

Portfolio Manager Quarterly Comment

Market review

The standout feature of the markets in the fourth quarter was higher than usual volatility in the equity markets and the near 35% collapse in oil prices. Since the beginning of the year the US equity market had been driven higher by earnings growth associated with tax cuts and outperformance by the US economy. Other markets struggled to perform in the face of a stronger Dollar, rising oil prices and trade tensions between the US and its trading partners, mainly China. Oil prices hit a four-year peak in early October before evidence started to emerge showing increased US crude stocks and a report from the International Energy Agency revising demand growth for oil for 2018 and 2019 lower due to weaker economic growth.

While global growth was downgraded by the International Monetary Fund, it remained around trend growth at 3.2%. In the background, the sabre rattling around trade tensions remained a sword of Damocles with a full trade war potentially shrinking global trade by 17% and global growth by up to an estimated -0.5%. With the Republicans losing the House in the mid-term elections, President Trump's ability to impact domestic policy has been curtailed and it remains to be seen if Trump will continue escalating import duties from the current 10% to 25%. The Chinese PMI disappointed with the Shanghai stock exchange down 19% for the year despite the government attempting to stimulate demand by cutting the bank reserve requirement four times. The Brexit vote, which will take place in January, also created much uncertainty in the UK and the rest of Europe. The Italian economy was also increasingly a concern with a ballooning deficit pointing to fiscal risks driven by the aim to lower the retirement age and provide a minimum wage. Italian sovereign bond spreads spiked by over 300 basis points (bps) on concerns of a Eurozone break-up and the Italian stock market was down 16% in 2018.

Domestically, business confidence remains very weak as demonstrated by South African Chamber of Commerce and Industry (SACCI) business confidence data. Private sector fixed-capital formation has collapsed from 17% of GDP in 2007 to lows of 11% of GDP currently. Political uncertainty weighed on the JSE as ex-Finance Minister Nene's testimony at the Zondo commission led to his recall by the president ahead of the Medium Term Budget Policy Statement. However, the appointment of former South African Reserve Bank Governor, Tito Mboweni – our fourth finance minister in three years – seemed to have calmed local markets.

Local demand continued to falter from the impact of higher VAT, the oil price reaching four-year highs (before pulling back in the final quarter) and interest rates being on an upward trend again. Consumption expenditure as a percentage of GDP has pulled back to 59%, which has only been lower during the Global Financial Crisis. The public sector wage increase this past year was a healthy 7.5% p.a. and this has yet to feed through to the economy. NERSA has given Eskom permission to claw back R33 billion over a four-year period, which will have a minor impact on inflation, but a 12% tariff increase in 2019 will hit consumers' wallets very hard.

For the calendar year 2018, the FTSE/JSE Shareholder Weighted Index (SWIX) declined by 11.7% and local property sank 25.3%. Nominal bonds returned 7.7%, narrowly ahead of cash with a return of 7.3%, while inflation-linked bonds (ILBs) were flat. The Rand was 16.2% weaker over the year, sliding from R12.38/\$ to R14.38/\$.

Global equity markets ended the year in negative territory with the MSCI Emerging Markets Index down 14.6% in Dollar terms while the MSCI World Index gave up 8.7%. Global bonds, as measured by the Bloomberg Barclays Global Aggregate Bond Index, closed 1.2% lower for 2018.

Asset allocation

Looking to the relative valuations of the various asset classes, we see local equities as offering good long-term value and as such are cautiously buying physical local equity. As a value investor, we cannot ignore the compelling long-term potential returns on offer from SA equities, confirmed by the aggregation of our analysts' bottom-up-driven valuations at an individual stock level. In spite of the attractiveness of equities, we continue to protect a portion of our equities from market declines through the use of cost-effective derivative overlays.

We added to our SA long bond position over the course of the year, more especially when bonds weakened in line with emerging market peers. Even though local bonds have since strengthened, the current yield of about 9% on the 10-year bond still offers an attractive prospective real return. CPI is well under control and expected to remain within the 3-6% target band for the foreseeable future. Although ILBs trade at fair value, we maintain our preference for nominal bonds over ILBs from a valuation perspective.

The decision to retain a long position in short-term interest-bearing assets has held the funds in very good stead during this period of heightened market volatility. We continue to pick up quality-enhanced cash-type assets, providing overall real yields in this component of the fund of close to 3.5%, while continuing to ensure that the strong credit quality characteristics of the fund were not compromised in the search for yield.

On the international side, we retain our preference for equities and select property over fixed-income assets. Although we remain comfortable in our current, diversified allocation to foreign equities, we have during the fourth quarter taken the opportunity to lighten our allocation in favour of more favourably valued local assets. Emerging markets (EMs) are cheap, but South African equities are highly correlated with other EM equities, with commodity prices being a common factor driving their economies. We therefore retain a low position in EM equities, preferring to gain exposure to this asset class through the local counterpart. We have added slightly to global sovereign bonds but remain well underweight, based on relative valuations and the unattractive real returns on offer. Even though the Rand is undervalued against developed market currencies, we believe the extent of the undervaluation is not significant enough to increase our exposure to offshore assets at this stage.

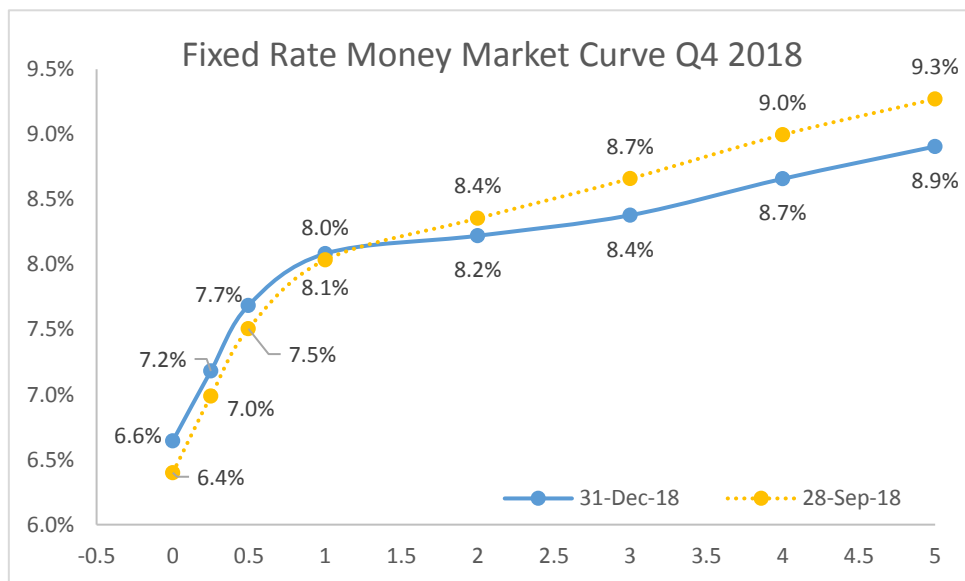
Short-term interest-bearing instruments

In the fourth quarter, the listed credit market continued the trend seen throughout the year of tightening spreads caused by a healthy demand for credit in an environment of limited supply. Gross issuance for 2018 came to R115 billion, a significant drop from 2017's record number of R142 billion, and the lowest yearly issuance since 2014. The most active sector in terms of issuance was the financial sector, followed by corporates, with relatively little in the way of SOE issuance. The JSE floating rate spread index tightened by 36 bps in 2018, while the fixed-rate index tightened by 10 bps, driven especially by aggressive tightening in corporate and bank subordinated and Additional Tier 1 (AT1) spreads.

Some of the more notable financial issuances included Liberty Group's Tier 2 bond, AT1 bonds issued by Absa Group and Nedbank Group, and FirstRand Bank's first-ever AT1 bond, all of which

were oversubscribed and priced inside price guidance. Senior bond issuances included transactions by BNP Paribas Personal Finance, Absa Bank and Nedbank. November also saw Tier 2 issuances by Absa Group and Nedbank Group, while Standard Bank issued Tier 2 notes in December. Corporate issuance included transactions by Woolworths, AECL, Bidvestco, Toyota Financial Services, Netcare, Barloworld and Growthpoint. SOE issuance remained muted, with the only notable SOE issuances being transactions by the Industrial Development Corporation (IDC) and a new issue by Land Bank. Key securitisation issues included transactions by Amber House 5 RF and Thekwini Fund 15.

We remained highly selective in our investment in local credit in the fourth quarter, maintaining our focus on high-quality borrowers, and on issues that provide attractive risk-adjusted returns in our view. Where pricing guidance didn't appeal to us, we preferred to stay out of auctions. We took advantage of private placement opportunities to acquire healthy allocations in strong corporate issuers, and we also acquired bank and corporate paper in the secondary market when opportunities presented themselves. We saw some of the AT1 paper issued by banks in the quarter as an opportunity to pick up yield at a risk we consider acceptable. Fixed-rate term bank instruments issued in the over-the-counter (OTC) market also provided us with attractive yields, especially when market rates climbed higher early in the quarter. We generally preferred these over bank floating rate notes, and invested in the latter sparingly.



Equities

After peaking at around 13 772 at the end of January, the SWIX bottomed at around the 10 936 mark at the beginning of December, slumping by 4% in the final quarter to end the year down 11.7%, the **worst calendar loss** since the Global Financial Crisis. Across the equity sectors, the dispersion of returns was wide. **Resources** were at the top of the pile posting gains of 15% for the year while **financials** shed 8.8% and **industrials** lost 17.5%. The poor performance of industrial stocks must be seen in light of a number of JSE giants experiencing some serious wobbles this year as detailed further below:

Steinhoff International was engulfed in an information vacuum for most of the year with creditors cutting funding lines and the company having to dispose of assets to stay afloat. The share was down 63% and the PWC report on the debacle has yet to be released. **EOH** also fell from grace, down 54.3% in 2018. Like Steinhoff, the company was very acquisitive, benefiting from a sector which was fragmented while serving large clients especially in the public and financial sectors. **Aspen** fell hard this year, down 50.3%. Following a spate of European acquisitions, the company's debt burden forced it to dispose of its Chinese infant milk formula business. **Mediclinic International** experienced regulatory issues in Switzerland, which accounts for half its revenue. Issues at private hospital group Hirslanden led to a profit warning and the share price falling 17% in a day. Mediclinic closed the year down 42.2%. Finally, **British American Tobacco (BAT)**'s expected synergies from the US\$50 billion Rothman acquisition went up in smoke when the regulator announced that it would impose stricter nicotine regulation in the US. In addition, traditional cigarette sticks have been in decline while the younger generation chooses 'vaping' products and the US plans to ban menthol cigarettes, which represents a third of the cigarettes sold in the US. With menthol cigarettes making up over 20% of BAT's operating profit, the market panicked about the potential impact on the cash flows of BAT but with the share price down 39.3% in the past year we believe that this is more than discounted in the price. The stock trades on a forward price-earnings (P/E) ratio of 8 times and a forward dividend yield of 6% in Pounds.

On the flip side, resilient global growth and strong capital discipline by the miners meant that resources stocks led the pack. Our overweight positions in **diversified miners Anglo American plc** (31.1%), **BHP Group** (27.5%) and **Impala Platinum** (+13.1%) paid off this year.

The SIM house view portfolio outperformed the benchmark by about 45 bps over the past year. Key contributors to performance were Anglo American, BHP Group, Impala Platinum and Mondi. On the downside, the overweight position in poorly performing British American Tobacco hurt performance while the underweight positions in AngloGold Ashanti and Capitec also contributed negatively.

SIM Equity Strategy

Almost 30 of the top 40 JSE stocks are in bear market territory, i.e. down some 20% from the peak. This year has been characterised by a number of JSE-listed companies paying the price for their foreign forays and suffering from a regulatory backlash in a number of sectors such as hospitals, tobacco manufacturing and even gaming. However, in most cases the market has taken a worst-case scenario view, discounting entire lines of business or regions from the valuation of multinationals with a number of business lines. We will continue to seek out and identify such mispricing opportunities. The resources position we accumulated over the past few years when the sector was decimated delivered strong outperformance in 2018. With the current sell-off in some blue-chip stocks, we are able to accumulate positions in stocks which we believe are offering significant upside to intrinsic value.

Equity outlook

As value investors we focus on investing in unduly 'marked-down' stocks as such stocks tend to offer the most upside, which will be triggered at the first sign that business reality is nowhere as bad as what the market expects. We have been there before in 2008 when many expected a decade-long bear market for equities. And yet businesses adapt and adjust to tough economic conditions. In this context, we are of the view that patient equity investors will be rewarded with handsome returns over the next three years.

The undervaluation of the SA equity market is apparent from aggregating the SIM analysts' valuations of the underlying SWIX companies. This implies a greater than 30% upside to fair value for the SWIX index. Furthermore, based on consensus earnings forecasts, our equity now trades at a one-year forward P/E ratio of 11, if we exclude Naspers. We believe a P/E ratio of about 13 to 14 is more appropriate given our required real return of 6% for the local equity market.

Bonds

October's Medium Term Budget Policy Statement disappointed again as fiscal consolidation was delayed, owing to projections of fiscal deficits of about 4.3% of GDP. However, the quarter saw nominal bonds stage a pleasing recovery after two quarters of weakness, with nominal bonds posting a total return of 2.8%. Yields came in across the curve, but a steepening trend saw the very short end (1- to 3-year maturities) rallying significantly, returning over 3.8%. Much of this outperformance can be attributed to supply-demand dynamics caused by National Treasury's recent switch auctions, where the shortest maturity bonds (R204, R207 and R208) were bought back, and longer-dated bonds across the curve from the R2023 to the R2048 were issued in their place. ILBs continued to underperform nominal bonds, with a total return of only 0.4% over the quarter, while cash returned 1.8%. For the 2018 calendar year, nominal bonds returned 7.7%, ILBs returned 0.3%, while cash returned 7.3%. The performance of nominal bonds over the year was respectable, given several global and domestic headwinds, and despite foreigners being net sellers of SA's bonds to the tune of R71 billion.

We view the long-term fair value of nominal bonds to be at a yield where the generic 10-year bond is at a premium of 3% over our long-term inflation forecast of 5.25% (i.e. 8.25%). The 10-year yield as at the end of 2018 was 9.2%, suggesting that nominal bonds can be considered appealing based on our methodology. However, given the bond market volatility seen over the year, and the solid returns provided by our short-term interest-bearing instrument portfolio, we continued to maintain the modified duration of our bond portfolio well below that of the FTSE/JSE All Bond Index (ALBI), allowing us to benefit from a yield curve that bear-steepened over the year (and sparing our funds from much of the prevailing volatility). With nominal bonds offering real yields of 4% and better, compared to ILB yields closer to 3%, we retained our preference for nominal bonds over ILBs.

International

The US Federal Reserve (Fed) hiked rates four times in 2018, of 25 bps each, with two to four hikes expected in 2019. The US and China agreed to a temporary pause on tariff escalations but this appears to be a tenuous halt to the trade rhetoric. Global growth continued to be driven mainly by China and the US but both regions are dogged by headwinds. The US economy is running at full capacity with growth above potential and unemployment at multi-decade lows; and China continues with the delicate balance of transitioning its economy from investment-led to consumer-driven. The Chinese economy also faces another headwind in the form of weak credit extension, resulting in growth potentially slowing to 5% next year. It is also talking tough, stating that it would stick to its policy agenda and not be swayed by pressure from mainly the US to allow more competition. In President Xi's latest speech, of concern was that his party offered no new ideas to boost the economy, but reiterated the need for leadership and control over all aspects of the economy.

Within the European Union, German business sentiment fell further to multi-year lows of 101.0 from 102.0 in November, on trade and Brexit concerns, and tapering by the European Central Bank (ECB). Italy is a persistent area of risk within the union; the populist government has been fighting Brussels in relation to its 2019 budget and the year-end timeline to get it approved was almost missed, but for a breakthrough deal struck in late December. The uncertainty around Brexit is having dire

consequences for the UK economy, with house prices weakening, businesses delaying investment, muted consumer confidence and the weakening Pound stoking inflation. Recall that the exit deadline is 29 March 2019 and there is still much uncertainty as to the terms of the divorce proceedings. Japanese growth forecasts have been lowered to 1.3% from 1.5% to March 2020, with nominal GDP now 2.4% versus 2.8% previously, and CPI rising 1.1% (previous: 1.5%). On the positive side, global PMIs improved slightly over the quarter.

The yield on the benchmark 10-year US Treasury bond fell to 2.68% from 3.08% during the quarter, as the market repriced expectations of rate hikes for 2019 and beyond. This was despite a 0.25% increase in the federal funds rate at the December Federal Open Market Committee (FOMC) meeting. The dot plots, which show Fed officials' rate expectations, now suggest just two rate hikes in 2019 and a terminal rate of 2.75% in 2021, a decline of 0.25% compared to the September projections. Elsewhere, 10-year yields in Japan fell from 0.16% to 0% and in Germany the 10-year bund ended the year at 0.24%. The stock of debt with negative yields rose to circa US\$8.3 trillion by end 2018 from US\$5.7 trillion in October 2018.

For the 12 months to December in Dollar terms, the MSCI World Index recorded a negative return of 8.7% while the MSCI Emerging Markets Index declined 14.6%. Global bonds, as measured by the Bloomberg Barclays Global Aggregate Bond Index, declined by 1.2% over the year. In 2018, the local currency depreciated by 16.2% versus the US Dollar.

In relation to our international exposure, we continue to favour equities over property over bonds. Equity valuations have improved given the December market downturn, and our select property basket provides a yield superior to that of sovereign bonds.