Portfolio Manager Quarterly Comment

South African market overview

The FTSE/JSE All Share Index (ALSI) posted a total return of -2.2% vs. +4.5% for Q2 and -6% for Q1. South African resources and financials outperformed in Q3 with total returns of +5.2% and +2.8% respectively, while industrials were the drag on the index, shedding 7.8% over the quarter. Naspers, which was down 12.2%, was a big contributor to the fall in the index.

The best-performing sectors included technology (+10.4%), platinum (+25.5%) and non-life insurance (+16.6%). The worst performance came from pharmaceuticals (-31.8%), mobile telecoms (-12.8%) and media (-12.3%).

Year to date resources remains the best-performing sector (+20.9%) relative to declines for both industrials (-11.8%) and financials (-6.8%).

South Africa entered a recession for the first time since the global financial crisis. In addition to the challenging macroeconomic background, the recent period has been characterised by a number of company-specific calamities, which has resulted in their share prices experiencing sharp downward moves. MTN (down 18%) was hit by multiple regulatory financial claims in Nigeria, Aspen fell 34% after releasing disappointing results and Blue Label (down 49%) continues to be plagued by its Cell C acquisition.

The low growth environment has impacted confidence, resulting in returns from cash (7.3%) exceeding equities (6.7%) over the past three years. Year to date the MSCI South Africa Index is down 21% in US Dollars, significantly underperforming MSCI Emerging Markets, which were down just 7.4%. Second to Turkey, South Africa is one of the worst-performing emerging markets in 2018.

Performance

In spite of ongoing volatility, the portfolio continued to outperform its benchmark in the quarter due to good stock picking. Our large position in Old Mutual contributed positively (+14.5%) with the unbundling of Quilter Cheviot unlocking value for shareholders. We believe the counter remains very cheap and should see further uplift as Nedbank shares are still to be unbundled. The announcement by Investec to split its asset management company contributed positively to performance. In addition, we had very little exposure to both Aspen (-38%) and MTN (-18%), which added positively to relative performance.

Detractors from performance included Libstar (-27%), Shoprite (-12%) and Tiger Brands (-20%). While all three companies face short-term challenges due to the increased pressure on consumers and rising competitive activity, we remain positive on the long-term prospects for these companies and continue to selectively add to certain positions in the portfolio.

Outlook

The synchronised recovery in global activity faltered, with trade tensions and increasing political uncertainty in Europe. The US remains the bright spot globally with unemployment (at 3.7%) reaching its lowest level since 1969. Locally, corporate profit growth is growing at just 5.5% (i.e. no real growth). We are in the middle of a downturn in profit growth with no visible sign of a bottoming. The previous three downturns bottomed after corporate earnings had declined. Equity markets are, however, forward looking and will turn in anticipation of a recovery in earnings growth. Current consensus growth for FY19 for the ALSI is 18%, which includes over 25% growth for South African industrials. We view this as way too optimistic.

The price-earnings (P/E) (next 12 months) of the ALSI has fallen from 15.9x (its peak earlier this year) to 12.9x and is the lowest level in five years. This should provide some margin of safety against any further disappointments in profit growth.

So far, this year has been the worst year for equities since the global financial crisis in 2008. In this environment we continue to focus our efforts in uncovering companies that display a minimum of quality in the past financial performance and current financial position and which are trading below our assessment of intrinsic value. In times of increasing pessimism, our experience has proven that opportunities arise to buy great businesses at bargain prices.

With global interest rates moving firmly upwards, it will be the most expensive stocks (highest P/E) that are hit the hardest and as managers who seek out mispriced opportunities, this should play to our strengths.