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

It was a disappointing year, with the markets experiencing broad-based asset declines, while the fund underperformed its benchmark to end the year at -14.5%. This is a relatively new fund without a long-term track record.

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. A proposal to transfer R100 billion of the parastatal's debt to the government balance sheet would erode national debt-to-GDP by a further 2%. 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. 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. The rand was one of the weakest currencies globally. Worldwide markets were also weak as fears of trade wars, rising US inflation and the reversal of years of quantitative easing plagued market sentiment. Full-year index returns were dominated by the resource sector (up 15.5%), which was driven by globally-diversified miners such as Anglo American (+32%) and BHP Billiton (+28). Given weak global markets, domestic sentiment erosion and several stock-specific issues in offshore shares listed domestically, both financials (-8.8%) and industrials (-17.5%) declined over the full year. All sectors declined in Q4, with financials, resources and industrials down 2.1%, 4.5% and 6.5%, respectively.

We have the fortunate dilemma of seeing attractive value in both the offshore shares and domestic shares listed on the JSE, given the increased upside to our estimates of fair values after a year of marked declines.

The portfolio's core building blocks remain in place, with significant positions in offshore stocks, including Naspers, British American Tobacco and MTN. All of these companies have faced various challenges over the past year. In addition, we have used price weakness to build positions in other global businesses including Quilter and Anheuser -Busch InBev.

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 assert 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.

While our equity and balanced portfolios remain significantly exposed to offshore stocks, we have increased the domestic holdings resulting in a more balanced portfolio.

Domestically, we believe earnings bases are low, as cost bases have been trimmed and companies have faced several years of a tough economy 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.

The resource sector performed well over the full year, while Q4 declines can be attributed to the rising uncertainty over Chinese economic growth. Resource companies have benefitted from tight markets due to disciplined capital expenditure and Chinese environmental reform. China's commitment to environmental reform remains, but slowing growth means a finer balance may be needed between economic growth and environmental reform. While uncertainty exists, we believe a reasonable position can be justified. Miners are trading on high free cash flow yields and returning a fair amount of this to shareholders. The fund's core holding in Anglo American contributed to performance for the year, buoyed by Amplats. Other key portfolio holdings include Northam and Mondi. Northam has underperformed the other platinum miners, but its cost quartile position should improve as it ramps up production in the next few years.

Within the financial sector, performances were divergent. Banks and insurers outperformed the property sector, which was hit by a weak economy, undermining the position of landlords. The financial holdings in the fund are more skewed towards the banks, with a large holding in Nedbank, which trades at a significant discount (PE 9.2x) to the banking sector average. We also see value in a few of the high-quality property companies, notwithstanding the risk of an Edcon bankruptcy later this year.

Shares with exposure to the UK remained under pressure due to high Brexit uncertainty, as was reflected in the very poor share price performances of Intu and Hammerson. Both shares trade at massive discounts (>50%) to their underlying NAV. The premium nature of the shopping centre assets in both counters should be far better placed to navigate the shifting retail environment. We feel this thesis was affirmed in 2018 when Intu received its second expression of interest at a significant premium to the share price. Unfortunately, after requesting an initial extension, the consortium walked away during Q4 due to macroeconomic concerns related to Brexit, which remain an overhang.

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
Karl Leinberger, Sarah-Jane Alexander and Adrian Zetler
as at 31 December 2018