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

The fund returned 0.3% for the quarter, outperforming the financial sector benchmark, which declined -3.6%. Over more meaningful periods of five and 10 years, the fund has generated compound annual returns of 12.3% and 14.6% respectively, which compares to benchmark returns of 12.8% and 13.7%. Since inception the fund has delivered a compound annual return of 13.4%. The long-term track record of the fund remains respectable relative to both peers and the benchmark.

Once again banks (+4.2%) outperformed life insurers (+1.2%) during the quarter, driven in large part by continuing expectations of an improved macro outlook for South Africa following changes in the ANC political leadership in December, and the appointment of Cyril Ramaphosa as state president in February. Moody's kept its credit rating of SA sovereign debt at a notch above junk and somewhat surprisingly moved its outlook from negative to stable, reinforcing this positive sentiment. The positive contributions of the banks and insurers to sector performance were offset by negative returns from listed property (-19.6%) and general financials (-2.4%).

Contributors to fund performance for the quarter were overweight positions in Nedbank and Investec, as well as having no exposure to property stocks in the Resilient group of companies or to Capitec. Detractors from performance include overweight positions in Reinet and Intu, as well as underweight positions in Barclays Africa Group, FirstRand/RMH, Growthpoint and Redefine.

January was noteworthy for the release of short-seller Viceroy Research's report on Capitec. The previously unheard-of Viceroy rose to prominence with its report on Steinhoff in December, released on the same day that Steinhoff announced an investigation into accounting irregularities and the resignation of its CEO. Viceroy subsequently let on that it was busy with research on another South African-listed company, giving rise to frenzied speculation as to which stock it would be. Capitec was not one of those anticipated by the market. In our view, the report was irresponsible – it suggested that the bank was technically insolvent and urged the South African Reserve Bank (SARB) to put it into curatorship. Banking is a business that relies on trust; it requires depositors to trust the bank to repay the amounts they have lent to it on demand. If that trust were to evaporate overnight there is a real risk of a run on the bank – depositors demanding immediate repayment en masse, which the bank would be unable to honour unless those funds were sitting in cash and not on-lent to borrowers. Viceroy had gained a certain amount of credibility amongst the financially informed public with its Steinhoff report, and the Capitec report presented a risk of such a run. For this reason, the SARB stepped in rapidly with a statement affirming the soundness of the business.

The Viceroy report raised a number of points, not all of which were well researched or substantiated. One of the benefits of the to-ing and fro-ing between Viceroy and Capitec however was that swift and comprehensive responses to Viceroy's accusations were published by the company. This additional disclosure has provided investors such as ourselves with increased insight into how they manage and provide for their unsecured lending book, and has enabled us to enhance our understanding of its quality. Capitec's most recent financial results demonstrate that it is evolving into a comprehensive retail bank. It has grown its market share of banking clients (by number) to 27%, retail loans (by value) to 5.4% and retail deposits (by value) to 6.5%. Net transaction income (i.e. non-lending income) now makes up 41% of risk-adjusted gross income. Within a year of launch, the business has 290 000 credit cards in issue representing a 2% market share. It has recently launched a low-cost funeral plan insurance product in a JV with Sanlam. With no legacy systems, a large client base and a strong brand, but still a relatively small share of market by value, the opportunity to grow into adjacent product sets is significant. The business is well capitalised, and generates attractive ROEs.

The fund does not own Capitec, and has not done so for quite some time. The reason for this is not uncertainty as to whether the business is a going concern or not – we view this as a sustainable business with good growth opportunities. Our reticence hinges on valuation. At the current share price, it trades on a one year forward multiple of 18x earnings and P/B of 5.3x. Even considering the good growth opportunities available to it, this sort of valuation leaves very little margin of safety.

There is however a way to own Capitec indirectly, and a little more cheaply. This is through PSG. At market prices today, listed companies make up roughly 90% of PSG's NAV. Of these Capitec is the largest at 55%. It also owns another business we like and own directly in the fund – PSG Konsult (13% of NAV). Using market prices, PSG currently trades at a 13% discount to the sum of its parts. Applying our fair values to each of the underlying businesses (including a value below market for Capitec) results in a similar discount. In December, Steinhoff was a distressed seller of a portion of its holding in PSG and we participated in a placement at the time. The opportunity arose once again in the first quarter, and the fund increased its stake in the business to 2.8% of fund.

During the quarter we reduced the fund's holding in FirstRand and Standard Bank and sold out of Coronation, as these share prices rallied strongly. We added to positions in laggards Investec, Peregrine and PSG, and for the first time invested in selected SA property stocks after a heavy sell off.

Some of the euphoria that had been building in share prices for the first two months of the year receded in March, with banks down 3.3% and life insurers retracing 4.5%. With early signs of an improved operating environment, there is probably some upside to earnings growth forecasts in 2019/2020. Despite this, as a general comment, at these levels valuations (particularly those of the big four banks) provide a limited margin of safety. We continue to caution against expecting a repeat of the strong returns generated by the sector over the past 12 months.

Portfolio managers
Neill Young and Godwill Chahwahwa
as at 31 March 2018