

Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

Investors continued to weigh an encouraging global economic recovery against associated inflation worries and the potential scaling back of ultra-loose monetary policy in the second quarter. Nonetheless, optimism from the ongoing rollout in vaccination programmes and increasing economic activity, especially in the United States, continued to lend support to financial markets.

Global equities (MSCI All Countries World Index) consolidated gains in June to end the quarter up 7.4%. Developed market equities (MSCI World Index) ended the quarter 7.9% higher, outperforming their emerging market peers (MSCI Emerging Markets Index, +5.1%). Regionally, US equities (S&P 500 Index, +8.5%) enjoyed one of their best first-half performances since 1998, supported by solid Q1 earnings growth, the prospect of additional fiscal stimulus and growth stocks bouncing back in June. European equities (Euro Stoxx 600 Index, +5.5%) continued to benefit from global growth optimism, the acceleration in vaccinations, alongside a dovish European Central Bank (ECB), although COVID-sensitive sectors such as travel and leisure fell on Delta variant concerns. Elsewhere, mainland China's CSI 300 Index (+5.7%) rode a strong earnings season and foreigners snatching up local stocks on the yuan's advance, while a slow vaccine rollout in Japan held the Topix (-1.0%) back over the quarter.

Inflation jitters were a source of volatility for bond markets in bond markets. The Bloomberg Barclays Global Aggregate Bond Index closed the quarter up 1.3%, although returns diverged across regions, with UK and US bonds outperforming European sovereigns. In investment-grade credit, high yield continued to outperform year to date, while supply continued at a relentless pace.

All returns are quoted in US dollars.

The South African stock market weakened in June after a seven-month positive stretch. For the quarter, the ALSI ended a flat +0.1%, while the Capped SWIX was a slightly better +0.6%. At a super-sector level, financials (+7.9%) led performance, while industrials were up a soft 0.7% and resources down a hefty 5% over the period. Local bonds soundly outperformed their equity counterparts as the bond market continued to benefit from a supportive mix of external and domestic dynamics, with the downward trend in yields (yields fall as prices rise) sustained across most tenors over the period. Listed property (JSE All Property Index) posted a strong quarter amid the reopening trade, despite a wobble in May, to finish the quarter up +11.5%. Cash, as measured by the STeFI Composite Index, was broadly unchanged at 0.3% for the quarter. Despite the pullback in June as the greenback enjoyed some time in the sun, the rand still fared stronger against the US dollar, euro and pound sterling over the quarter as a whole.

Performance review

For the quarter, the portfolio delivered positive absolute returns.

Key positive contributions:

- On the local front, the allocation to the South African apparel retailers (The Foschini Group, Truworths International, Pepkor Holdings and Mr Price Group) and South African banks (Capitec Bank, ABSA Group and FirstRand) performed well over the quarter. Performance was further enhanced by holdings in MTN Group, Richemont and Investec.
- The offshore equity component benefitted from exposure to US big tech (Amazon, Alphabet, Facebook and Microsoft) and the China A shares also added to performance over the quarter.
- Exposure to South African credit and government bonds added value.

Key negative contributions:

- After a strong first quarter, the allocation to the Platinum Group Metals stocks (Impala and Anglo American Platinum) came under pressure over the quarter. Our holding in Naspers and Prosus also detracted from performance over the quarter.
- The exposure to Japanese equities weighed on the offshore equity component of the portfolio.
- Furthermore, the strong rand eroded offshore earnings, and overall, the offshore component of the portfolio detracted from performance.

Portfolio activity

Within the local equity component, we banked some gains by trimming some of the general mining exposure (Anglo American, BHP Group and Exxaro Resources) and platinum-group metals (PGMs)

mining exposure (Anglo American Platinum and Impala Platinum). We took advantage of the attractive entry points by adding to holdings in Bid Corp, Aspen Pharmacare, Life Healthcare and Netcare. We also increased exposure in Sasol, Glencore and Sappi (where the upside to market consensus forecasts remains high given prevailing commodity prices) by taking some profits in Sibanye-Stillwater and selling the residual holding in Harmony Gold Mining Co.

Within the offshore equity component, we sold our Japanese equity exposure to raise cash for more attractive opportunities. We also added to overall ZAR exposure.

Outlook and strategy

As we are exiting the second wave of COVID-19 across various markets and vaccine rollouts are underway, hopes for a return to a pre-pandemic 'normal' 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 a balanced and diversified exposure across asset classes, geographies, sectors and individual assets. In assessing the environment and making asset allocation decisions, we continue to tilt the portfolio to those asset classes (and underlying assets) that score well in terms of our compelling forces framework: fundamentals, valuations and market price behaviour.

The offshore allocation remains favourably disposed to equities, with a tilt towards cyclical companies where earnings have troughed and are recovering and valuations are reasonable. Our allocations to US banks and semi-conductor companies continue to see upgrades to forecasts as the economic recovery takes hold. We also have exposure to high-quality, attractively valued companies with improving operating performance. This includes quality compounders with pricing power or structural winners in healthcare and tech-related sectors. We believe these companies exhibit a long runway for strong, sustainable earnings growth that the market appears to be underestimating.

Regionally, we continue to have a positive skew towards Asia, as Chinese markets continue to exhibit reasonable valuations, while earnings have substantial upside over the medium term, in our view. 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 and industry leaders are seeing market growth, potential market share expansion and higher margins over time. The Chinese equity market also offers significant diversification benefits given their low correlations with the domestic equity market, thus exhibiting attractive risk and return attributes from a portfolio construction perspective.

As economic data continues to improve, the developed market central bankers are sounding marginally less dovish, as can be expected to maintain the right economic equilibrium. We have seen large short positions in the fixed income market being washed out, and curves begin to bear-flatten in anticipation of future rate hikes. During the quarter, nominal yields peaked in April, while breakeven inflation

peaked in May, reflecting more confidence in inflation being transitory rather than structural. We expect bond yields to continue to trend higher towards the end of the year as we get nearer to the commencement of tapering and rate hikes.

The local equity composition is well diversified, and the portfolio remains tilted towards select cyclical exposures at the expense of more defensive holdings. We still have capital, albeit less than previously, invested in global defensive companies, Naspers and Prosus and have been adding to our exposure in Bid Corp and Aspen Pharmacare, where there is scope for positive earnings revisions. These stocks also provide additional protection against any potential rand weakness. This sits alongside our healthy allocation to global cyclical stocks (diversified miners, platinum miners, Sappi, Sasol and luxury goods maker, Richemont) geared to the global economic cycle, which continue to exhibit favourable earnings revisions profiles. In our view, most of the exposures in this bucket are benefitting from tight commodity markets and low inventory levels. We also have a healthy allocation to South African banks, where earnings revisions have started to turn positive and valuations are attractive. This sits alongside exposure to apparel retailers and Motus Holdings which have good earnings revisions profiles and are trading at reasonable valuations as the South African consumer has been more resilient than the market had feared. Exposure to local defensive businesses has previously only been through MTN Group, Pick 'n Pay Stores and Bidvest Group and has been limited as earnings revisions and valuations have not been as compelling in this space. However, we started to build positions in Life Healthcare and Netcare, as the earnings revisions profile appears to have troughed, given an improving occupancy profile into 2022 that results in strong positive operating leverage that the market appears to be under-estimating, in our view.

We have maintained the material allocation to local sovereign bonds, especially within the context of the global fixed income universe. The SARB is facing less pressure than other emerging market central bankers to raise interest rates and are currently on hold. The continued willingness to exercise fiscal prudence and the further reduced supply will provide some support to bonds. We continue to like the buffer provided by the income profile of local bonds and believe bonds are supported by attractive valuations versus their own history, 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 recognise that global bond markets will weigh on the domestic market and will selectively take profit on selected parts of the curve as it reaches fair value, while continuing to be positive on the medium-term total risk-adjusted return profile for domestic bonds.

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