Please note that the commentary is for the retail class of the Fund.

Performance

In another strong quarter for SA financial stocks, the Fund returned 13%, bringing the 12-month return to 39%. Since inception the Fund has delivered a 11.5% annualised return, 1% ahead of the benchmark.

Global markets continued their strong march upwards in Q3 of 2024. The MSCI ACWI returned 7% for the quarter, lifting the year-to-date (ytd) return to 19%. The returns are broad based across markets and have been supported by generally resilient economic growth and employment data. Continued easing in inflation supported the start of cuts in policy rates across many markets, including the US where a larger-than-expected 50bps was announced. The positive outlook also reflected in global bond markets with in a 7% return in the Bloomberg Barclays Global Aggregate Bond Index for the quarter (4% ytd).

Emerging markets joined the party, rising 9% in Q3 and 17% ytd. China was a strong contributor to these returns as a raft of stimulus measures were finally announced in September, resulting in a 24% return for the MSCI China Index in that month alone.

Geopolitical tensions remain high and appear to be escalating in the Middle East, raising the potential of a broader regional conflict. The oil price has bounced off its September lows and the gold price ended the quarter close to an all-time high above $2 600/oz, perhaps reflecting these risks despite the relatively benign economic environment that appears to be unfolding.

Domestic markets performed strongly as positive sentiment attributed to the new coalition government continued into Q3, supported by a 25bps rate cut from the SARB in September. The JSE Capped SWIX returned 10% for the quarter taking the ytd return to 16%. The bond market rallied strongly as yields declined taking the ALBI return to 11% for the quarter and 17% ytd. This optimism is also reflected in the currency as the rand closed the quarter at 17.27 to the USD, a strengthening of 6% since the beginning of the year – almost all of which happened in Q3.

The financial index once again outperformed the broader market and returned 14% for the quarter, led by the short-term insurers which were up 22%. Life insurers rose 16% and banks 13%. Contributors to Fund performance relative to the benchmark include overweight positions in Discovery, OUTsurance and Standard Bank and underweight positions in Reinet and Old Mutual. Detractors from performance include underweight positions in Momentum Group and Nedbank as well as overweight positions in Investec, PSG Financial Services and Sanlam.

Portfolio actions and fund positioning

One can certainly sketch a positive scenario to support the price moves that we have seen in domestic-facing assets. Nearly 100 days in, the GNU is performing well and there appears to be genuine intent on all sides to ensure its longevity and to work together constructively despite some teething problems. The private sector has seconded skills into government to assist with delivery. The country has experienced no loadshedding for almost 200 days and real plans to deal with other infrastructure challenges are taking shape. The strong rand and lower oil price are helping to deliver lower inflation and we have begun a rate-cutting cycle. The two-pot system could provide a short-term sugar-rush to consumers, boosting confidence somewhat and potentially supporting higher credit extension.

There are some quick fixes to be had (speeding up the processing of skilled work visas for example), but many of the challenges that we have flagged in the past persist. Decades of underinvestment in infrastructure (rail, ports, and water) will take years to correct. Failing municipalities will impede attempts at improvements in service delivery. The longer-term fiscal outlook remains challenged as constrained government revenue and continued high expenditure demands for the public sector wage bill, social grants and debt servicing costs mean that a rising debt-to-GDP ratio remains likely, even factoring in potentially higher GDP growth.

As a result, our exposure remains concentrated in high quality businesses that we would expect to outperform in a challenged economic environment. We are however cognisant of the risk of a more positive outcome – a high road scenario in which tangible evidence of real execution by government translates into better operating conditions for domestic businesses, as well as the buying of equities and bonds by foreign investors who have largely sat on the sidelines until now. The fortunes of the financial sector are particularly tied to those of the domestic economy, and this could well result in a rising tide lifting all boats, where the share prices of poorer quality businesses on depressed ratings have the potential to outperform the higher-quality businesses. We have not gone down this route in stock selection in the Fund, however.

During the quarter we saw positive flows into the Fund. These were applied to increasing the Fund’s holdings in St James’s Place, the banks (excepting Absa), Reinet, and Discovery.

The Fund’s 6.8% holding in Discovery is the second-largest overweight position in the portfolio. This is a business that increasingly slots into the high-quality category. The share sold off heavily earlier in the year at the time of reporting interim results, made complex by the implementation of the new IFRS17 insurance accounting standard, but possibly also on fears of the imminent signing into law of the NHI Bill. Historically, a significant portion of group profits were invested into new initiatives, in particular the bank in South Africa and partnerships with global insurers to commercialise its shared-value model intellectual property. The market became increasingly impatient on delivery, was sceptical on execution in the bank and questioned the lagged emergence of cash flow from the group. When reporting its final results in September, the company was at pains to emphasise that it is at a turning point in its lifecycle. Breakeven in the bank is imminent and conviction is building on the model, the Chinese health insurance JV grew profits strongly as did the Vitality Network partner business, and a recovery in the short-term insurance business is underway. NHI is likely to be amended in some form, or at the very least its full implementation is probably decades away. A much smaller proportion of group profits will now be invested in new initiatives, cashflow emergence is guided to improve and the group is targeting 15-20% annualised growth in earnings over the next five years along with an improving ROE in the upper teens. While the company has at times in the past been guilty of over-promising and under-delivering (on some admittedly ambitious targets), our modelling suggests the targets being set out now are achievable. The market appears to share this view, and the share price is up more than 50% from its lows six months ago.

Outlook

The sentiment emanating from South Africa is positive and this has been reflected in strong moves in both domestic asset prices and the currency. We are in the early phase of the coalition government and still need to see this mood translate into meaningful on-the-ground action. If this comes about, there is scope for improved earnings growth from domestic-facing businesses and possibly a further rerating of equities. The financial sector, being liquid and largely domestic facing, should benefit were this to happen and, similarly, this should reflect in the performance of the Fund.

Portfolio managers
Neill Young and Godwill Chahwahwa
as at 30 September 2024