Discovery Cautious Balanced Fund

Market background

The buoyant equity market momentum at the end of 2020 carried into the first three weeks of January as the Democrats won the Senate and fuelled hopes of increased fiscal stimulus. This optimism, however, petered out in the final week, as the market gave back all the gains in the wake of a spike in volatility. The VIX (CBOE Volatility Index) rose sharply as a group of retail traders inspired by Reddit posters drove up the share prices of the most heavily shorted stocks (such as GameStop and AMC Entertainment), causing some hedge funds to incur billions of dollars in losses as they had to liquidate their positions.

Emerging market equities (MSCI Emerging Markets Index +3.1%) were led by the Asia ex-Japan region, that benefited from strong inflows and good economic data out of China. They managed to outperform their developed market (MSCI Developed Markets Index -1%) peers, which recorded losses, led by the Europe. Global bonds (Bloomberg Barclays Global Aggregate Bond Index) struggled over the same period, closing 0.9% weaker over the month. All returns are quoted in or against US dollars.

On the local front, South African equities had a very strong start to the year, building on the momentum experienced in the last two months of 2020, with the FTSE/JSE All Share Index rising 5.2% as industrials led performance (+8.4%) underpinned by technology (Naspers, +15.2% and Prosus, +9.2%), followed by resources (+5.1%). Financials were under pressure, giving up some of the previous quarters' gains (-2.6%). Within resources, forestry & paper (Sappi, +30.2%) was a standout performer over the month. Listed property (FTSE/JSE All Property Index -3.2%) gave up some gains made towards the end of 2020. Local bonds (FTSE/JSE All Bond Index +0.8%) delivered a modest return, on much improved fiscal revenue from higher-than-expected corporate taxes. The rand retreated against the US dollar, euro and pound sterling.

Performance review

For the month, the portfolio delivered positive absolute returns.

Key positive contributions:

- The allocation to the Naspers/Prosus stable, Sappi and Sasol performed well over the month. Performance was further enhanced by holdings in South African general retailers (Truworths International and Pepkor).
- While more muted when compared to equities, domestic bonds outperformed cash over the month. The portfolio's bias towards bonds within the domestic fixed income space continued to support performance.
- The portfolio's Asian exposure and US banks position contributed positively to returns.
- The weaker rand versus the US dollar enhanced gains from the offshore component of the portfolio.

Key negative contributions:

- Given the weak performance from the financials sector, holdings in South African banks detracted from performance. Anheuser-Busch InBev also came under pressure over the month.
- Our exposure to Europe and cyclical Japanese equities weighed on the offshore equity component of the portfolio.

Portfolio activity

Within the local equity component, we continued to increase our holdings in select cyclical exposures at the expense of more defensive sectors, as we still prefer exposure to stocks that are poised to benefit from a recovery post the 2020 pandemic. We banked some gains on the Naspers/Prosus position in order to take advantage of the attractive entry points in Sasol and Sibanye-Stillwater, where the upside to market consensus forecasts remains high, given prevailing commodity prices. We also continue to trim our holding in British American Tobacco, while topping up our positions in SA Banks and Pepkor, as the trend in earnings revisions appears to be troughing and valuation levels offered a good entry point.

We closed out the positioning on GBPUSD, bringing it to neutral, on the back of a successful Brexit deal and added some ZARUSD and AUDUSD as strong commodity prices continue to support both their terms of trade.

Outlook and strategy

As we are exit the second wave of COVID-19 across various markets and vaccine rollouts are ongoing, hopes for a return to normalcy, coupled with improving momentum in global growth are supportive of markets. We remain vigilant in monitoring some of the potential risks of medium-term 'scarring' in economies and government finances but also look for differentiation in recovery paths in the breadth of the different markets we invest in.

To navigate through this, we continue to have balanced and diversified exposure across asset classes, geographies, sectors and individual assets. As we assess current market dynamics and decide on asset allocation, we continue to tilt the portfolio to those asset classes (and underlying assets) scoring well in terms of our compelling forces framework: fundamentals, valuations and market price behaviour.

The offshore allocation continues to favour equities, with exposure trending more towards cyclical companies where earnings appear to have bottomed and valuations are reasonable, in our view. Regionally, we continue to have a positive skew towards Asia. The China growth story – the economic engine for the Asian region – remains more positive than the rest of the world. Chinese markets continue to exhibit reasonable valuations, and we believe earnings have substantial upside over the medium term. China's consumer industries have great growth potential given the low penetration levels in many consumer sectors, while increasing household wealth is driving consumption upgrades, while industry leaders are seeing market growth, potential market share expansion and higher margins over time. In Japan, with Yoshihide Suga now at the helm, there is renewed focus on the reform agenda, and this could prove positive for growth. Japanese corporate balance sheets are relatively healthy and provided support in managing through the COVID-19 pandemic. They are also in a strong position to improve their profitability from these trough levels over the medium term, coupled with attractive valuations. Both the Chinese and Japanese equity markets also offer significant diversification benefits given their low correlations with the domestic equity market, thus exhibiting attractive risk and return attributes from a portfolio construction perspective.

Global bond yields have started to rise on the back of anticipation of a reflationary environment. Central bank officials have been vocal about their tolerance for short-term inflationary pressures in favour of maintaining supportive environment for recovery and an improvement in unemployment rates. Real yields begun to compress and while the front end of global bond yield curves is likely to be anchored by an easing bias from central banks, we expect curves to steepen, pricing in higher inflation and continued supply from treasury departments in the developed world. We thus, prefer other asset class opportunities which we deem to exhibit better risk-return characteristics.

The local equity composition is well-diversified, and we continue to tilt the portfolio towards select cyclical exposures where the earnings revisions cycle is presenting some good opportunities, while harvesting gains on the more defensive exposures. We still have some capital, albeit less than previously, invested in global defensive companies (Naspers, Prosus, British American Tobacco, Bid Corp and Anheuser-Busch InBev) where earnings expectations remain relatively robust, while valuations are reasonable. These stocks also provide additional protection against any potential rand weakness. This sits alongside a growing allocation to global cyclical stocks (diversified miners, PGM miners, and luxury goods maker, Richemont) geared to the global economic cycle and exhibiting favourable earnings revisions profiles. Most of the exposures in this bucket are benefitting from the faster China recovery versus the rest of the world, as well as tight commodity markets, in our view. We also have a growing exposure to select local cyclical plays (Standard Bank Group, ABSA Group, FirstRand, Sanlam, The Foschini Group, and Capitec Bank) with decent relative earnings revisions profiles, trading at reasonable valuations and where we also have high conviction in terms of balance sheet quality. Our exposure to Sappi and Sasol has increased, as we have more conviction around their balance sheet strength. Both companies have decent relative earnings revisions profiles and are trading at reasonable valuations. Our exposure to local defensive businesses (MTN Group, AVI, Pick 'n Pay Stores) is limited as earnings revisions and valuations are still not as compelling in this space.

We have maintained the material allocation to local sovereign bonds and the asset class remains our preferred play in the local fixed income spectrum. We think that we may have reached the end of the cutting cycle but expect the SARB to remain on hold as the economy recovers. We continue to see opportunities along the steep curve, without understating the fact that our assessment of fair value (the appropriate yield to compensate lenders for risk) is now substantially higher, given the heightened credit risk. While concerns around deteriorating fiscal metrics could keep a lid on capital gains, the buffer provided by the income profile of local bonds provides a robust underpin to the asset class, in our view. Additionally, local bond valuations continue to look attractive versus their own history (the current spread between the 2-year and 10-year government bonds is extremely elevated in historical terms) as well as against emerging market peers (the domestic 10-year government bond has one of the highest real yields versus its counterparts, particularly those with a similar risk profile). We will selectively take profit on selected parts of the curve as it reaches fair value and continue to be positive on the medium-term total risk-adjusted return profile for domestic bonds.

DISCLAIMER:

Discovery Life Investment Services Pty (Ltd): Registration number 2007/005969/07, branded as Discovery Invest, is an authorised financial services provider. Product rules and terms and conditions apply.

The views and opinions expressed in this article are for information purposes only and should not be seen as advice as defined in the Financial Advisory and Intermediary Services Act. Discovery shall not be liable for any actions taken by any person based on the correctness of this information. For full details on the products, benefits and any conditions, please refer to the relevant fact file. For tailored financial advice, please contact your financial adviser.

For the full CIS disclosure and risk statement, go to:
CIS disclosure:
http://www.discovery.co.za/assets/discoverycoza/corporate/cis-disclosure.pdf
Risk disclosure:
http://www.discovery.co.za/assets/discoverycoza/corporate/risk-disclosure.pdf