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

The fund returned 3.1% for the quarter, compared with the financial sector benchmark, which delivered 5.4%. Over longer periods of five and ten years, the fund has generated compound annual returns of 4.8% and 14.4%, respectively, which compare to benchmark returns of 7.1% and 15.1%, respectively. Since inception, the fund has delivered compound annual growth of 12.4%, outperforming the benchmark return of 10.6%.

The SA market maintained the positive momentum from the first quarter, with the FTSE/JSE All Share Index delivering 3.9% for the second quarter. Within that, the financial sector outperformed both the industrial (4.0%) and resources (2.4%) indexes. Within the financial sector, banks (9.7%) outpaced the life sector (5.7%). These returns were delivered against the backdrop of a weak domestic economy. Data released in the period showed Q1 2019 GDP contracted -3.2% q/q, the worst sequential deterioration since Q1 2009, with weakness across a broad base of sectors. This weakness, combined with persistently low inflation and favourable global interest rate expectations, has increased the likelihood of future local rate cuts.

Despite the weakness in the economy, the earnings of the banks and life companies have, up to now, shown resilience. While bank lending growth is currently muted, particularly in the retail space, rising credit losses have remained within risk appetite and costs managed in line with a softer revenue environment. Life companies have seen some pressure on new business volumes and there is some evidence of emerging lapse risk around their entry-level products, but even there the impact to their earnings bases has been manageable. The operating environment is not expected to improve in the near term and, if anything, is likely to get tougher. We therefore expect to see more earnings pressure across the sector and indeed across the economy as the downcycle deepens.

Contributors to fund performance for the period included underweight positions in Capitec Bank, Redefine Income Fund and Capital & Counties, as well as overweight positions in Investec and MMI Holdings. Capitec Bank is a great franchise that continues to deliver strong earnings growth, but trades at a valuation that we believe more than discounts the attractive franchise value and growth on offer. The main detractors from fund performance for the period included an underweight position in Absa and overweight positions in Intu, Hammerson and Quilter plc. During the quarter, the UK-listed property stocks came under significant pressure as two large retailers, Debenhams and the Arcadia Group (Topshop owners) announced rent cuts via Company Voluntary Arrangements (CVAs) – a form of insolvency resolution mechanism in the UK. Both Intu and Hammerson are owners of prime retail assets that should remain relevant over the long term for retailers in an omni-channel environment, something we believe is not reflected in the current valuations.

During the quarter we took the opportunity to increase our holdings in MMI, Liberty and Investec and initiated a position in CML. Life companies have continued to de-rate relative to banks and currently trade at attractive valuations – hence the decision to increase the life sector holding in the fund. MMI has started to demonstrate an improvement in operations and the implementation of disciplined, shareholder-friendly capital allocation under new management, as evidenced by the R2bn share buyback and rationalisation of underperforming operations. The Liberty management team is energised under Dave Munro and focused on driving adviser productivity while containing costs, with the aim of making it more competitive in the highly-contested middle market. MMI and Liberty are both trading below our assessment of intrinsic value and offer attractive margins of safety. These purchases were funded from reducing our holdings in Peregrine, Reinet, Old Mutual and FirstRand, where we saw reduced margin of safety as share prices increased.

The results of the much-awaited South African election were broadly in line with expectations, with the ANC maintaining its majority rule, albeit through slightly declined support at the general election level. The appointment of a new, smaller cabinet was a positive development, reinforcing the message of fiscal discipline. It remains to be seen how the president will navigate the political divisions within the ruling party to deliver on the reforms needed to turn around the economic fortunes of the country. The ability of domestic-facing businesses to meaningfully grow earnings depends largely on the ruling party's ability to deliver on these reforms and restore consumer and business confidence. We think this challenge is significant and unlikely to materialise in the short term. Within the fund, the focus on identifying and investing in undervalued strong franchises remains unchanged.

Portfolio managers
Neill Young and Godwill Chahwahwa
as at 30 June 2019