

Discovery Global Value Equity Feeder Fund

Market background

Global equities gained in the first quarter, driven higher by hopes of a sustained recovery as COVID-19 vaccines were rolled out; the release of generally strong fourth-quarter earnings that showed many companies are bouncing back from their pandemic slowdowns; and expectations that the substantial stimulus being planned by the US and other major economies will drive growth.

Against this backdrop, the shares of businesses perceived as cyclical fared particularly well, as did those of companies whose stock-prices and business models have been hit hardest by the pandemic. These broad categories include a sizeable number of 'value' companies, making it another good quarter for value equities generally.

Equities were fairly volatile, however. With inflation expectations rising, markets were particularly sensitive to indications of future monetary tightening to rein in price rises. They were also notably influenced by delays in vaccine roll-outs and set-backs in halting the progress of the pandemic, with a third COVID-19 wave sweeping continental Europe as the quarter progressed and parts of Latin America continuing to experience severe challenges in containing the coronavirus.

Performance review

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

At the macro level, the portfolio's significant outperformance reflected the continued recovery of value equities as confidence in a sustained recovery grew over the quarter. At the stock level, a diverse group

of companies (by sector and region) contributed to relative returns. They included Chinese internet search company Baidu, whose shares surged on news of its plans to enter the electric/smart vehicle market in partnership with automaker Geely. Expectations of a continued recovery in China's advertising market also helped. Our holdings in Bank of America and American Express also benefited relative returns, with their shares gaining along with the US financial services sector on expectations that the reopening of the US economy and government stimulus will drive business activity, while higher yields should boost profits. Additionally, car-seat maker Adient's shares rose after it announced a series of transactions that will give it more control of its China strategy, independently of its joint venture partner. The deals should help it capture growth in profitable segments and develop its overall China business.

Among the main detractors, tyres and car-parts business Continental, contributed negatively to relative returns, its shares declining on disappointing results. We maintain our positive long-term view on the business. Engineering and consultancy business John Wood – which serves the oil & gas industry, among others, and was a new purchase in the previous quarter – was another detractor, partly due to its decision not to pay a final dividend and because of a weaker order book for this year. While the near-term picture is not without challenges for John Wood, we see some very interesting value opportunities in oil & gas for long-term investors, and we think companies that provide services to the sector are a good way to access this theme. The position in Rolls-Royce also detracted, its shares impacted by further signs that the recovery in long-haul air travel will be slow, which will continue to hurt its business supplying and servicing engines for commercial airliners. For related reasons, our holding in Turkish airports operator TAV Havalimanlari weighed on relative returns. We see considerable upside potential in both businesses, longer term.

Portfolio activity

Significant purchases over the period included Prudential Corporation Asia (PCA). Prudential spun-off its UK division (M&G) last year and is now left with two businesses: Jackson National, a US life insurer which offers mainly variable annuities, and a leading Asian insurance business, PCA. The company has announced it will demerge its US business in Q2 of this year and maintain a 20% stake, which it will monetise over time, and PCA will remain the only asset. Prudential has been trading in line with its US peers, even though PCA accounts for the majority of the group's value, supported by high growth in the Asia business, thanks to long-term structural demand drivers that remain intact after COVID. The separation will make for a clearer investment case and an easier comparison with peers. PCA has competitive advantages and exposure to a growing industry, driven by secular trends. It generates high ROEs and the majority of its business has predictable characteristics, being from insurance underwriting. We believe the stock is cheap on an absolute basis relative to the returns the business is able to generate and the room to compound growth in the medium term. It's also cheap on a relative basis versus AIA, its closest comparable.

Significant sales over the period included Autonation, Adecco, GEA and Travis Perkins, which had either reached or exceeded our estimates of intrinsic value. We also switched out of Lloyds Banking and Virgin Money into NatWest. Lloyds still looks like the marginally higher returning player, but has lost share in the UK mortgage market. NatWest has been growing share by contrast, partly organically, but also due to activity like the recent acquisition of Metro Bank's mortgage book.

Outlook and strategy

Given that everyone seems to be talking about potential 'value rotations' at the moment, we thought it might be useful to share some thoughts on that subject.

It seems people are starting to believe in value again, or at least in those businesses and sectors that generally make up the value universe today (although as we've said before, its constituents change over time, and today's quality growth compounder can become tomorrow's deep value opportunity). Bank of America's fund manager survey, which measures fund positioning, shows an almost complete reversal: what was loathed a year ago (banks, industrials, UK, emerging markets) is loved today.

Value stocks are seeing earnings upgrades, giving them both earnings and price momentum. In terms of performance, value has clearly had a very good run in the past six months, both in the US and globally. By some measures, it has just delivered its best quarterly return since 2000. However, 'value' is still significantly underwater even since the start of last year (though our funds have done rather better than this), implying plenty of room for more recovery.

But even after the recent rally, value stocks are still very cheap, both in absolute terms and especially relative to the benchmark and growth/quality/momentum stocks. We see this both in our own portfolios – with stocks that trade on an average 40% discount to fair value, based on conservative estimates of growth, profitability and cost of capital – and in the wider market. In conclusion, the value thesis itself appears to be gaining acceptance, while value stocks' earnings and price momentum continue to build. Recent outperformance notwithstanding, we believe value has a lot of room for further upside, with value stocks still trading at discounts to history and even wider discounts to pretty much any other factor in the market.

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