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

Macro overview

Global economic growth remains healthy, having plateaued at 3.5% - 4% in 2018, supported by extremely aggressive monetary policies adopted by central banks since the global financial crisis. Inflation has been well contained against many predictions, although it has edged up to around 2% in the US. Monetary policy in the US has started to normalise and the Federal Reserve has hiked interest rates a number of times. The Fed is also expected to continue the hiking cycle during 2019. Monetary policy in Europe is expected to follow suit, with the European Central Bank anticipated to start hiking interest rates during 2019.

But not everything is positive. A stronger dollar, rising global bond yields, trade wars and some self-inflicted injuries - such as uncertainty about land reform in South Africa and Turkey's president showing dictator-like tendencies - have negatively affected emerging markets. Turkey, Argentina, Brazil and South Africa have borne the brunt of the contagion. Brexit is another major global uncertainty affecting not only the UK and Europe, but also all the UK's trading partners, of which South Africa is one. The possibility is increasing that the UK will leave the European Union without a deal.

In South Africa, the short-lived 'Ramaphoria' phase following the ANC elective conference in December is over and has been overtaken by 'Ramarealism'. JSE-listed shares which generate their earnings from the domestic economy have given up most of the earlier gains (related to the election of Cyril Ramaphosa as ANC president) now that the economy has slipped into recession. The emerging market crisis has put the rand under pressure which, together with a higher oil price, has caused fuel prices to rise. Fortunately, the South African Reserve Bank chose not to raise interest rates at its September Monetary Policy Committee meeting.

However, not all is negative either. The Zondo commission is investigating state capture, acolytes of former president Jacob Zuma, such as National Prosecuting Authority head Shaun Abrahams and head of SARS Tom Moyane, have been removed from their positions, and some of the boards of state-owned enterprises have been reconstituted. We also have a revised Mining Charter and the nuclear deal is off the table. These are steps in the right direction, but unfortunately years of corruption and poor governance are not remedied overnight. On the upside, we think the current period of rand weakness is overdone and we would not be surprised to see the currency recover some of its losses.

Fund performance

The fund has the dual mandate of beating inflation by 3% over time and protecting capital over all rolling 12-month periods. While we were able to protect capital, the fund unfortunately did not achieve its inflation plus 3% target in the recent past (longer-term returns are still ahead of benchmark), which has been disappointing.

Portfolio activity

We took advantage of the market sell-off during the quarter (Capped SWIX declined by 1.7% for the quarter and 7.4% year-to-date) to increase the fund's allocation to domestic equity by adding to our positions in Standard Bank, Anglo American and Advtech.

Standard Bank remains one of the fund's top holdings. We have used the recent share price weakness on the back of concerns around the slowing domestic economy to add to our holding. We believe that on a 9x forward price earnings ratio (8x our assessment of normalised earnings) and 6% dividend yield, the valuation is attractive and already reflects many of the market concerns.

The local property sector was again under pressure, declining -1.0% for the quarter and by 22.2% year-to-date. We expect domestic properties to show muted nominal growth in distributions over the medium term, however, combined with an attractive initial yield, offers an enticing holding period return. We increased the fund's allocation to domestic property during the quarter by adding to positions in Growthpoint, Nepi Rockcastle and Redefine on the back of share price weakness.

The rise in government bond yields to levels between 9% and 10%, depending on its duration, is particularly attractive to funds such as this with a target of beating inflation by 3%. Inflation is expected to average between 5% and 6% over the long term. Buying bonds at these attractive real yields was therefore an opportunity that we did not want to miss out on and have further added to our South African bond holdings during the quarter. To buy these bonds, we used the rand weakness to lighten our global holdings.

Outlook

Five years ago, we warned investors to expect lower market returns. Unfortunately, we were reasonably accurate. We have emerged from a tough five-year period which we have made worse by not delivering alpha within the domestic equity component of our income and growth funds. Going forward, we see a far more attractive investment environment in which it will be easier to reach our inflation-plus targets. We believe our portfolios are appropriately positioned for the upturn, though we will never lose sight of the need to be defensive. We think our portfolios are well diversified, our asset allocation is prudent, and we have sufficient exposure to growth assets to take advantage of the attractive upside in many high-quality shares.

Portfolio managers
Charles de Kock and Duane Cable
as at 30 September 2018