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

The fund returned -7.6% for the quarter, while the benchmark returned -6.8%. The retracement in the third quarter of 2019 (Q3-19) has pulled the year-to-date returns into negative territory for both the fund and the Financials Index. Over five and 10 years, the fund has generated compound annual returns of 3.4% and 11.7%, respectively, compared to benchmark returns of 5.5% and 12.7%. Since inception, the fund has delivered a compound annual return of 11.8%, outperforming the benchmark return of 10.1%.

Consistent with the performance of many emerging markets (EMs), the broader South African market suffered a weak quarter, with the All Share Index (ALSI) declining 4.6%. The financial sector underperformed the ALSI, with banks (-7.8%) and life insurers (-7.6%) contributing in equal measure, while property stocks performed slightly less poorly (-4.2%). The fund has limited exposure to South African listed property, and this is reflected in the performance relative to the benchmark.

The economic environment facing domestic businesses remains extremely challenging. While GDP growth rebounded somewhat in the second quarter of the year from the negative print in the first quarter, growth remains very weak and lags both developed and EM peers. The result of this is that GDP per capita has been negative in real terms since 2014. Eskom remains the most significant risk to both sustainable growth and government finances. A Special Appropriations Bill tabled in July allocated an R60 billion to the utility over the next two years, in addition to the R23 billion per annum allocated in February, indicating just how severe the situation is. Yet there is no evidence of any progress in restructuring the entity. Consumer and business confidence dropped to multi-decade lows in Q3-19. Unsurprisingly, there is growing impatience to see policy statements by government translating into action, and it is unlikely that we will see a return to consumption and investment until this happens. Treasury has released a pragmatic policy document on restoring growth, yet, disappointingly, this has been opposed by members of the governing alliance, and once again, is just policy until implemented. And where well-intended policy implementation has happened in the form of National Health Insurance (NHI) and the Credit Amendment Act, the affordability and unintended consequences thereof seem not to have been properly considered.

In this context, company results released during Q3-19 demonstrated remarkable resilience, particularly the banks, which are typically considered more cyclical businesses. Advances grew in upper single/lower double-digits, and, despite downward pressure on margins and non-interest revenue, credit losses (although ticking up) remain relatively benign and cost control has been good. All the Big Four banks showed mid-single digit earnings growth, although all were aided by contributions from their non-SA operations.

Contributors to quarterly performance include overweight positions in Quilter, Hammerson and Reinet, and underweight positions in Remgro and Absa. Interestingly, as an indication of the skittishness of the market, three of these positions (Quilter, Hammerson and Absa) were the top detractors from performance in the prior quarter. Detractors from performance in the current quarter include overweight positions in Discovery, Intu and Investec and underweight positions in property stock NEPI Rockcastle and Capitec.

The Discovery share price came under significant pressure during the quarter, most likely for several reasons:

- The share was certainly not optically cheap on near-term metrics – it has traded at a healthy premium to embedded value for some time while most of its peers trade at discounts, and, even after the decline, its 12-month forward multiple is still around 14.5 times. This at a time in which most other financial sector stocks were declining and trading on single digit price-to-earnings ratios.
- The bank rollout is behind schedule, and the costs associated with this are now increasingly being expensed rather than capitalised, impacting earnings.
- Reports from two analysts questioning the quality of the reported numbers, and the assumptions inherent in the valuation of the life businesses.

The biggest single driver of the decline in the share price, however, was probably the introduction of the NHI Bill. This has called into question the future of private medical schemes and, therefore, administrators. Discovery Health is the administrator of the largest open medical scheme in the country as well as several closed medical schemes and is a strong cash-flow generator, providing funding to new initiatives to the group. If this business were to be summarily terminated, it would have significant implications for Discovery. Through our interactions, it is clear, however, that there is still much work to be done in formulating a workable model for NHI that crowds in all necessary stakeholders, and that it is improbable that the role of private medical schemes will be significantly constrained over the medium term.

Discovery invests significant time and effort explaining its accounting and embedded value methodology as well as its approach to funding new business growth to analysts, providing a basis on which to formulate a view on its appropriateness. Considering the life business is relatively immature, we do not consider the methodology excessively aggressive. The fact that the bank rollout is six months behind schedule is immaterial, given the long-term opportunity that it presents for investors. First impressions count and it is far more important to ensure that a disruptive business meets expectations on launch. Discovery does appear expensive relative to peers on near-term metrics, but the vastly superior growth opportunities that a number of its initiatives present - the bank, short-term insurance, the partner markets in the Vitality Group, and its joint venture with Ping-An Health in China – need to be considered. On this basis, we consider the multiple on normal earnings to be attractive. It should also be borne in mind that none of the growth initiatives are included in the group embedded value. We consider Discovery attractively valued and it remains a significant holding in the fund at 5.7%.

During the quarter we switched some of the fund's holding in FirstRand into its holding company RMH as the discount to the underlying asset widened. In addition, we built relatively small positions in PSG and Absa. We sold the fund's holding in PSG Konsult and reduced some exposure to Standard Bank and Investec.

The outlook for domestic earnings growth hinges very much on a return of consumer and business confidence, which, in turn, depends heavily on seeing policy translate into action. Dealing with Eskom is at the top of this list. We are hopeful that some clarity will emerge in the Medium-Term Budget Policy Statement at the end of October, but much more than this is required to convince participants in the economy that we find ourselves in cyclical and not a structural downturn. Despite low valuations, the sector is likely to tread water until we see meaningful progress in this regard.

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