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

The fund returned 2.1% for the quarter. Over five and 10 years, the fund has generated compound annual returns of 1.9% and 11.3% respectively, compared to benchmark returns of 3.9% and 12.3%. Since inception, the fund has delivered a compound annual return of 11.7%, outperforming the benchmark return of 10.2%.

South African investor confidence remains weak as impatience has set in with the slow pace of much needed reform. State-owned entities are fragile, with South African Airways entering business rescue in the fourth quarter and the Passenger Rail Agency of South Africa placed under administration. The rebuilding of critical institutions is underway, with strengthened teams in place at the South African Revenue Service and the National Prosecuting Authority and, most recently, the appointment of a new CEO at Eskom. The plight of Eskom remains concerning, as years of poor maintenance leave an unstable power utility. Unplanned outages are very disruptive given the lack of spare capacity and pose a major threat to economic growth prospects. The severe load shedding experienced in December is expected to have taken a toll on retailers' fourth-quarter earnings. Growth continued to disappoint with a contraction in both the first and third quarter. Low domestic growth and low inflation (3.7% CPI for 2019) should give rise to rate cuts. However, the South African Reserve Bank has been reluctant to cut rates, believing that dovish monetary policy will have a limited impact, given the high structural impediments to growth.

Despite this backdrop, the broader South African market was positive for the quarter, with the All Share Index returning 4.6% on the back of very strong performance from the resources sector, up 13.8%. The financial sector lagged the overall market, coming in at 2.8%, but within that, the life sector (5.2%) outperformed both the banks (-0.1%) and domestic property sector (0.6%).

The banks continue to deliver low earnings growth as conservative lending policies have supported low credit loss ratios even in a tough economy. We remain concerned that rising competition will put further pressures on fees in both the retail and commercial banking environment. The local banks have done a good job of protecting earnings with a strong focus on costs. While current valuations remain attractive, an uptick in domestic growth is needed to return the banks to a stronger growth trajectory.

Our underweight position in listed property has contributed to longer-term performance. The property stocks have been battered by the weak economy, reflected in increasing vacancy levels, large rental reversions and reduced rental escalations. We expect the sector will struggle to show distribution growth over the medium term as rentals that have benefited from high escalations for many years come up for renewal and are rebased to market. We remain cautious on domestic property.

For the quarter, the top contributors to performance include overweight positions in Quilter, Momentum Metropolitan Holdings and Investec as well as underweights in Absa and Nepi Rockcastle PLC. Detractors from performance for the quarter include overweight positions in Nedbank and Standard Bank as well as underweights in Remgro, Capitec Bank and Sanlam. Capitec Bank has been a great long-term success story in the banking sector, carving out a very profitable market share in both unsecured loans and retail banking. Going forward, Capitec has opportunities to expand into other financial services products to drive further growth but with the share trading on a 23x price-to-earnings ratio and 7.7x price-to-book multiple, most of this growth appears priced in with no margin of safety in our view.

During the quarter, the UK political landscape continued to evolve, particularly around Brexit, culminating in an election held on 12 December in which the incumbent, Boris Johnson, won a large majority and with it, a stronger mandate to deliver on Brexit. The pound strengthened and UK stocks rallied, benefiting the fund through holdings in Quilter and Investec. We continue to hold both shares in the fund as they trade well below our assessment of their intrinsic value. Quilter trades on a low double-digit P/E multiple, well below their peers in the UK, but importantly, which we believe is not reflective of the strength of their focused, vertically-integrated wealth model. Investec bank, which trades at an undemanding single-digit multiple, will this year unbundle their cash-generative asset management business to shareholders, a step towards unlocking the intrinsic value of the business.

During the quarter, we added to the banks into price weakness as valuations became more attractive. These were funded from Old Mutual, Peregrine, Reinet, Momentum and Sanlam.

Over time, the discounts at which some of the financial holding companies in our universe trade relative to the value of their underlying holdings has widened and it was refreshing when RMH and Remgro management announced their intention to unbundle the FirstRand shares owned by these companies in an effort to tackle this discount. This is a positive step towards unlocking value for shareholders and we would hope to see other holding companies targeting these wide discounts in the future.

The tough macro environment will put pressure on the ability for companies to deliver on earnings growth going forward. The strong franchises will ultimately come out of this cycle stronger, while significant shareholder value can be lost in the weaker businesses. We therefore continue to seek well-priced opportunities in the durable companies for the long term.

Portfolio managers
Neill Young and Godwill Chahwahwa
as at 31 December 2019