as adding to the British American Tobacco holding as its share price underperformed and valuation became more attractive. These purchases were funded from a variety of sources as individual names relatively outperformed.

It has been a challenging year. Shares prices plummeted on disappointing news flow and there have been few marginal buyers for assets with uncertainty. Given the extent of share price declines, we see compelling value in many names which now trade at significant discounts to our assessment of fair value. The team continues to do as we have done before; cut out the noise, work hard to interrogate investment theses and invest for the long term, where we believe the inherent value in many of our holdings will reassert itself.

Portfolio managers
Sarah-Jane Alexander and Adrian Zetler
as at 31 December 2018