Discovery Flexible Property

Market background

Simmering investor anxiety came to a boil in September as the confluence of increasingly aggressive comments and actions by major central banks, a spike in US Treasury yields, persisting supply bottlenecks and an energy crunch spooked inflation and growth concerns. Notwithstanding a bruising September, (DM) equities (MSCI World Index, -0.0%) closed the quarter a shave lower, while their emerging market (EM) peers (MSCI Emerging Markets Index, -8.1%) absorbed most of the heavy blows from the global selloff and a torrent of negative newsflow from China. US Treasuries, which serve as an important indicator for financial markets, saw yields on the 10-year note soar from 1.31% to 1.55% in a matter of days. The Bloomberg Barclays Global Aggregate Bond Index ended the quarter down 0.9%

In the United States the Delta variant slowed consumer spending and economic expansion in the summer, while inflationary pressures remained at decade highs. The Federal Open Market Committee (FOMC) made no changes to monetary policy at its 22 September meeting. Fed Chair Jerome Powell reiterated the hiking cycle would travel on a separate timeline to tapering, although it appears that most FOMC participants now see rate hikes becoming necessary by next year.

While initially shrugging off the rapidly spreading Delta variant, recent official indicators are pointing toward slowing momentum in the European economy. That said, the bloc's economy looks set to deliver robust growth in Q3 on the back of higher vaccination rates through the summer, though the recovery still lags that of the US and China. The European Central Bank's (ECB) Governing Council (GC) meeting concluded with no change in interest rate policy as widely expected. The UK economy bounced back at a rate of 5.5% quarter on quarter (q/q) in Q2 2021, stronger than the initial estimate of 4.8%. While a strong resurgence from the winter lockdown, the economy has still not returned to its pre-pandemic level.

Locally, the South Africa's economy has proven more resilient than was initially anticipated with a GDP print of 1.2% q/q, ahead of consensus expectations. Exports remained relatively robust, boosted by a reopening of trade markets and a strong commodity price basket. Attention has now shifted to 3Q growth data, which is likely to come in weaker on the back of the July civil unrest and tougher lockdown restrictions amid the third wave of COVID infections. Headline inflation quickened to 4.9% y/y in August, above consensus expectations. As widely expected, the South African Reserve Bank Monetary Policy Committee unanimously left the benchmark lending rate unchanged at its September policy setting meeting but sounded slightly more hawkish with members now pencilling rate hikes through 2022 and 2023.

South African equities ended the month and quarter in negative territory, as positive domestic currents were largely offset by exogenous shocks. The benchmark FTSE/JSE All Share Index (ALSI) came under immense pressure (down 3% in September and 0.8% over Q1), with regulatory. In fixed income, the JSE All Bond Index managed to eke out 0.4% as local bonds were buffeted by intensifying inflation worries, negative developments in China, and hawkish guidance from major central banks – bad news for emerging market debt and currencies. The listed property (JSE All Property Index) sector managed to pare back some of the riot-induced losses to close out the quarter up 6.5%.

Performance review

For the quarter, the Fund delivered strong absolute returns but slightly lagged the benchmark.

The allocation to offshore companies, those included in the JSE All Property Index as well as off-benchmark positions, contributed negatively to performance over the quarter.

On a positive note, the high-conviction position in value name Hyprop Investments added meaningfully to performance. Underweight positions in Fortress B and Liberty Two Degrees also helped relative performance. The former continues to have a complicated capital structure that hinders the share class in the current environment, while the latter's assets are most exposed to the negative dynamics currently being experienced within the retail environment.

Portfolio activity

We continuously look to seek out counters offering the right combination of sustainable earnings and growth at reasonable valuations. During the quarter, we added to our preferred and underappreciated mid-cap section of the sector, increasing exposure to the likes of Investec Property Fund. We also added to Central European exposure in light of supportive macroeconomic dynamics. The more value-orientated counters we have had high conviction in still have much to offer in our view, and thus we maintain meaningful overweight positions. We have redirected a portion of profits and started to reduce underweight positions in specific defensive names such as Equites Property Fund.

Outlook and strategy

After what has been a testing few years for the listed property sector, the sector has shown good signs of recovery in 2021, with a reversion back to sustainable practices offering sustainable dividends yields as most property companies reintroduce dividend payments and look forward with a degree of confidence – notwithstanding the weaker fundamentals. The civil unrest back in July threatened to be a significant blow to what looked to be a stabilising retail property sub-sector. While undoubtedly negative, thankfully the direct and specific damage to the asset class appears to be limited.

While the sector is still recovering from the impacts of Covid, and now the recent civil unrest, in our view, the challenging fundamentals are offset by supportive valuations. The sector trades on a forward dividend yield of 9% (10% for SA only) which includes a pay-out ratio, and a c.25% discount to net asset value (NAV), where valuation declines are slowing and, in some cases, moving back into positive territory. The reduced pay-out ratios provide liquidity and balance sheet support, and support sustainable dividend yields 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.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by a more sustainable yield, together with the prospect of the sector re-rating as dividends become more regular and balance sheet structures are corrected. 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.

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