

The narrative around what the short-term driving forces for global equity markets are, has not changed materially since the previous quarter, nor since the beginning of the year. Investors are still fixated by the anticipation of lower interest rates in the US and the ebb and flow of trade war rhetoric between the US and its major trading partners. During the third quarter, these variables resulted in essentially a zero-return generated by global equities. We did see the US Federal Reserve Board (the Fed) cutting rates by 25 basis points at its last Federal Open Market Committee meeting, but a slightly less dovish commentary surrounding the interest rate cut disappointed investors. On the other hand, there has been some reprieve in the tit-for-tat tariffs imposed by both the US and China, with implementation dates pushed out and negotiations continuing. The year-to-date benchmark index return of 16.2% speaks more to a low base from the fourth quarter of last year (the 12 months lagging return is only 1.4%) than to better news on the economic or corporate profits fronts. The three-year return of 9.7% p.a. is slightly above long-term averages.

The US equity market continues to perform better than its counterparts around the world. It has outperformed Europe by 6.5% over the first nine months of the year and by over 4% over the last 12 months. The performance of its financial sector relative to that of Europe, as well as the strength of the information technology (IT) sector in the US, explains the majority of this outperformance. Japan had a better quarter in relative terms, but still lags the US materially over the longer periods. Emerging markets (EMs) continue to underperform their developed market peers, primarily as a result of poorer corporate profit growth and some self-inflicted economic pain. EM currencies by and large have actually been reasonably strong.

From a sectoral perspective, consumer staples outperformed over the quarter, while the economically sensitive energy and materials sectors underperformed. IT and real estate were also strong. Over the last 12 months, utilities and real estate were the strongest outperformers, on the back of expectations of lower interest rates, with consumer staples also outperforming the benchmark index by almost 9%. Energy and materials were the underperformers, with healthcare also lagging as a result of proposals by Democratic Party presidential candidates to radically overhaul the US healthcare system.

Global bonds continued to rally (reflecting lower yields), as concerns about global growth prospects lingered, with no visible signs of inflationary pressures in the developed economies. However, in dollar terms, most bond markets generated negative returns as a result of the stronger US dollar, discussed in more detail below. Over the last year, global bonds have generated very strong returns, with US bonds returning 11.0% and European bonds over 8%, despite the stronger US dollar over this period.

Global property performed well over the quarter, handsomely outperforming equities, and, over the last 12 months, have now generated better returns than equities. Logistics continued to find favour with investors, but even retail real estate investment trusts (REITs) had a good quarter. Japanese property stocks performed the best, with the US not far below. Hong Kong REITs and developers lost a fair amount of their value in the light of the escalation in violence in the territory.

The US dollar continues to strengthen against its major trading partners, causing more angst amongst the Trump administration about the competitiveness of US exports. The US dollar outperformed the euro by over 4% over the quarter, and by 6.2% over the last year. The Japanese yen was the only major currency that strengthened against the US dollar over the last year.

In the light of the increased global uncertainties it is not surprising that gold continued to do well, generating a positive return of almost 4% over the quarter. However, given the extent of the perceived risks around the globe, we are slightly disappointed by the performance of the precious metal.

Your fund performed well over the quarter, returning 1.1%. Over the last 12 months, the return was an impressive 4.0%, and, since inception, (which is now over 10 years ago), the compounded return has been 4.0% pa, a remarkable track record for a lower-risk fund. Over the last five years, the return was a more modest 2.3% pa. Over longer-term measurement periods, the fund has convincingly outperformed its cash-related benchmark.

Our equity holdings did slightly better than the index over the quarter, and significantly better over one year. Over both three and five years, the performance of the equity carve-out has been credible. Hedging a portion of the equity risk has again cost the fund some insurance premium. We continue to believe that it is the prudent thing to do and has allowed us to keep the equity exposure slightly higher than we otherwise would have done. Our property stock picks have performed poorly over most periods, reflecting the impact that Intu Properties has had on the fund. In addition, some of the other UK and European property names also underperformed. Our fixed interest holdings detracted over the quarter but have had long periods of outperformance over the longer term. Gold added to performance, as did our decision to hedge our currency exposures back into US dollars.

Over the last 12 months, major contributors to the strong relative equity performance included both cable companies Altice US and Charter Communications. These stocks related as earnings marginally surprised on the upside, and investors reassessed their cash flow prospects as capital spending is projected to decline significantly into the future. We discuss these stocks in more detail at the end of this report. Other contributors included both alternative asset managers Blackstone & Carlyle (strong operational results and corporate restructurings well received by investors), Adidas (strong operational result and a rerating), Pershing Square (strong investment results and good capital allocation), and Facebook (strong results despite negative news headlines).

Detractors included Intu Properties (further deterioration in the UK retail environment putting pressure on an overleveraged balance sheet), Aspen (derating on balance sheet concerns), British American Tobacco (further derating on industry concerns), and L Brands (poor trading resulting in a further decline in margins). While the issue of over-indebtedness seems to be a common cause for underperformance, we believe most of these companies will be able to trade out of their balance sheet constraints. Intu Properties is the exception to this view, and the company is actively looking to address its balance sheet through asset sales and other means.

Both of our cable holdings, Charter Communications and Altice USA, have strongly outperformed the market year to date, up 45% and 74% respectively. As the leading providers of broadband internet in the United States, we believe cable operators are well placed to benefit from the continued shift of entertainment online. Data usage in the US is high, with operators disclosing average monthly household data consumption of 250 GB. This continues to grow strongly.

A cable system can be compared to an electricity grid transmitting data from one point to another, and today, most US homes have cable running past them, dug into the pavement many years before. Cable operators own advantaged infrastructure with speeds of 1 Gb per second readily available and operate in natural monopolies in most towns and cities, making them well placed to benefit from the strong structural tailwind of rapidly increasing data demand.

The market has historically focused on cable's declining traditional pay-TV business, even though broadband internet is now the primary product sold into the home. Broadband is a must-have, sticky product for consumers, is growing its subscriber base strongly and contributes the bulk of cable earnings and almost all free cash flow (FCF) today. Pay-TV's contribution to overall company valuation must not be over-estimated. We believe the cable investment case remains underappreciated, with Charter and Altice USA trading on 2020 FCF yields of 7% and 9% respectively and with strong growth in FCF expected. Both trade at material discounts to the market and we continue to hold them as core positions in the funds.

We remain cautious in our portfolio construction, mindful of our exposure to risky assets, given the global risks referred to above. We still see no value on global bonds and continue to have a fair exposure to property. We have trimmed our gold exposure somewhat recently. We continue to be excited about the prospects for our holdings in the portfolio, tempered somewhat by being mindful that the world is a volatile place right now.

Portfolio managers
Louis Stassen and Neil Padoa
as at 30 September 2019