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

Performance

Following a positive second quarter, the industrial sector experienced a negative third quarter (Q3-23), with the Fund delivering -6.3% relative to the benchmark return of -6.2%, bringing the Fund return for the last 12 months to 23.6%. Since its inception, the Fund has generated an annualised return of 15.3%, 2.0% per annum ahead of the benchmark.

Fund positioning

Global financial market news in Q3-23 was dominated by data showing a more convincing moderation in headline and core inflation in developed economies, coupled with central banks signalling more clearly that policy rates may be at or close to peaking but will remain high for longer. Activity data, especially in the US, has been more resilient than most expected, given high inflation and rising policy rates. The risk of a recession in this environment has receded but not disappeared – high interest rates for longer will continue to put pressure on borrowing costs and related activity. Financial conditions continue to tighten as financial intermediaries remain cautious, and a recession in the US is still possible into 2024. While European growth remains subdued, and China's recovery has faltered with weaker global demand undermining export growth and the challenging effects of its weak property market, uncertainty is high, and asset prices remain under pressure.

In the last quarter, the MSCI World Index retreated -3.5% while the MSCI Emerging Market Index was down -2.9%. Against this backdrop, the JSE All Share Index declined -3.5%, and within that, industrials fared the worst at -6.2%, followed by the resources sector at -4.3%. Financials performed the best at 2.2%.

During the quarter, we reduced the Fund's underweight in Richemont into share price weakness, added to the position in Mondi and introduced Curro into the portfolio. Global luxury stocks have come under pressure this past quarter amidst concerns of a demand slowdown in the US and a weak recovery in China following the easing of Covid restrictions. In addition, high inflation and rising interest rates started impacting consumer discretionary spending. The resultant sell-off drove a significant correction in price-to-earnings (PE) multiples from the peaks reached in 2021 of 34x for the sector (excluding Hermès) to the current 19x, in line with the long-term sector average. Richemont declined some 25% during the quarter and trades on an attractive 15.7x PE ratio (or 13.8x excluding surplus cash on the balance sheet). We have used this weakness to add to the Fund's holding.

The paper and packaging sector has also come under cyclical pressure off the highs reached in 2022 as demand softened in a higher interest rate environment and the industry worked stocks down from high levels built when supply was constrained by tight global supply chains in 2022. Paper packaging is a sector that stands to benefit over the long term from structural tailwinds around sustainability in packaging (e.g., the shift from plastic to paper) as well as the shift in retail sales in favour of ecommerce.

Within the sector, Mondi is a market leader with low cost, well-invested plants, enabling them to generate market-leading returns while maintaining a robust balance sheet through the cycle. They are investing significantly in new capacity to take advantage of these structural tailwinds. Mondi has recently completed their exit from Russia, proceeds from which will be returned to shareholders. This capital return equals roughly 10% of Mondi's current market capitalisation. The share trades on an attractive 11.7x PE multiple (excluding the Russia sale proceeds) and offers mid-teens growth per annum over the medium term as the new capacity comes on stream, offering an attractive return profile in our view.

Prospects for the private education sector in SA are attractive in our view, and in addition to the holding in ADvTECH, we have introduced Curro into the Fund. The underinvestment and limited capacity in the public education system support growth in private education for the long term. Curro has undergone significant investment into new schools but is now at a point where they can grow into this capacity with much lower capex needed. This is supportive of strong free cash flow generation and earnings growth going forward, which we believe is underappreciated given the undemanding multiple (11x) the business currently trades at. We funded these additions by exiting the Altron and Barloworld holdings and reducing the holding in Anheuser-Busch InBev.

Contributors to fund performance for the quarter include underweight positions in Richemont and MultiChoice and overweights in ADvTECH, Grindrod and British American Tobacco. Detractors from performance were underweight positions in Shoprite, Bidvest, Truworths and The Foschini Group and an overweight in Naspers.

Outlook

We remain underweight domestic stocks in the Fund as the domestic picture remains challenging while valuations are not sufficiently attractive relative to the downside risks. Loadshedding continues to be a critical constraint on economic activity, and while investments are being made on the renewable side to alleviate the power constraints, it will be some time before these efforts bear fruit. Other infrastructure challenges, such as an underinvested and declining rail infrastructure, continue to add significantly to the cost of doing business in the country. We continue to look for opportunities to position the Fund to generate the best risk-adjusted returns available within the industrial universe.

Portfolio managers
Nicholas Hops and Godwill Chahwahwa
as at 30 September 2023