Portfolio Manager Quarterly Comment

Market overview

In an *annus horribilis* for global equities, December was the worst month for the asset class since 1988 with **global equities** down 7% in the month to end the year **down 9%** - the **sixth worst year on record**. There was nowhere to hide with emerging markets down 14% faring as badly as most of the developed world, with the US remaining the most resilient (down 5%).

2018 was a year where the negative headlines only served to make investors jumpy. While global growth was downgraded by the IMF, 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% import tariffs to 25%.

Perhaps the best metaphor for how the global markets imploded this year was the art work "Girl with Balloon" by British artist Banksy, which shredded itself after being auctioned for 1m pounds by Sotheby's! 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 on concerns about a Eurozone break-up and the Italian stock market was down 16% in 2018.

South Africa

Business confidence remains very weak as demonstrated by the 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 the finance minister's confession at the Zondo commission led to his recall by the president ahead of the Medium Term Budget. However, the appointment of former Reserve Bank governor, Tito Mboweni – our fourth finance minister in three years - calmed the market's nerves.

Local demand appears to be flailing from the impact of higher VAT, the oil price reaching four-year highs on the back of Iranian sanctions (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. Public Sector wage increases this past year was a healthy 7.5% pa and this has yet to feed through the economy. Eskom will be able to claw back R33bn over a four-year period, which will have an minor impact on inflation, but a 12% tariff increase in 2019 will hit consumers' wallets very hard. With our economy in recession while the rest of the globe is growing at trend levels, the new administration is trying to drive an economic recovery via capital expenditure with R843bn set aside for three years and the R400bn infrastructure fund a concrete measure to drive expenditure.

What added to, and detracted from, performance

The SIM Top Choice Fund was down some 6.9% during the year, **outperforming** the FTSE/JSE Shareholder Weighted index, which was down 11.7% in 2018.

The main driver of performance was the **exposure to resources stocks, with the sector up over 15% in 2018.** Resilient global growth and strong capital discipline by the miners meant that resources stocks led the pack. Our overweights in diversified miners **Anglo American Plc (31%)** and **BHP Billiton (27%)** paid off this year. Our overweight position in **Implats** (+13% for the year) performed well in the final quarter, up 33%, with the miner starting a restructuring process of loss-making Rustenburg shafts in order to claw back profitability.

Our third largest holding, **Old Mutual**, was up over 8% if we take into account the unbundling of UK wealth manager Quilter and their 30% shareholding in Nedbank. Old Mutual now has come home with a primary listing on the JSE and will focus on its core South African financial services offering. We retained our shares in Nedbank, which was up close to 4% in the final quarter. **Standard Bank**, whose Nigerian operation was caught in the cross-fire between MTN and the Central Bank of Nigeria with a fine imposed on all the banks involved in the repatriation of dividends by MTN over the past decade, was down almost 4% for the year.

Naspers, the largest position in the fund, pulled back 16% in 2018. Despite realising $12bn from selling down some of their Tencent (China) stake and their stake in Flipkart (India), the stock was hurt by a slowdown in the growth rate of Tencent. The Chinese have instituted a new regulatory process, which has made it more onerous to get approval for new online games. Naspers, however, continues to trade at a considerable discount to its investment in Tencent.

British American Tobacco's expected synergies from the $50bn Rothman acquisition went up in smoke when the regulator announced that they would impose stricter nicotine regulation in the US. In addition, traditional cigarette sticks have been in decline while the younger generation choose "vaping" products and the US plans to ban menthol cigarettes, which represents a third of the cigarettes sold in the US. With menthol making up over 20% of BAT's operating profit, the market panicked about the potential impact on the cash flows from BAT but with the share price down close to 40% in the past year this is more than discounted in the price. The stock trades on a forward PE of 8x and a forward dividend yield of 6% in Pounds.

Our 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 discounting entire lines of business or regions from the valuation of a multinational with a number of business lines. It is the principal job of our analysts to identify such mispricing opportunities. As value investors we focus on investing in stocks which are heavily marked down as such stocks 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, patient equity investor will be rewarded with handsome returns over the next three years.

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.