Discovery Flexible Property

Market background

The first month of the year was a mixed one for global markets, as uncertainty surrounding the timing of rate cuts from the US Federal Reserve (Fed) cooled investor expectations. In the euro area, equities experienced a positive start to the year, while in the UK, sentiment declined after December's inflation print rose above expectations. The Chinese stock market struggled to gain momentum, as concerns over tighter regulations in the gaming industry lingered through the market. The government introduced measures to limit short selling on Chinese equities, although this did little to ease market concerns. South Africa's resources sector declined on the back of weaker Chinese sentiment, highlighting the strong correlation between the two economies. In more positive news, monthly retail figures for November showed the local consumer environment to be more resilient than expected, while lower levels of load shedding provided some comfort to investors.

Performance review

For the month, the portfolio marginally underperformed its benchmark.

The portfolio's underweight exposure to Fortress Real Estate was among the largest detractors from relative performance for the month, after having been one of the largest positive contributors over the previous reporting period. The counter has been overshadowed by pending corporate action with multiple parties vying for specific interests. In our view, the base case outcome does not stack up fundamentally. However, many market players have voted in support of the relevant resolutions, citing 'deal fatigue' alongside a desire for Fortress Real Estate to reemerge as an investable option within the property universe. The deal closes in February, which will result in a single share being formed from its parent A and B units.

Global off-benchmark counters formed the bulk of the other main detractors, as the rally from local counters outpaced their global counterparts on changes in rate expectations. This benefitted the portfolio's overweight exposure to Redefine Properties, which contributed positively to performance for the month.

Outlook and strategy

The sharp increase in interest rates over 2022 and into 2023 resulted in a steep derating of the listed property sector, both locally and abroad. However, as the rhetoric regarding a pivot on rate decisions entered the fray in late 2023, interest-rate sensitive instruments re-rated, benefitting property stocks globally. Although there is much debate on whether markets have moved too much too soon, property continues to provide a decent yield, while earnings growth troughs, having been impacted by the steep rate increases of 2023.

As the interest rate cycle turns, the positive impacts on the property sector are compounded. Alongside rating support, the bottom line benefits from deceased finance costs. Typically, property companies on average hedge out c.90% of their interest rate exposure. In anticipation of rate changes, many companies have not renewed their hedging instruments. As such, the average for the sector sits below 80%, with the lowest at 55%. This provides a material upside opportunity for earnings and dividends in the sector as the cycle turns.

DISCLAIMER: