Portfolio Manager Quarterly Comment

Market overview

After experiencing their worst December since 1931, global stocks posted their best January since 1987 and global equities had their second-best quarter on record. But the rally wasn’t plain sailing, with economic data releases surprising on the downside. Global PMI fell at the beginning of the year to the lowest level in two years, led by developed markets, with the German PMI and China also at three-year lows. Global manufacturing data show that we may be in contraction territory. Global growth is trending around the 3% mark, but the key question remains whether global growth has indeed bottomed at around trend levels.

Explaining the strong quarter

The temporary ceasefire in the trade war and the postponement of the 25% tariff rate have provided the markets with some relief. The US Federal Reserve (Fed) joined the party with some dovish comments and markets now expect the Fed to cut rates both this year and the next, with only a modest rise in the US 10-year bond rate being anticipated. Finally, lower volatility provided a more favourable environment for risky assets.

Despite the S&P 500 Index posting its best start of the year in a decade, the inversion of the US yield curve at the end of the quarter put a damper on the initial bullish mood with concerns of a recession looming. The Fed will be using interest rates to target inflation, but Fed Chair Jerome Powell mentioned that the US was not at the neutral rate providing optimism that future hikes will be delayed. Actually, Powell even said that they would consider increasing liquidity again by using their balance sheet again to ensure financial stability. The Fed has effectively paused with the federal funds rate at 2.5%, which is below the neutral level of 3%. This provided a boost to risk assets and weakened the greenback temporarily.

However, the possibility of a no-deal Brexit is also in the balance with another extension expected beyond the crucial 2 April vote. There is an increasing possibility that Britain will go for the customs union route (a so-called ‘soft’ Brexit) but there remains the possibility of a referendum and an early election.

The Chinese economy continues to experience a soft landing with growth expected to be in the 6.0-6.5% per annum range in the year to come, the slowest growth rate in three decades. The Chinese are stimulating their economy further with tax cuts – the latest measure to be implemented – and at the end of March the Manufacturing PMI surprised on the upside with the biggest month-on-month increase since 2012.

South Africa

In the past decade economic growth has been hampered structurally. The South African Reserve Bank (SARB) lead indicator has started pointing downwards due to low manufacturing confidence and orders. Manufacturing confidence and orders have remained low for 10 years with the latest data showing a deepening contraction. We nonetheless expect a mild recovery from the GDP shock suffered in the first half of 2018 – which is partly linked to the weakening terms of trade and weaker exchange rate (PPP Rand/Dollar estimate being closer to 13) – to shift our growth rate back towards a tepid 1.4% run rate (structurally we remain stuck below 2%). Underlying consumption growth is likely to remain subdued due to the fact that remuneration growth at 5% is at the lowest since the 1970s and the consumer has started saving again due to negative wealth effects. This has led to real retail sales dropping to close to zero in line with real disposable income growth.
Despite this backdrop, the SARB continues to target a high neutral real rate and is not being accommodating in order to anchor inflation lower at 4.5%. Given outflows, the SARB has much less room to cut rates than other emerging market central banks. A key risk remains Eskom with the electricity availability factor dropping to 65% at the beginning of the year leading to stage four load shedding. This has already negatively impacted manufacturing output. In the National Budget, government committed to provide some R69 billion of support to Eskom over the next three years, partly allaying short-term fears given its balance sheet hole of some R250 billion.

What added to, and detracted from, performance

The SIM Top Choice Fund was up by over 12% this quarter, handsomely outperforming the FTSE/JSE Shareholder Weighted Index (SWIX), which was up 6%. Over the past decade, the fund is one of the top performing equity funds in the country.

The main driver of performance was the exposure to resources stocks, with the sector up almost 18% this quarter. Production issue and strong capital discipline by the miners meant buoyed commodity prices with iron prices experiencing a supply squeeze after dam failures in Brazil and a cyclone interrupting production in Western Australia. Our overweight holdings in diversified miners Anglo American plc (22%) and BHP (17%) performed well. Our third largest holding, Implats (+66%), was the exceptional performer this quarter as the turnaround of the Impala Lease Area was reflected in very strong interim numbers.

The big news were positive steps by Naspers to unlock its 40% discount to listed assets. At the end of March, Naspers announced it would list a new consumer internet company, NewCo, in Amsterdam, which would house its 31% stake in Tencent and other valuable classified assets. This will make NewCo the largest consumer tech business in Europe at a $100 billion market cap and a top-10 company in size globally. In addition to the unbundling of MultiChoice earlier in the quarter, this should bring down the weight of Naspers in the SWIX from 24% to 18% (the stock had a 5% weight in 2013), while NewCo should attract a weight of around 6% as a new inward listing on the JSE. We view the separate listing of NewCo on the Euronext Amsterdam exchange as positive in terms of attracting a range of active and passive shareholders and enhancing the ability of Naspers to raise capital offshore. Naspers remains the largest position in the fund and was up a pleasing 21% this quarter. Another industrial holding, British American Tobacco (+30%) performed strongly after delivering solid results.

On the downside, Sappi was down 15% on the back of weaker pulp prices, which will put its European profits under pressure. The stock, however, trades on an attractive P/E of under 8x and a dividend yield of 3.5%. Old Mutual was up a disappointing 1% with its maiden standalone results marred by a spike in mortality (an industry trend) and a revision in its Zimbabwean earnings by using a more realistic exchange rate. Old Mutual trades at a substantial discount to its peers with an attractive double-digit forward dividend yield.

Our strategy

Value investing requires patience and a long-term horizon. As demonstrated this year, alpha is lumpy and is impossible to time. After four mediocre years, a number of JSE stocks have been trading well below our estimate of intrinsic value, which we expect to realise in the forthcoming years. In addition, there has been uncharacteristic macro volatility and many corporates have scored own goals through ill-timed acquisitions and venturing beyond our shores into areas where they do not enjoy a similar dominant industry position. Regulation has also proven more severe in a number of sectors and this
has forced incumbents to operate under stricter scrutiny and with limited operational freedom. However, most of these issues have been discounted in current stock prices, and we back the strong management teams to guide their companies out of their current mire.

The JSE is trading on a forward P/E of 13x and an attractive forward dividend yield of close to 4%. As value investors we will capitalise on any market dislocations. The fund reflects the best views of SIM’s equity unit trust portfolio managers and holds approximately 20 stocks. It is not benchmark-cognisant and owns no offshore stocks. We believe that this portfolio provides the best of both worlds in terms of representing our investment ideas aggressively, while providing adequate diversification. The fund’s largest holdings are companies of which valuations are below our estimate of fair value.