

Discovery Global Value Equity Feeder Fund

Market background

Rising hopes of an end to the pandemic and a sustained recovery brought cheer to equity markets in the final quarter of 2020. News in November that COVID-19 vaccines were almost ready for deployment sent stocks sharply higher, with gains cemented towards year-end as major central banks confirmed their commitment to supporting economies, US politicians agreed a stimulus package, and the EU and the UK sealed a trade pact.

Gains were especially strong for more cyclical equities and for stocks that had suffered most from the coronavirus, such as shares in airlines and other travel-related businesses. These parts of the market include many companies that have been trading at low valuations, and so the quarter was characterised by a strong 'value' rally. Against this backdrop, value equities significantly outperformed growth equities during the quarter, including the 'big tech' stocks that had dominated the stock-market recovery since the COVID lows of March.

Performance review

For the quarter, the portfolio delivered a strong absolute return and outperformed the MSCI All Countries World Index (ACWI).

At the macro level, the Fund's significant outperformance reflected the recovery of value equities, the shares of companies that have been particularly affected by the pandemic, and more generally those of

businesses perceived as cyclical. These parts of the market gained especially in the latter half of the period as the prospect of a return to something like normality appeared on the horizon – an eventuality for which we had been positioning the portfolio for many months. More specifically, the Fund’s relative performance was aided by our focus on good-quality companies with robust balance sheets that, while deeply discounted at the height of market concern over the coronavirus, we believed were well placed to emerge strongly as a recovery gained traction.

We benefited especially from some of the ‘COVID-recovery’ themes we have been allocating to since the COVID-linked sell-off last spring – reflecting our view that some good companies exposed to sectors such as travel, for example, had sold off excessively and represented exceptional value for investors with a sufficiently long horizon.

At the stock level, relative performance was helped by our investments in companies exposed to the auto sector, whose shares gained in the period after data showed that global vehicle production in Q3 was much better than expected. Adient – which makes car seats, among other things – was among the beneficiaries in our portfolio of the much-improved sentiment towards auto-related companies. Other key contributors to relative performance included several travel-related businesses. They were led by Rolls-Royce, with the jet-engine maker’s shares gaining more than 40% in a single day in November on the news of the vaccine breakthrough. Other significant contributors for similar reasons included airline leasing company AerCap and low-cost airline easyJet, which had suffered heavy declines earlier in 2020 and which also benefited from expectations that air travel would resume in time.

Autoparts business BorgWarner was among the main detractors in the period. Its shares were impacted partly by news that General Motors may make its own drive systems and motors for electric vehicles. We continue to see value in BorgWarner and (selectively) in the wider auto sector, given the very gloomy view the market has had of it in recent years. Other detractors included pharma and life-sciences business Bayer, which issued a profit warning in October. Bayer’s crop-sciences business was weak in the period, partly due to the pandemic, which has reduced bio-ethanol demand and prices for major crops. Nevertheless, we believe Bayer’s valuation is extremely attractive for a company operating in stable, growing markets and with leadership positions in every one of its segments. Finally, GEA Group, an engineering company focused on the food & beverage and agriculture sectors, also detracted; despite solid results in the period, its shares lagged the rally having already risen sharply in Q2.

Portfolio activity

We added to positions in AerCap, Bayer, Rolls-Royce and Tav Havalimanlari, and trimmed our position in GEA Group. We also bought Exor, MakeMyTrip and Grupo Aeroportuario Del Sureste.

Outlook and strategy

We have always believed that economic conditions would improve eventually, and that the market had overreacted in a number of areas, and have been investing accordingly. Many of the positions we have built since the March sell-off – and indeed investments we made long before then – have performed strongly since the positive news on vaccines.

But even after substantial gains, value equities – many of which are in more cyclical sectors – are still underperforming the rest of the market. Don't forget that, before the coronavirus, many people believed a recession was coming. Consequently, businesses perceived as cyclical were being hammered, while growth stocks soared. The coronavirus exacerbated these trends, rather than creating them. In other words, we think 'value' still has a lot of room to run: value stocks remain cheap relative to our conservatively-appraised estimates of intrinsic value, and relative to growth stocks.

So though the market backdrop has changed, our focus remains on seeking companies that are trading below our assessments of fair value – a task made particularly interesting at present given that market moves in 2020 have driven an even larger and more diverse group of businesses than usual into the 'value' camp.

In doing so, we continue to fish in a variety of value pools, including 'Fallen Angels' (typically former stock-market darlings that have experienced a significant but non-fatal blow), 'Cyclical Leaders' (good businesses that are suffering from a sector downturn), 'Special Situations' (often turnaround stories or companies whose value we believe is being underestimated as a result of M&A), 'Hidden Assets' (businesses with valuable properties that are not recognised, such as services that cannot be computerised), and 'Deep Value' (mediocre businesses at very attractive prices). While we may access all of these areas, our primary focus remains on businesses we believe to be good quality (and often with strong balance sheets) but that are trading at a discount for some reason.

What is changing to some extent is the type of stocks that are now appearing on our value screens, as certain businesses and industries previously regarded as stock-market darlings, and that were valued as such, de-rate to more reasonable levels relative to their profits. Among them, for example, are a number of branded consumer-staples businesses, a category that rarely crosses the desk of a value investor. The most promising candidates have already passed through our due-diligence processes, including a British soft-drinks company, a Brazilian brewer and a South African food and beverage producer. As always, we are conducting detailed research on each candidate and will update you on any additions to the portfolio.

Finally, we would like to emphasise that our portfolio is not wholly cyclically geared. Far from it. We continue to be diversified across several value-related themes, and many of our investments are good businesses in sectors that are experiencing structural growth (travel, for example), but whose valuations are depressed for one reason or another. That said, we believe we are well positioned to benefit from a cyclical upturn, should one become established, while the not insignificant risk that

inflation may run ahead of expectations in the coming months represents another potential tailwind for the stocks in our portfolio.

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