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

The fund returned 3.2% for the quarter, outperforming the benchmark return of 2.8%. Over more meaningful periods of five and 10 years, the fund has generated compound annual returns of 10.0% and 14.5% respectively, compared to benchmark returns of 10.9% and 13.9%. Since inception, the fund has generated a compound annual growth rate of 13.0%, while the index has generated 10.9%. The long-term track record of the fund continues to stack up well against competitors and the benchmark.

The third quarter of the year was once again a challenging one for domestic markets. Growth remains very weak, confirmed by data indicating that South Africa moved into a technical recession in the second quarter. Although inflation has remained relatively low at around 5%, the weaker rand and rising oil price suggest that inflationary pressure is starting to build, and the possibility has increased of a hike in the repo rate before the end of the year. Financials fared better than most domestic-facing sectors for the quarter. Much of the sector's 2.8% return, however, was driven by life insurers, with a total return of 12.4%, while banks were up only 1.4%.

Contributors to fund performance relative to its benchmark for the quarter include overweight positions in Discovery and Nedbank, as well as having no exposure to Absa and the underperforming property stocks Growthpoint and Redefine. Detractors from performance include underweight positions in Sanlam and FirstRand (both of which we consider to be high quality, well managed companies but comparatively fully valued), no exposure to Capitec, and overweight positions in UK property stocks Intu and Hammerson. The latter two trade at significant discounts to NAV and should provide attractive rand-hedge characteristics. They have clearly not borne fruit in this period of ongoing rand weakness, as the shares have been impacted by ongoing uncertainty around Brexit and questions over the longevity of traditional retail models. We continue to see value in both shares.

Most banks and insurers reported financial results during the quarter. In the context of the weak macro environment, the banks delivered commendable results, with their domestic operations delivering mid-single digit earnings growth. While advances growth has remained sluggish, costs were generally well controlled and impairments largely benign. Of interest in these results was the transition to a new accounting standard on non-performing loans and bad debt provisioning (IFRS9). As the necessary adjustments to the value of loan books were taken through opening equity rather than current earnings, the transition allowed for a larger adjustment than banks may normally be willing to stomach. The move provided us with an insight into which banks were previously relatively underprovided (in our opinion Absa) and which used the opportunity to bolster provisions to benefit future earnings (in our opinion Standard Bank). The environment remains tough for life insurers, with muted equity market growth and a challenging consumer environment. As a result, new business volumes and margins remained under pressure and insurers doubled down on cost-saving efforts.

Towards the end of the quarter, Investec announced the splitting of the group into two separate listed entities: the bank and wealth and investment activities will remain in the current listing, and the asset management business will be separately listed and unbundled to shareholders. The fund has an 11% position in Investec (the fund's largest overweight position), as we feel that the market materially undervalues the sum of the group's parts. One of the reasons for this is that not all the cash flows from the capital-light, high ROE asset management and wealth and investment businesses find their way back to shareholders, but a portion is allocated to support the banking operations. The returns generated by both the South African and UK banks are below what we would consider to be normal, despite these businesses not being excessively capitalised. There is strategic rationale in retaining the wealth and investment business in the bank, but the proposed unbundling of the asset manager should create value for shareholders by providing direct access to its cashflows, and by focusing management's attention on improving returns in the bank. While this has long been part of the investment case for Investec, this action coincides with a transition to a new leadership team and has happened sooner than we had anticipated. We consider this an encouraging sign of a strong focus from the new CEOs on addressing the implicit discount that the market places on the group.

The quarter was not a particularly active one for the fund from a trading point of view. We continued to add the holding of Quilter plc and made small reductions to the fund's holdings in MMI, PSG and Old Mutual.

The South African economic environment remains challenging, and the outlook for growth is weak. While the revised Mining Charter provides some policy certainty and is a step in the right direction, more action is required to build confidence, particularly around land reform. We expect earnings growth for the financial sector to remain subdued for the remainder of this year and probably into the first half of 2019. But we are cautiously optimistic that an improved operating environment will begin to emerge subsequent to the national election, albeit off a weak base.

Portfolio managers
Neill Young and Godwill Chahwahwa

as at 30 September 2018