Discovery Flexible Property

Market background

Financial markets endured extreme volatility in the first quarter (Q1,) notably from late February after Russia initiated military action against Ukraine. Western governments responded with sanctions on the Russian state and some individuals linked to the state machinery. Prior to this, the market had been focused on the potential for aggressive central-bank interest-rate hikes to address high inflation in Europe and the US. Developed market stocks (MSCI World Index) recouped some losses in March but still ended the quarter down 3.0%, while emerging market stocks (MSCI Emerging Markets Index) extended losses, down 5.0% over the period. Regionally, the US benchmark S&P 500 (-4.7%) and Euro Stoxx 600 (-8.13%) both rounded off their first quarter in the red since the Q1 2020 selloff, with the latter impacted by the economic implications of geopolitical turmoil and scorching inflation. In Asia, China's blue-chip CSI 300 Index (-13.5%) and Japan's Topix (-7.5%) struggled in Q1 as both countries wrestled with the highly virulent Omicron variant on top of geopolitical headwinds. Fixed Income markets had one of the most brutal selloff quarters amid higher inflation expectations and more hawkish central-bank rhetoric in response. The Bloomberg Barclays Global Aggregate Bond Index (which measures total returns of sovereign and corporate debt) has thus far capped the biggest drawdown since the Global Financial Crisis and was down 6.2% over Q1. All returns are quoted in US dollars.

Meanwhile, South Africa's equity markets have had a notably strong start to the year. The benchmark FTSE/JSE All Share Index (ALSI) rose 4.6% over Q1, while the Capped SWIX fared better, up 6.7%. South Africa has been one of the best performing markets year to date, particularly when accounting for the rand strengthening 9.2% against the US dollar, thus boosting returns in dollar terms. At a super-sector level, it was a consistent theme of resources (+19.0%) and financials (+16.7%) driving performance, while industrials struggled throughout, declining -3.1%, weighed down by the Naspers-Prosus stable underperforming. The local bond market (JSE All Bond Index) capped consecutive months of gains and in dollar terms was the second best-performing among emerging market peers as yields remained attractive to foreign investors. Despite paring back losses in March, the listed property sector struggled for most of the quarter, down 1.6% in light of rising bond yields, large exposure to Eastern European assets and in some cases rand strength. In currencies, the rand was one of the best-performing EM currencies behind the Brazilian real over the quarter, up 9.2% against the US dollar.

Performance review

For the quarter, the Fund underperformed the benchmark.

While the off-benchmark international holdings saw significantly better performance in local currency, the strong rand undermined effective returns in the portfolio.

Conversely, the portfolio's relatively sticky positioning in mid-cap South African names with attractive combinations of dividend yield and growth, proved constructive over the quarter, contributing positively to performance.

Portfolio activity

We continuously look to seek out counters offering strong combinations of sustainable earnings and growth at reasonable valuations. During the quarter, we continued to add to names that offer more attractive medium- and long-term fundamental stories such as Stor-Age Property Fund and Equites. Similarly, we used the weakness seen in Eastern Europe along with the strong South African rand to add to NEPI Rockcastle. The general volatility in Q1 also presented opportunities to add tactically to already held positions such as Redefine Properties – understanding that the yield on a sustainable basis is highly attractive by a significant margin relative to peers, while it continues to improve its balance sheet.

Outlook and strategy

The listed property sector has seen a strong recovery in 2021 following years of dismal returns. While the recovery has been substantial, it remains one of the few sectors still below its pre-COVID levels. The global events of the first quarter realising a negative performance. The pandemic has created an unprecedented environment, particularly for real estate markets. However, a level of normalcy has returned to the sector, as all metrics continue to show improvement or least a troughing in performance. Demand will likely continue to be subdued, especially in the office space, while retail and industrial have started showing green shoots. That said, rental prospects will remain muted for some time. Vacancies have been well-contained but at the cost of rental declines.

In our view, the challenging fundamentals are offset by supportive valuations. The sector trades on a forward yield of c.9% (c.10% for SA only) and a c.20% discount to net asset value (NAV). While dividend yields have been reduced due to pay-out ratios in favour of liquidity and balance sheet support, they are now also likely to be more sustainable and in line with international best practice. On a sustainable earnings basis, like-for-like rental growth is forecast to be below inflation for the next two to three years, while deleveraging will further dampen growth prospects.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by a more sustainable cash-covered yield, together with a supportive valuation that reflects near term operational and balance sheet concerns.

In the current environment, we continue to assess the portfolio risks and actively screen for opportunities that market dynamics such as these are likely to offer. Ultimately, we aim to provide our clients' portfolios with the best risk-adjusted medium- and long-term outcomes.