

Discovery Cautious Balanced Fund

Market background

The month was marked by bouts of volatility as investors weighed an encouraging global economic recovery against associated inflation worries and the potential scaling back of ultra-loose monetary policy.

Developed market equities (MSCI World Index) ended the month 1.4% higher, lagging their emerging market peers (MSCI Emerging Markets Index) which posted gains of 2.3%. Regionally, US equities (S&P 500 Index, +0.7%) touched all-time highs during the month, with first-quarter (Q1) corporate earnings posting a strong beat on consensus expectations, but tech and consumer discretionary sectors weighed on the bourse. Global growth optimism, an improved vaccination rollout, alongside a dovish European Central Bank (ECB) saw European equities (Euro Stoxx 600 Index, +3.6%) record a fourth straight month of gains. Elsewhere, Asian stocks benefitted from cyclical tailwinds, lifting Japan's Topix Index +1.3% higher. Mainland China's CSI 300 Index (+5.9%) went on a tear towards month-end, with foreigners going on a shopping spree of local stocks as the yuan's advance to a three-year high made onshore assets more appealing.

It was another flat month in bond markets, as inflation jitters continued to fuel volatility over the period. The Bloomberg Barclays Global Aggregate Bond Index recorded its second straight month of positive gains, up 1.1% for the period, with UK and US bonds outperforming European government bonds.

All returns are quoted in US dollars.

The South African stock market capped the seventh straight month of positive gains, tracking higher in line with global peers. The benchmark FTSE/JSE All Share Index ended 1.6% higher, while the Capped SWIX posted an even better 2.9% at the close. At a super-sector level, financials (+9.3%) did most of the heavy lifting, aided by industrials which finished a modest 1.6%, while resources ended in the red for the first time since the selloff in October. Local bonds outperformed equities two months on the trot, as the bond market continued to find favour from a supportive external backdrop and positive domestic dynamics, with yields edging lower (yields fall as prices rise) across most tenors, apart from the 2023 note, while foreigners returned to be net buyers over the period. Listed property (JSE All Property Index) pared back some of its stellar gains in May, falling 3.2% over the month. Cash, as measured by the STeFI Composite Index, was broadly unchanged at 0.3% for the month. In currencies, the rand rallied to its best level against the US dollar since 2019 amid the risk-on trade, also ending stronger against the euro and pound sterling.

Performance review

For the month, the portfolio delivered marginally positive absolute returns.

Key positive contributions:

- The allocation to the South African (hereon SA) apparel retail stocks (The Foschini Group, Pepkor and Truworths International) and SA Banks (ABSA Group, FirstRand and Capitec Bank) performed well over the month. Performance was further enhanced by our holdings in MTN, Richemont and Bidvest Group.
- Having exposure to China and Europe aided performance, as did the allocation to US.

Key negative contributions:

- After a strong first quarter, the allocation to the platinum-group metals (PGM) stocks (Impala Platinum and Anglo American Platinum) continued to toil under pressure. The holding in the Naspers-Prosus stable also detracted from performance over the month.
- Holdings in Japanese equities and semi-conductors detracted from the offshore equity component of the portfolio.
- Overall, the allocation to the offshore component of the portfolio detracted from performance as the stronger rand eroded offshore gains.

Portfolio activity

Within the local equity component, we took some profits on BHP Group and PGMs to further enhance our positions in ABSA Group, Bid Corp and Life Healthcare – where we see upside to consensus forecasts at reasonable valuations. We also added to our holdings in The Foschini Group and continued to build a position in Woolworths by reducing exposure to Sanlam, where the earnings revisions profile has disappointed relative to our expectations.

Within the offshore equity component, we sold some Japanese equity exposure to raise cash for more attractive opportunities.

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 maintain 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, Semi-conductor and capital goods 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. In Japan, as the global capex cycle begins to turn and global PMIs continue to improve, we expect Japanese industrials to continue rebounding. 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.

Developed market central bankers have demonstrated a willingness to look through this year's inflation and want confirmation of a stabilized broad-based recovery. This easy monetary policy stance is likely to continue to anchor the short end of the curve. We expect high inflation prints over the next few months to test the longer end of yield curves, but any overshoot should be viewed as a buying opportunity.

The local equity composition is well diversified, and the portfolio is tilted towards select cyclical exposures at the expense of more defensive holdings. We still have some capital invested in global

defensive companies (Naspers, Prosus, Bid Corp) where earnings expectations remain relatively robust, while valuations are reasonable. These stocks also provide additional protection against any potential rand weakness. While we have taken some profits in the miners, we still have a healthy allocation to global cyclical stocks (diversified miners, platinum miners, Sappi, Sasol 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 tight commodity markets and low inventory levels, in our view. We also have a growing exposure to the SA Banks where earnings revisions have started to turn and valuations are attractive, alongside our exposure to apparel retailers and Motus Holdings, which have good earnings revisions profiles, trading at reasonable valuations. While our exposure to local defensive businesses is limited given that earnings revisions and valuations are still not as compelling in this space, we have found select opportunities in MTN Group, Pick 'n Pay Stores and Bidvest Group and we have also been building up a position in Life Healthcare.

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 EM central bankers and are currently on pause. 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. Furthermore, the bonds are supported by attractive valuations versus their own history as well as against EM 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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