Discovery Flexible Property

Market background

September was a brutal month for global equity markets, with the US S&P 500 Index down 9.3%. The continued global equity correction means the MSCI World Index has been down in seven of the nine months this year. The negative themes in Q3 remained the strong US dollar (USD) and lower revisions to global growth forecasts. The euro area continues to see the biggest economic growth downgrades as energy concerns take their toll. Meanwhile, fiscal policy missteps in the UK (unfunded tax cuts) saw the pound plunge to all-time lows, while gilts shot up significantly (yields rise as prices fall). In the aftermath, the Bank of England (BoE) intervened in the gilt market, to prevent calamities in the UK pension market.

Equities booked losses which deepened towards the end of the quarter. Developed market (DM) stocks (MSCI World Index) fell 6% over the quarter, while emerging markets (MSCI Emerging Markets Index) shed even heavier losses, down 11.4%. On a year-to-date basis, emerging markets are underperforming their developed markets peers, with the MSCI EM down 28.9% (-26.3% ex-Russia) compared to the MSCI World return of 25.4%.

In fixed income, hawkish central bank rhetoric and sticky inflation saw bond markets routed in Q3. US Treasuries fell 4.4% over the quarter, with the yield on the US benchmark 10-year note ending September at 3.83, from 3.01 at the beginning of July. European sovereigns also lost considerable ground, down 5.1%, while a tumultuous week in the UK financial markets in September saw gilts book the worst performance in the quarter as gilts soared to 14-year highs before the Bank of England stepped in to stop the bleeding. The Bloomberg Barclays Global Aggregate Bond Index ended the month down a weighty 6.9%.

All returns are quoted in US dollars.

In South Africa rolling power outages made an unwelcome return to everyday life. The manufacturing PMI slid back into contraction in September, coming in at 48.2, a drop from 52.1 in August as the state power utility struggled to keep the power on in September. Incoming data suggests the SA economy likely entered a recession in Q3, and the outlook for Q3 and the remainder of 2022 is less encouraging, as the country's longest-ever stint of power outages, and a lack of business confidence and policy reform continue to hinder growth. There was, however, a modicum of relief as consumer prices eased to 7.6% y/y in August, in line with consensus, as transport inflation moderated. The South African Reserve Bank's (SARB) followed through with another 75bps hike in September, bringing the repo rate to 6.25% p.a., and guided for more tightening ahead as it aims to bring inflation back to target.

South African equities fell in lockstep with their global peers over the quarter. The FTSE/JSE All Share Index was fell 4.2% for the month and 1.4% for Q3 as a whole, while the Capped SWIX was down 3.8% and 2.4%, respectively. The JSE All Bond Index had a tough month but managed to end the quarter on positive footing, up 0.6%. Listed property (JSE ALPI) extended losses, down 4.1% in Q3 amid increasing recession fears, as well as elevated inflation and central bank efforts to tighten monetary conditions.

Performance review

For the quarter, the Fund outperformed the benchmark.

Underweight exposure to German-exposed Sirius Real Estate contributed positively to performance on the back of heightened anxiety around the energy crisis in Europe and concerns regarding valuation at this point in the cycle. Conversely overweight positions in South African counters, SA Corporate Real Estate Fund and Attacq buttressed performance. Both names published pleasing results, demonstrating resilience and recovery in their key focus areas in the South African market.

The Fund's exposure to off-benchmark UK logistics play, Tritax Big Box REIT, contributed negatively to performance against the tumultuous British macroeconomic backdrop. The investment case fundamentally, however, remains solid.

Portfolio activity

During the quarter, we increased exposure to local names offering a combination of highly attractive and sustainable yields coupled with reasonable growth outlooks, along with improving or stable balance sheets. Given the volatility in the period, we seized opportunities to add exposure to the likes of Redefine Properties and SA Corporate, at attractive valuations.

Outlook and strategy

After a strong 2021, in 2022, the listed property sector has been impacted by sentiment surrounding rising interest rates. However, the sector's operations have shown significant recovery since their COVID-induced lows, particularly in retail and industrial, while office continues to suffer from an oversupplied market. Retail vacancies are squeezing lower, and with no new retail space supply, the tide is turning in favour of landlords, with many starting to indicate expectations of positive rental reversions. The operational finance cost impact of rising interest rates is also expected to be relatively muted, as most of the debt in the sector is hedged at historically high levels. Thus, earnings will continue to be driven by property fundamentals.

In our view, the challenging fundamentals continue to be offset by supportive valuations. The sector trades on a forward yield of c.11% (c.11.5% for SA only) and a c.35% 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. In 2022, companies have shown a return to consistent dividend payments, which is more sustainable as companies' cash flows and balance sheets are largely restored.

We believe the sector offers attractive value over a medium- to long-term horizon, primarily underpinned by a relatively high sustainable cash-covered yield, together with a supportive valuation. Over the medium term, we remain constructive with distribution growth off a sustainable income base, as the economy recovers.

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.