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

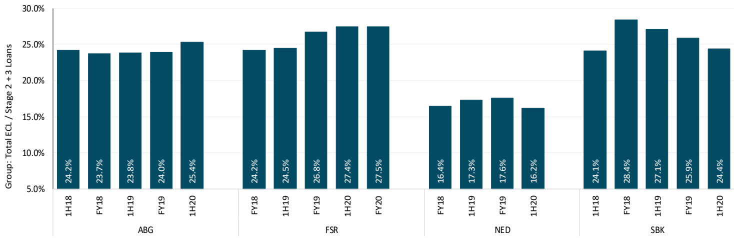
The rebound in financial stocks experienced in the second quarter of the year failed to carry through to the third quarter (Q3-20), with the benchmark returning -1.6%, while the Fund produced a zero return. This means that, year-to-date, the sector has declined 32.7%, reflecting a very limited recovery from the -37.8% at the end of March. The Fund has outperformed its benchmark over this period, but this is of little comfort given the extent of the decline in value. The severe sector drawdown continues to negatively impact longer-term returns, with the Fund returning -10.2%, -5.9% and 5.8% per annum over three, five and 10 years compared to index returns of -10.6%, -5.4% and 6.2%.

Global equity markets continued to strengthen in Q3-20, with the MSCI All Country World Index up 8.1% in US dollars, although increasing evidence of a resurgence in Covid-19 infections resulted in a 3% decline in September. The South African (SA) equity market fared less well, with the Capped Swix index up only 1% in rand for the quarter. Resource stocks continue to drive the performance of the market (up 6.0%) while the financial (-1.6%) and industrial (-2.3%) sectors were the laggards. This divergence reflects the longer-term structural challenges the domestic economy faces, now exacerbated by the impact of Covid-19. During the quarter, the rand strengthened from 17.35 to 16.75 against the dollar, the South African Reserve Bank cut the repo rate by an additional 25 basis points (bps) to 350bps (an all-time low), and the yield on the R2030 government bond increased from 9.25% to 9.42%. The SA sovereign yield curve is currently the steepest it has been in the democratic era. While this means that real yields are very attractive when compared to emerging market peers, it illustrates that the risks of a debt trap and potential default are increasingly reflected in long bond prices.

The performance of the financial sector, being predominantly domestic-facing, reflects these concerns. However, within the sector, returns were relatively dispersed. Banks returned 6.2%, life companies -6.5%, and listed property -14.1%. Most of the banks and life companies reported results to June during the period, and this provided us with a clearer indication of the impact of the Covid-19 lockdown on these businesses. While the results to an extent reflect the experience of the first six months of the year, accounting standards require that they also take into account expectations of what is likely to happen in the future. Banks must provide for anticipated future bad debt write-offs, and life insurance companies set aside reserves to absorb anticipated declines in persistency and increases in mortality claims. The performance of the property sector reflects concerns around an over-spaced sector with a weak outlook for net rental income growth in retail and office portfolios, combined with the highly geared (and in some cases unsustainable) structure of their balance sheets.

Banks all reported earnings declines in excess of 40% for the six months to June (FirstRand has a June year-end and reported a 38% decline in earnings, but its June half is of most interest and for this period reported a 78% decline in earnings). As one would expect, these businesses faced an almost perfect storm: muted advances growth, a contraction in interest margins given the lower rate environment and constrained non-interest revenue due to the drop off in economic activity. However, the biggest driver by far was a significant increase in bad debt charges to levels above those seen during the Global Financial Crisis. Of great interest at this point is an assessment of the extent of provisioning of each of the banks – have they adequately provided for the abnormally high level of defaults that are likely to emerge and can therefore return to more normal bad debt levels in the near future, or is there more to come? This is not a simple exercise. The banks have provided payment relief to certain customers during this period, and the extent of their likely rehabilitation is uncertain at this point. Similarly, job losses, small business failures and corporate insolvencies may take some time to emerge as relief packages such as the Unemployment Insurance Fund's Temporary Employer-Employee Relief Scheme and the government-guaranteed lending scheme drop away. In addition, there are differences in the composition of the banks' lending books, as well as their classifications of loan quality.

As a crude tool, however, one can look at total provision coverage of what are termed Stage 2 loans (loans for which each bank considers there to be a significant increase in credit risk) combined with Stage 3 loans (loans considered to be non-performing). Adopting this approach in a time of much uncertainty should capture most of the loans that have the potential to be non-performing but haven't yet been classified as such. As one can see from the charts below, FirstRand and Absa have increased their coverage over the past six months, while Nedbank and Standard Bank have reduced theirs. FirstRand has the highest coverage, while Nedbank has the lowest. In the case of FirstRand, this would suggest a greater cushion exists to absorb future bad debts, while, in the case of Nedbank, the lower coverage may reflect higher collateral values on their significant commercial property lending book.



As a general comment, we regard the banks' books as being sufficiently provided. Despite this, we anticipate bad debt charges to remain elevated for a period of 12-18 months as increased evidence of strain emerges. Earnings for these companies are unlikely to return to pre-Covid-19 2019 levels until 2023 or 2024. The market appears to be looking through much of the near-term earnings noise, but the ratings on longer-term 'normal earnings' are comparably low, certainly relative to their own history. Therein lies the challenge in investing in domestic stocks and, in particular, the banks, which are, in many respects, a proxy for the SA economy: a structurally low growth environment will constrain earnings growth and returns, which, in turn, constrains the ratings afforded to these companies. FirstRand represents the largest investment of the Fund, at 19.4%. It is certainly not the cheapest of the four banks, but we view its rating as attractive in the SA context given its ability to recover to a position of generating superior excess returns, the conservatively provided advances book, and its strength in digital – the importance of which has been illustrated all the more in the lockdown period.

Contributors to Fund performance relative to the benchmark for the quarter included underweight positions in Old Mutual and property stocks as well as overweight positions in PSG, FirstRand and Discovery. Detractors included underweights position in Capitec and Transaction Capital along with overweight positions in Momentum Metropolitan Holdings and small caps EPE Capital Partners and Alexander Forbes. During the quarter, we increased holdings in Standard Bank, FirstRand, Sanlam and ABSA and reduced holdings in Discovery, Quilter and Rand Merchant Insurance. In addition, we exited the position in Old Mutual.

Banks are trading at all-time lows on a price-to-book basis and life insurers look similar on price-to-embedded-value metrics. Capital positions for both are sound. Property stocks also trade at record yields and discounts to net asset value (but here we believe capital positions are less robust and that, in some cases, rights issues will be required.) While these metrics suggest the sector is inexpensive, one should bear in mind that it is predominantly a domestic-facing one, and, therefore, the performance of the companies operating within it will be largely tied to the fortunes of the SA economy. Already under severe strain, the impact of Covid-19 lockdowns on the economy is likely to be long lasting. We anticipate a challenging operating environment to persist for these business for some time.

Portfolio managers
Neill Young and Godwill Chahwahwa
as at 30 September 2020