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

Performance

The Fund was flat for the quarter. With strong Q1-22 performance rolling off, the 12-month return for the Fund has dropped to -12.9% in a declining SA financial sector. Since inception, the Fund has generated an annualised return of 10.5%, 1.1% ahead of the benchmark.

Global markets started the year strongly, buoyed by the reopening of China, high levels of inflation beginning to roll off and an expectation of a peak in policy rates. This optimism was subsequently somewhat dimmed as inflation remained stubbornly high, with central bankers reiterating their commitment to continue with restrictive monetary policy until the job is done.

The extent of rapid rate hikes that developed markets have experienced over the past 12 months always ran the risk of resulting in something breaking. It turned out to be a run on a mid-size bank on the West Coast of the US that ultimately brought down Credit Suisse, a 166-year-old institution that (despite suffering a damaged reputation and low investor confidence) was in fact quite comfortable from both a capital and a liquidity point of view. The events in the global banking sector are expected to lead to tighter credit conditions, which has the positive spin-off of lower inflation resulting in less pressure on central banks to increase rates further. As a result, the quarter ended with markets rallying once again, reversing the declines of February.

South African markets followed the upward trend in global markets initially, but the impact of ongoing elevated levels of loadshedding on domestic economic growth is becoming increasingly apparent with cuts to GDP forecasts. In addition, softer commodity prices and an unbudgeted above-inflation increase in the public sector wage bill are once again focusing attention on sovereign debt sustainability. The FTSE/JSE Capped SWIX returned 2.4% for the quarter, driven principally by industrials and a rally in gold shares towards the end of March. The financial sector returned 0.4% for the quarter, driven by positive returns from insurers (+13.3% from life and +11.8% from non-life) but offset by a -2.3% return from the banks.

Contributions to the Fund's performance relative to the benchmark came from its underweight positions in Investec and Capitec and overweight positions in UK wealth manager St James Place as well as insurers Santam, Sanlam, Discovery and OUTsurance. The most significant detractor from performance was an overweight position in Transaction Capital. In addition, underweight positions in Old Mutual, Reinet and HCI detracted.

Portfolio actions and fund positioning

During the quarter, we increased the Fund's holdings in FirstRand, Capitec, Sanlam and Standard Bank and initiated a position in Investec. This was funded by a reduction in the holdings of OUTsurance, Nedbank, Quilter and NinetyOne.

The Fund remains overweight the banks. As illustrated in the most recent set of financial results they are, to varying degrees, beneficiaries of higher interest rates due to the endowment effect of earnings on lazy deposits and capital. This will continue to be the case into 2023 as the effect of higher average interest rates year-on-year washes through. In addition, corporate lending (which until recently had taken a backseat to retail lending) looks set to drive advances growth as businesses take on borrowings to build self-provided power for their operations. The big question to be asked is the extent to which the higher rate environment translates into greater borrower stress and an explosion in bad debts. While we anticipate credit loss ratios to increase, we don't see a blow-out in credit as a high probability event. Corporate and higher end consumer balance sheets are in reasonable shape, lending policies through Covid have been relatively conservative and balance sheets are well provided. The traditional "Big 4" banks trade on attractive multiples of between 6.5 and 9 times one-year forward earnings, and on very healthy dividend yields. Capital positions are strong, so much so that two of the banks (Nedbank and Investec) are in the process of buying back shares in addition to declaring healthy dividend pay-outs.

At the same time, the Fund is underweight the life insurers. While the sector has outperformed in the most recent quarter, it is a long-term underperformer against the banks, has put the challenges of Covid largely behind it, and its constituents to trade on inexpensive multiples and attractive dividend yields. It is tempting to see this as an opportunity to switch some of the bank exposure into the life companies. However, we have concerns about the longer-term outlook for several businesses in this sector. The core of their business models, selling risk cover, is under threat. At the bottom end of the market, banks are increasingly encroaching on the life insurers' turf in the sale of simple non-underwritten products such as funeral cover and credit life insurance, driven by their superior data-gathering ability and lower cost of distribution. At the upper end, growth in the complex underwritten risk market has stagnated and cost bases previously established to handle large volumes of new business now need to be drastically rationalised to restore profitability of the remaining business that is written. These are significant challenges for large, staid institutions to deal with. We are therefore very selective in the life insurance companies that we hold in the Fund, preferring businesses that are more diversified and have strong positions in the markets in which they operate.

Transaction Capital detracted meaningfully from Fund performance during the quarter. Following a trading update in mid-March indicating that ongoing economic headwinds had forced a significant restructuring of its subsidiary SA Taxi, the share price declined by almost 70% in the space of three days. The fact that this happened while Silicon Valley Bank was imploding probably didn't help matters. At the time of the announcement, the Fund held a 2.4% position in the company. Whilst we attributed limited value to SA Taxi even prior to this announcement (c.10% of our fair value) we overestimated the defensiveness of this business and its ability to pass on costs in a market in which public rail transport had all but collapsed. The brutal market reaction implicitly wrote down not just SA Taxi but also took a significant haircut to the overall value of the company. We believe that the other two businesses owned by Transaction Capital, WeBuyCars and Nutun, are worth significantly more than the current share price and justify a holding in the share. The ongoing confidence and support of funders will be critical in achieving our assessment of fair value.

Outlook

The global economy faces several countervailing forces. Inflation continues to roll over as base effects start to wash through and energy prices soften, yet levels remain stubbornly above central bank targets and labour markets remain tight. Strong economic growth indicators in the US and Europe had prompted concerns of higher interest rates for longer. However, the events of March may well lead to tighter credit conditions, resulting in a dampening effect on growth on the one hand but a quicker end to monetary policy tightening on the other. The Chinese economy has reopened and appears to be promoting a friendlier approach to capital markets, yet geopolitical tensions remain exceptionally high and there appears to be no end in sight to the war in Ukraine.

Domestically we continue to face our own set of challenges. Loadshedding has worsened and although significant investment by both corporates and individuals is going into self-generation, it will be some time before this starts to bear fruit. Transnet's woes continue to strangle our ability to export the commodities that we produce. And while it's not expected to have a significant impact on our ability to trade, grey listing is another cross in the box for those considering investment in the country.

The outlook for the financial sector is largely tied to the fortunes of the South African macro economy. The environment in which we currently find ourselves, along with some of the sector-specific structural challenges discussed above, cause us to continue our caution in the outlook for the broader sector. However, valuations are not demanding, and this provides a margin of safety in projecting attractive longer-term returns for the Fund.

Portfolio managers
Neill Young and Godwill Chahwahwa
as at 31 March 2023