Fund Commentary

Sanlam Investment Management Value Fund

December 2018

Portfolio Manager Quarterly Comment

South African market overview

The market volatility continued in December with the MSCI World markets falling by 7.6% in US dollar terms. The MSCI Emerging Markets index fell by 2.6%. Fears of the US-China trade wars continued to fuel the negative sentiment, while the “shutdown” in the US economy over December, together with fears of a slowdown in the US economy into 2019, played havoc with global markets. The negative returns were broad based with all sectors within the MSCI World Index posting negative returns.

For most investors 2018 was a year to forget. In 2018 the MSCI EM index lost 14.2% in dollar terms, while the MSCI World Index lost 8.2%, the worst annual performance since 2008. Asia was down 15.2%. The Rand depreciated by 1.6% against the Dollar in the last quarter of 2018. For the full year, it depreciated by 13.9% making it the fifth worst performing currency within the Emerging Market universe.

Turning to South African equities, December proved to be more positive with the FTSE/ JSE Capped Swix Index rising by 2.6% (in Rand). However, for 2018 the Index was down 10.9%. This was the worst annual loss since 2008. Large caps lost 8.2%, mid-caps were down 9.7%, while the small cap sector declined by 14.6%. From a sector perspective, SA Resources outperformed with a total return of 15.5%, while Financials declined by 8.8% and Industrials fell by 17.5%.

Performance

Notwithstanding the tough performance in 2018, your portfolio was able to outperform its benchmark by a wide margin. The alpha generated this year has also been broad based with the stock picking being positive within Resources, Financials and Industrials. In addition, our stock picking within the small cap sector has been good in 2018, contributing to the positive alpha. Some of the small cap shares that performed well in the portfolio in 2018 were: Stefanutti Stocks (up 59%), Altron (up 52%), Grand Parade Investments (up 36%) and Adcorp (up 9%). This remains a differentiating factor for our strategy relative to our peers.

We increased the pace of shareholder activism during 2018. This is in our clients’ best interests and is demonstrated by the positive returns across the shares where we have taken an active stance to improve shareholder value. We played an active role, together with other like-minded shareholders, in improving returns within Altron, Grand Parade Investments and Adcorp.

Outlook

The recent correction in local and global markets is, in our opinion, healthy. Valuations have now come back to levels that we regard as more reasonable from a long-term value creation perspective. We also see good quality companies that we previously regarded as too expensive now looking very attractive. This improves the breadth of the market opportunities and allows us to improve the overall quality of the portfolio at attractive long-term valuations.

Last year (2018) was the worst year for equities since the Global Financial Crisis in 2008. In times of increasing pessimism, our experience has proven that opportunities arise to buy great businesses at bargain basement prices.

As we have mentioned in the past, with global interest rates moving firmly upwards, it will be the most expensive stocks (highest PE) that are hit the hardest and as managers who seek out mispriced opportunities, this should play to our strengths.

The Price to Earnings ratio (PE) of the FTSE/ JSE All Share Index has contracted by 23% from a PE of 21.2 times (in 2017) to its current level of 16.4 times. Although market consensus earnings forecasts of 15% in 2019 may be a bit too optimistic (although the base is low), the forward PE ratio of 12.3 times is more reflective of fair value. The one-year forward dividend yield is a more respectable 4.2%. A few additional statistics are interesting to note: of the 123 stocks on the JSE that we actively research (this makes up more than 95% of the market capitalisation of the JSE), the median one-year forward PE ratio is 10.4 times. A total of 45% of the number of companies are trading on one-year forward PE ratios less than 10 times. The probability of generating real long-term returns from South African equities has increased dramatically.

For the first time in a number of years we are identifying good quality businesses trading at attractive long-term intrinsic valuations. This excites us as active managers. The valuation metrics are, undoubtedly, more attractive. The only caveat is an uncertain economic and political environment in the short term as we build up to the elections in South Africa. A more stable political environment with market friendly economic policies would certainly ignite a period of attractive returns for South African investors. In light of a slightly stronger Rand, lower oil prices and stable inflation it is likely that the SA Reserve Bank could pause on interest rate hikes. These factors should underpin an improved level of consumer confidence. Although global growth is likely to slow in 2019 (in particular the US and China), we have seen eight interest rate hikes in the US since December 2015. It is likely that we're coming to the end of the interest rate hiking cycle in the US with possibly one more hike in 2019.