The tough investment climate in the mid- and small-cap space has continued, with the fund down 4.8% over the past year. The five-year compound annual growth rate (CAGR) return of 4.0% for the fund is below inflation and shows how difficult it has been to produce decent returns, bearing in mind that the fund was the second best performing fund in the mid/small cap space over this time period.

Investing in small-cap funds is essentially a bullish call on South Africa and the rand. The fund has over 70% exposure to South African industrials, and a rand hedge component of only 20%. This is essentially a feature of our investable universe and our inability to invest in big global businesses. The subdued five-year return is therefore not surprising – the South African economy has had a very tough time over this period. Poor results from many companies bear testament to this.

Of more relevance perhaps is the outlook for the fund. It needs a healthier South African economy to produce inflation-beating returns. Right now, there is not much positive news around and it is hard to see how the economy can deliver GDP growth of 2% or above. But the market is pricing in this bleak scenario, and many shares are looking more undervalued than we have seen in a while. We are unlikely to see any pickup in the South African economy before the May 2019 elections, but what is clear is that the base is pretty low and the political landscape is significantly improved compared to just a year ago. It is difficult to invest amid the negative news which we are subjected to every day, but so often, times such as these prove to be the best time to invest.

Over the past year, the largest contributor to the fund's performance was the holding in Altron. This is gratifying in that we built a large position in Altron in 2016 after years of disappointing results caused the share price to decline from around R30 per share to R6 per share. New management and shareholders have done an outstanding job to reposition the company and the recent results show that this is now bearing fruit.

The biggest detractor to fund performance over the past year has been the holding in Dawn, a manufacturer, distribution and warehousing group, A few years ago, we participated in the recapitalisation of the company in the belief that this would give it the headroom to successfully restructure its operations. Unfortunately, this coincided with a brutal business environment which has made the turnaround extremely difficult, despite management's best efforts.

The largest addition to the fund in the quarter was the purchase of Life Healthcare, the hospital business with exposure to South Africa and the UK, having agreed to sell its stake in an Indian hospital business. Hospital businesses are generally of high quality, with high barriers to entry and constant and growing demand for their services, offset somewhat by the fact that they operate in a regulated environment. The significant decline in the share price of Life Healthcare means that it can now be bought on a 12 – 13 forward price earnings ratio, which we think is attractive.

The largest sale in the quarter was the position in Hammerson, the UK-based property stock. The environment for UK property owners is brutal right now with their customers (the retailers) under intense pressure and generally wanting less space, combined with rising interest and capitalisation rates. The Hammerson share price has held up reasonably well, possibly as a result of the failed offer from Klépierre to buy the company. Unless further corporate activity takes place, we think Hammerson will experience a difficult few years.

Portfolio managers
Alistair Lea and Siphamandla Shozi
as at 30 September 2018