Sanlam

Fund Commentary

Sanlam Investment Management Fund

June 2021

Portfolio Manager Quarterly Comment

Market review

The second quarter of 2021 (Q2) saw continued momentum in the economic recovery globally as the combination of loose monetary policy and government assistance combined with confidence related to economies opening up post lockdown aided markets. Vaccine rollouts have given consumers confidence that the worst is over and yet there remains widespread economic dislocation as different markets have received different levels of support and vaccine rollouts have been quite uneven across developed and emerging markets. The extent of time that has passed since the virus first emerged and the confidence that governments have in opening up the economy have resulted in supply chain disruptions and complications, particularly with global manufacturers. In addition, the service economy is also far from recovered and with new variants of the virus arriving in different geographies, has resulted in only partial reopenings in a number of markets.

In the US, Biden continues to push forward on his stimulus agenda, with up to $6 trillion in government funding potentially available to reinvigorate the US economy. Political disagreements between the two main parties are likely to result in a more measured outcome, which is also taking time to conclude. In the meantime, the US is experiencing significantly lower unemployment figures and, in some instances, struggling to secure job openings in more mainstream activities as individuals continue to benefit from government support in the form of monthly cheques and other assistance. Vaccine rollouts in the US have to date been fairly successful and resulted in the US economy opening up materially, although cross-border activity is still severely inhibited. The combination of individuals having been restricted for a significant period, significant built-up savings as a result of not being able to spend, as well as record low interest rates is now fuelling significant demand. In addition, as a result of rising demand globally and supply chain bottlenecks, supply is being somewhat constrained. Manufacturers have also limited expansion for a protracted period. This is all combining to raise prices and for the first time in a long while inflation is ratcheting up strongly.

The Federal Reserve (Fed) is taking a pragmatic approach and while it did signal that interest rate increases will be brought forward, these are only expected in 2022 and likely only in the second half of the year. There are still signs that while demand is strong, particularly in areas like housing, there remains some unevenness to the recovery and if anything, the pandemic has accentuated the income disparity between the wealthy and the poor. Withdrawing government support in the form of low interest rates or welfare support too early is likely to result in a short-term overheated economy subsequently collapsing if not done in a measured way. Meanwhile, agricultural and commodity prices continue to rise, though some consolidation was evident in the quarter, although the oil price continued to move higher, aided by a restrained OPEC.

Environmental considerations are also likely to be inflationary in the medium term. As such, the Fed will be on standby to ascertain whether recent price rises are more supply-driven or whether demand is also assisting. The massive government stimulus provided to the US economy has significantly improved liquidity, but this is also giving rise to asset pricing distortions. As this liquidity is gradually reduced, this may create some issues in the future. Inevitably, the US government now finds itself massively indebted, which will take many years to resolve and, in a sense, will constrain the US economy unless more productive economic growth can become evident. Biden's infrastructure plans are a move in the right direction, but the question remains how efficient all of this spending will be? Only time will tell. In the meantime, the US economy looks likely to surprise positively in the short term, mainly due to pent-up demand and the huge economic stimulus.

Investments

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In Europe, the economic recovery is far more uneven and only underpinned by intervention from the European Central Bank (ECB) in the form of liquidity across markets and other government support across the region. A number of European countries have been slow to roll out vaccines, which has complicated the economic recovery as travel and supply chains have been slow to fully recover. New variants of the virus have also delayed the reopening up of some key markets. Demand across Europe has picked up and much like the US, with the long period of restrictions, rising savings, supply disruptions, etc. also resulting in rising inflation, although demand overall remains more modest than in the US. The services sector of the economy in Europe has also been slower to recover given the uneven vaccine rollout across markets and the dependence on tourism for a number of markets ultimately impacting economic growth. Global supply issues are also constraining the full recovery of the manufacturing sector, with, for example, the auto industry experiencing component shortages, resulting in a more modest recovery in production. On the other hand, record low interest rates, significant liquidity and high savings levels, combined with an aging population have stimulated segments like the luxury goods industry, notwithstanding limited international travel.

The UK seems to have struggled the most within the region and having only recently exited the European Union (EU), has been impacted by the new Delta variant of the virus and while vaccine rollouts have been relatively quick, infection levels remain elevated. The UK also has a high service component to their economy where the recovery has been stymied by the dependence on Europe as well as tourism and delays in opening up the leisure sector. Government support in the form of grants and income support remains extended and has been more generous than the US, although this will inevitably come at a price as record debt levels will inevitably constrain Europe's complete recovery for a long time. Europe faces a number of structural challenges and these remain and will continue to restrain any future economic recovery, resulting in potential voting challenges in the future for aspirant governments across the region. Like the US, income inequality has likely accentuated through the pandemic period, which is likely to fuel increased voter disgruntlement, making policy changes across countries in Europe challenging.

Emerging markets (EM) showed some signs of recovery, although the pace has been held back by more limited government support and a slower pace of vaccine rollouts as access remains problematic. EM typically benefit from global economic growth and participate broadly in developed market demand. This period of economic growth has been more constrained by internal support within developed markets and more constrained globalisation as supply chains remain disrupted and cross-border trade remains challenging. In addition, the disrupted manufacturing base has created distortions in production, resulting in uneven economic growth across different emerging markets. Rising commodity prices have assisted commodity producers, with the oil majors notable beneficiaries of the rising oil price. Some pull-back in industrial commodity pricing was, however, evident in the quarter and in addition, a lack of mining capital expansion and transportation challenges have resulted in commodity producers not necessarily benefiting completely from the more buoyant demand for their products.

Political challenges have also hampered supply. Over time a number of EM have become more service-orientated and as vaccine rollouts have been slow here, these markets have not seen the recovery at all in large segments of their service sectors, especially in tourism. Within EM there have been a number of political issues and broad unhappiness with vaccine access and monetary support. In addition, with prices rising globally, several EM countries have been raising interest rates in anticipation of future higher prices and recovering demand. This does seem somewhat premature, although arguably interest rates were cut significantly at the early part of the pandemic.

Emerging market participation in the global recovery is likely to be somewhat uneven as we go forward as developed economies increasingly support local manufacture even if this is at higher prices. Rising demand for alternative energy is also likely to be more internally sourced but may well be at higher prices. To date, EM currencies look reasonably well behaved and, in some cases, have even

strengthened vs. a weak US dollar, which has contained inflation somewhat in the short term. China recovered strongly from the virus early and has experienced strong economic growth, although this does now look to be slowing. China is also looking to shift away from manufacturing into value-added areas and consumption, aided by government policy and state-backed support. China has also expanded its area of influence in the broader region, which has not been that well received by the US. Biden now recognises some of the challenges a more assertive Chinese government represents, while at the same time the Chinese are also carefully managing slower economic growth in order to ensure no social unrest in the future.

Like other markets, China also faces a growing disparity between wealthy and poor, which has been accentuated by the pandemic. Rising prices have also raised some concern among Chinese officials, with recent intervention looking to manage the pricing environment. China's own environmental aspirations are also likely to create future challenges on the supply side as recent energy challenges can attest. Political challenges within emerging markets look slightly more manageable, often as a result of a controlling party dictating policy. As long as economic growth remains reasonable this should remain the case. Increased political incursions need to be carefully watched to ensure these don't escalate. Should commodity prices continue to rise in the future as several market participants expect, there may well be a wider dispersion of economic growth within different emerging markets as many will benefit from exports, while those that are more dependent on imports may struggle with slower growth and higher inflation.

In South Africa, the economic recovery remains held back by the slow pace of vaccine rollouts, increased restrictions following rising infection levels, with the country moving back to adjusted level 4 lockdown at quarter-end, as well as economic policy inertia and weak demand. While broadly the economy has continued to normalise, several key sectors remain challenged, namely those in the service economy, especially in tourism, sport and live events. Indeed, compared to developed markets the slow pace of vaccine rollouts is of some concern and unfortunately not helped by rising infection levels as the third wave of infections arrives. Over time the SA economy has become more service-orientated at the expense of manufacturing and it is this area that unfortunately has been most impacted by the pandemic. In addition, the government and municipal services area has grown as a proportion of the SA economy, but is now slowly being reined in and in itself a detractor to economic growth.

Many unsustainable practices within government SOEs and municipalities have resulted in funding being withdrawn, which results in more efficient allocation of future capital but initially slows the economy – unless better practices are implemented at the same time. Unfortunately, there is a broad shortage of skills in various industries, which makes enacting these much-needed changes difficult. Structural challenges in the educational sector have unfortunately hampered skills development. In the quarter there have been some signs of improving consumer and business confidence, resulting in a recovery in economic growth, although admittedly off a low base created from Covid-19 in the prior year. Returning to a more robust level of economic growth remains challenging as there has been little support from government policy, with political issues continuing to hamstring the ruling party from being more assertive and stimulatory.

Low interest rates are supporting some consumer demand; however, a lack of government handouts and limited employment growth is not providing enough support to get the economy going. Demand outside SA from our neighbouring countries also remains subdued. Prior to the virus arriving, the SA fiscal situation was somewhat precarious, with unsustainably high debt levels that continued to rise post Covid-19 in a virtuous circle. This was made worse by the pandemic and limited what could be provided in the form of state-lending and other financial support. Small and medium-sized entities (SMEs) have suffered most, resulting in significant capacity on the small, medium and micro enterprise (SMME) side leaving the industry permanently. Invariably large business looks like the winner, as it was able to cut capacity and had long-term funding to draw on. While progress is being made on the Eskom side, a series of disruptions in the quarter again reminded us how fragile our energy supply remains. On the

positive side, the announcement from the president that energy users can more meaningfully generate their own supply of energy was well received by the market and will assist in future as several power plants face decommissioning in future years.

SA has also benefited from rising demand for commodities, as our trade surpluses continue to surprise positively, lending support to rand strength and keeping inflation in check. The platinum group metals in particular have seen strong demand which, if sustained, will aid economic growth. Unfortunately, over time mining has shrunk as a broad contributor to the economy. Logistical and port challenges have also moderated what would have been even better export figures. Inflation, aided by a strong currency, at least looks like it will be contained, notwithstanding rising prices in areas like agriculture and oil and other commodities. The agricultural sector appears to be having a strong period and is benefiting from decent weather, higher international soft commodity prices and increased production – a somewhat unusual combination, but well received by the farming community. Overall, we expect the SA economy to continue recovering gradually, but it would be greatly assisted by lower infection levels and a more expansive vaccine rollout programme, as well as more decisive and supportive government economic policy.

From a global financial market perspective, equity markets continued to strengthen throughout Q2 as the combination of significant global liquidity and record low interest rates continue to support financial markets as capital seeks the best return. As markets open up post lockdown, albeit in a somewhat haphazard way, investors have supported financial markets, although continue to favour developed markets over emerging markets as liquidity is internally focused and hasn't shifted materially into emerging markets just yet. Indeed, some commentators are questioning what happens once the liquidity is withdrawn, with central bankers likely to keep record low developed market interest rates on hold for an extended period of time, until evidence of how effective all this monetary support has been for markets economically. There is perhaps an element of distortion in capital allocation, not only to appease the poor voter, but also in financial markets where various exchanges remain close to record highs. Improved liquidity, improving consumer confidence and record low interest rates are also supporting the property market globally, aided by supply shortages as double-digit price increases are experienced in many markets. Accessing the property market for young workers will remain challenging.

Evidence of inflation rising globally and becoming more broad-based is now more accepted, accentuated by supply disruptions and capacity constraints, as well as manufacturing and transportation bottlenecks. For now, it appears as if rising inflation may be temporary, induced by the disruptions from Covid-19 and not a function of unreasonable demand. Initially, previously, US bond yields had risen in expectation of higher inflation and robust economic growth, however, in Q2, long-term yields declined as most investors expect the recent bout of inflation now to be temporary. The Fed has indicated that it will tolerate inflation above their long-term expectations of around 2% for an extended period, as ultimately they expect inflation to self-correct downwards after this initial spike. There is a risk that the Fed may be behind the curve, as inflation expectations continue to ratchet up in response to various input costs that continue to rise and a lack of investment in new capacity, which has supported higher prices for longer. Current demand is distorted by an extended period of lockdown in some key segments and consumer confidence that has been stimulated by central bank liquidity. Inevitably something will have to give as debt levels in the US, Europe, Japan and elsewhere look very elevated and are likely to crowd out investment unless incremental capital can be efficiently deployed.

Emerging markets have lagged developed markets as they have not had the benefit of 'US-type' interest rates nor the central bank support that the US has enjoyed. Some geographies are more self-reliant than others in an environment where countries are becoming more introspective and less inclined to support global trade. In Q2, prices of agricultural products and other raw materials continued to rise, although some industrial commodities weakened after a period of protracted strength in prior quarters. The oil price continued to rise as OPEC remains constrained in increasing production. Shifts to more environmentally-friendly energy sources have already started to create supply challenges in some key

markets. This will need to be carefully monitored, especially as energy producers have been very reluctant to bring on new capacity in environmentally-challenged sectors. China as an example experienced some manufacturing disruptions in Q2 due to energy challenges, which may be made far worse in future if the country is to achieve their recently profiled and ambitious environmental aspirations. Currencies were surprisingly well behaved in Q2 as capital waits for the next shift economically. Emerging markets are expected to improve as vaccine rollouts broaden and should liquidity redirect here from the US and other developed markets, it may well support a more significant rebound in these markets. On the other hand, some Asian markets that have exhibited relatively robust economic growth amid a modest virus impact are now showing signs of slowing down. Ultimately, a carefully measured approach is probably warranted given the many imbalances that exist across markets.

In Q2, the MSCI World Index was up again by 7.9%, outperforming emerging markets, which were also up a reasonable 5.1%. Indeed, year-to-date developed markets have performed well, aided by record low interest rates, significant government support and a strongly recovering market, with the impact from the virus receding. Emerging markets have not enjoyed the same level of support, although rising commodity prices have aided selected markets. Year-to-date the MSCI World Index is up 13.3% whereas the MSCI Emerging Markets Index is up 7.6% in US dollar.

From a South African perspective, the market declined slightly after an exceptionally strong first quarter of 2021, with the FTSE/JSE Shareholder Weighted All Share Index (SWIX) down 1.8% in Q2. The resources sector declined by 5% in Q2 as a result of a decline in commodity prices, particularly the industrial and precious metal commodity prices after an extended period of previously rising prices. Some cooling off of global economic growth towards the end of the quarter was no doubt a contributing factor, particularly with demand out of China slowing. Industrials moved sideways, with the sector up 0.8%, although there was a wide dispersion of returns within the sector, with the personal goods and support services sectors performing strongly, while the technology sector was down sharply. Financials performed the strongest in Q2, with banks and property shares performing particularly well, aiding a sector performance of 7.5% for Q2. Year-to-date the SWIX is up 11.2%, with all three sectors performing broadly similarly, with industrials leading, up 13.8%, followed by the resources sector, up 12.8%, and financials still up a respectful 11.7%. The best performing areas of the market year-to-date have been the more economically-sensitive local shares and the chemical sector, given the rapid rise in the oil price. The weakest sector has been the technology sector given the regulatory and other challenges here.

Portfolio performance

The SIM General Equity Fund had a reasonable Q2 performance, although it slightly underperformed its benchmark, the FTSE/JSE Capped Shareholder Weighted All Share Index (Capped SWIX), by 38 basis points (bps) and in absolute terms was broadly flat for the quarter. The fund was also weak vs. competitors in Q2. It does, however, remain important to focus on the long term and after an exceptionally strong Q1 performance some consolidation was inevitable. Year-to-date the fund has outperformed its benchmark by 334 bps and remains in the top quartile of performers among peers. Over the medium and long term the fund has an excellent track record.

Contributors to performance in the quarter include an underweight position in Anglo American Platinum, which declined sharply in the period. We remain constructive on the mining shares and had expected the platinum producers to pull back after a strong period of prior performance. We do expect the platinum sector to recover in the second half of 2021 and have meaningful overweight positions in Northam Platinum and Impala Platinum, which have both detracted from performance in the quarter. We took advantage of high prices to selectively trim overweight positions in Impala and Royal Bafokeng

Platinum, as well as Glencore, but then topped up on Northam as the share had declined meaningfully and was showing better relative value. Northam has just completed a major buyback and BEE refinancing deal and is very well positioned, as they remain one of the few platinum producers who have invested in meaningful capacity expansion projects prior to the rise in underlying prices.

Other contributors to performance in the quarter include Distell, Nedbank, MTN and Dis-Chem. We built up a meaningful overweight position in Distell at very attractive prices only recently and were able to participate in a strong share performance as the Heineken group approached Remgro, who is also a major investor in Distell, with a potential corporate deal. At this stage it remains unclear what will eventuate, although it is likely that Distell will combine the majority of their assets with components of Heineken's African operations. Nedbank performed very well in the quarter as economically-sensitive SA counters rebounded on improved economic prospects and a realisation by investors that the significant credit loss provisions provided by the banks may unwind sooner than expected. Nedbank also received notification that Old Mutual will unbundle the majority of the share they own in Nedbank, which should improve liquidity. MTN has been a strong performer for a while after a prior long period of underperformance. Patience has certainly been necessary, but this is the type of opportunity we prefer: out-of-favour shares trading well below our intrinsic values through a normalised cycle. A confluence of positive factors has arisen simultaneously to aid MTN's performance recently. Dis-Chem has also performed well after an initial period of 'growth dilution' as the group initially took on too many expansion projects at the same time, but is now benefiting from this investment as it scales.

In terms of detractors from active performance in Q2, we have no exposure to Capitec Bank as we have preferred the other banks and with the share performing very well, this detracted from active performance. Our overweight exposure to the other banks would have largely offset what Capitec detracted from an active performance perspective in the quarter. Richemont also performed well, defying the critics as luxury goods spend recovered sharply and, in some instances, even exceeded pre-pandemic levels. A lot is now priced into Richemont's future sales expectations and we remain more cautious, preferring a larger margin of safety, although we do have some exposure to the group. Sappi weakened sharply in Q2, reversing some of the strong performance in Q1 as international paper prices weakened. We are constructive on the share and are of the view that the pricing environment should recover in the medium term, with Sappi to be well placed when this eventuates. A healthy margin of safety exists for Sappi relative to the current share price, although timing when the paper cycle will recover is never clear. Northam detracted in Q2 as platinum prices reversed somewhat, enabling us to increase our exposure to the group at attractive prices. Growthpoint performed well in Q2, as did several other property shares. We are, however, cautious about a strong rebound in the property sector, although we do recognise that it was oversold previously.

For the 12 months ended June 2021, the fund has had a very strong performance in absolute terms, with the fund up 30.7%, benefiting from the post-pandemic recovery, although pleasingly there was also excellent active performance, with the fund outperforming the Capped SWIX benchmark by 312 bps and sitting comfortably in the top half of the ranking table vs. the peers for the period. The contributors to performance over 12 months included a number of resource counters as we have been constructive on the sector before it became more broadly appealing among competitors, with our overweight positions in Impala, Sasol and Sibanye-Stillwater adding significant alpha to the portfolio. Royal Bafokeng also contributed positively, but it was pleasing to see that even within the sector there was good selection, with our underweight position in gold counters also adding value, of which our underweight position in AngloGold Ashanti contributed the most to active returns. Some of the industrial counters also added value, although overshadowed by the mining shares given the relative strength in this sector.

In terms of detractors over a 12-month time horizon, the fund's exposure to the Sanlam High Quality International Fund detracted the most from performance. The fund was overtaken by the combination of a strong relative local performance and rand strength. Over time the fund should provide a broader

range of opportunities not available in the local market, adding diversification. The fund has a good long-term track record, but over this shorter time horizon it did detract from performance.

Other detractors include Capitec, which recovered far quicker than expected and remains expensive but performed well, and British American Tobacco, which has struggled to adapt quickly enough to next-generation sales and lagged more high-performing cyclical recovery shares. Datatec also detracted from performance notwithstanding a much-improved 2021 result as investors continue to shun the share. Shoprite also rebounded quickly and has been aided by a more internal focus. We have no exposure to the group and are of the view there is not much safety in the valuation.

Our strategy and conclusion

We remain mindful that we continue to have an overweight position in the resources sector as a confluence of factors have arisen to support the sector for longer than initially expected. While a number of commodity prices are now well above our long-term prices, within the sector there are other commodity prices that remain below our long-term ‘normalised pricing’. With this in mind, sector and stock selection within the mining sector are now more important. We have been rotating out of areas that have done well and recycling back into different areas that are currently weak or out of favour. That said, we are also pragmatic and recognise that a more nuanced approach is required as in some instances pricing has remained reasonable while capacity limitations in the industry in certain commodities will result in pricing remaining relatively buoyant for an extended period. As always, the near-term strong outlook needs to be tempered with a healthy sense check and a significant margin of safety from a valuation perspective.

We remain constructive on Sasol and Sappi and while the former has benefiting recently from a rising oil price, the combination of an improved balance sheet, higher oil prices for longer relative to our long-term pricing, as well as the internal reorganising and cost cutting inside the group will materially benefit Sasol over the medium term. Not much of this is currently priced into the share by the market and thus we remain with a significant active position in the share. Sappi has recently retreated after initially recovering, and is now well below our fair value. Over time we expect the environment to gradually improve for the share. A long-term mindset is key.

On the financial side of the portfolio, much like components of the local industrial sector, there has been a sharp rebound as better-than-expected results and a gradually improving economy have surprised market participants. As to how much of this earnings surprise continues remains to be seen, although in many instances the full recovery has not been priced in as some uncertainty remains. We have trimmed selective financial counters, although mainly in the insurance sector as we believe there is better value elsewhere. The property sector has also rebounded materially and is looking closer to fair value.

We have made selective additions to industrial counters that look well placed for a gradually improving local economy but have been held back by investor caution or uncertainty as to when the economy fully recovers. We prefer stock picking and don’t want to rely unduly on the SA economy performing as it’s unclear post the Covid-19 recovery whether we shift into an environment of more meaningful economic growth. We prefer to seek opportunities where expectations are cautious and a heathy margin of safety exists from a valuation perspective. A number of international counters are also looking more interesting after a bout of weakness and rand strength, and we’ve been adding to Naspers and others which currently seem very out of favour.

The environment over the past 18 months has resulted in significant disruptions making detailed stock-picking work worthwhile and, as always, we will endeavour to seek the best opportunities for the fund

using our pragmatic value detailed-orientated bottom-up research process. A long-term though-the-cycle orientation is key, as is the ability to weather the storm in anticipation of future returns.