Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

After a solid start to the fourth quarter (Q4) of 2022, global markets lost some momentum in December as the prospect of a global recession weighed on investor sentiment, while hawkish rhetoric from the US Federal Reserve (Fed) compounded this after they reiterated its message of 'higher rates for longer'. Monetary policymakers from other key economies followed suit and this weakened investor sentiment and weighed on global economic growth prospects. In Asia, investors welcomed news that the Chinese government would partially relax its COVID restrictions and further reopen the economy. The Bank of Japan (BoJ) surprised markets by increasing the upper limit of its tolerance band on 10-year government bonds, suggesting that the country may pivot towards a tighter monetary policy in 2023. Locally, President Cyril Ramaphosa survived the fallout from the 'Phala Phala' scandal and was re-elected as party leader for a second term following a tightly contested race at the 55th National ANC Conference.

Although December's risk-off sentiment curtailed October and November's gains somewhat, net positive returns for the fourth quarter as a whole came as a welcomed relief for investors. For Q4, developed markets (MSCI All Country World Index) returned +9.4%, marginally outperforming the +9.2% generated by emerging markets (MSCI Emerging Markets Index) over the same period. Turning to fixed income, US Treasuries ended the quarter largely flat, after yields rose in December. The yield on the benchmark US 10-year Treasury note closed the quarter at around 3.87% (up from 3.68% in November and 3.83% at the end of Q3). European sovereigns also lost ground, with the 10-year bond yield (AAA-rated composite) climbing to 2.55% at the end of December, compounded by news that the European Central Bank would begin reducing its €5 trillion bond holdings as of March 2023.

All returns are quoted in US dollars.

South African equities tracked their international counterparts higher over the quarter, with the FTSE/JSE Capped SWIX gaining +12.2%. All major sectors closed the fourth quarter higher, with financials gaining +12.9%, industrials +15.7% and resources 16.1%. The JSE All Bond Index was among the standout performers across emerging market debt, ending the quarter on a positive footing, up 5.7%. Listed property (JSE ALPI) also made gains over the fourth quarter, closing +18.2%. Meanwhile, cash, as measured by the STeFI Composite Index, delivered +1.6% over the same period. It was a mixed quarter for the rand, after gaining ground against the US dollar, the local currency was flat against the pound sterling and tracked lower relative to the euro.

Performance review

For the month, the portfolio delivered positive absolute returns.

For the quarter, the Fund delivered a positive absolute return.

Key positive contributions:

- There was broad-based strength in SA and global equity over the quarter that added to returns, in particular:
    - Within the SA equity component, the Naspers-Prosus stable, diversified miners (Anglo American, BHP Group, Glencore) and SA-listed property contributed strongly to returns. Exposure to Richemont, Bid Corp and Capitec Bank also enhanced returns.
    - The offshore equity component benefitted from our exposure to China equities. Holdings in Universal Music Group, Philip Morris International, Mastercard and ExxonMobil & BP were standout performers.
- The allocation to SA and global bonds also added to absolute returns.

Key negative contributions:

- In the local equity component, Sasol, Sanlam and SA retailers (The Foschini Group, Mr Price Group and Pepkor) detracted from returns over the quarter.
- The offshore equity’s allocation to Apple and Roche weighed on returns.
- Rand strength over the period was an additional headwind to the offshore exposure of the portfolio.

Portfolio activity

Earlier in the quarter (mid-October), we took advantage of the sharp correction in offshore equity markets and dollar strength by adding to global equities using cash, while also taking some profits on our long USD/short USD block economies. Given the subsequent strong rally in global markets, we reduced our global equity exposure at the beginning of December. On weakness, we continued to add to existing positions in global bonds, with our positioning focused on high-grade nations with leverage and housing imbalances (Australia, New Zealand, South Korea and Canada).

We also took advantage of the strength in the SA equity market by trimming some exposure in November in SA banks (ABSA Group and Nedbank) and Richemont into strength so that we have dry powder to take advantage of any areas of weakness. This was subsequently deployed into SA bonds following the market sell off and good entry point due to the Phala Phala scandal.

Within the local equity component, we trimmed our position in the Naspers-Prosus stable, British American Tobacco, Bid Corp and Glencore after a strong run of performance. We also trimmed our holdings in The Foschini Group and Mr Price Group, as we are concerned with their earnings revisions profiles. We used some of the proceeds of the sales to initiate a position in Anheuser-Busch InBev and topped up our positions in Capitec, South32 and Anglo American on weakness, where the earnings revisions profiles are more supportive over the next 12 months. We also switched our Gold Fields holding into AngloGold Ashanti, where the M&A risk is lower going forward. In the offshore equity component, we topped up existing stocks in China as the COVID policy adjustments are supportive of a reopening over the course of 2023. We also topped up existing holdings in Intact Financial, Thermo Fisher and Barrick Gold and initiated positions in Intercontinental Exchange, Teleperformance and Boliden, where we believe their earnings resilience are intact given the current macro headwinds. These were funded from selling our full position in Electronic Arts into strength, exiting our residual holding in Amazon (where earnings risk is high), and a small trimming of larger positions into strength (Universal Music Group, Mastercard, United Health Group and Waste Management).

In local fixed income, we sold out of most of our inflation-linked bond position and rotated into R186 bonds (5-year government nominal bond) and R2030 bonds (8-year government nominal bond). We prefer this part of the curve given our view that the South African Reserve Bank (SARB) is approaching terminal rate (peak repo rate) and this should be supportive. We also used cash to add to our overall SA bond exposure at the long and ultra-long end of the curve.

Outlook and strategy

In 2023, we have a decoupling of China versus the US and other developed markets:

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The Chinese economy is reopening, and policymakers are doubling down on stimulus whilst developed markets are faced with having to suffer the consequences of the liquidity withdrawal and higher interest rates that are likely to impact growth in the coming months.

However, translating this into market performance is not as simple. While there is firm commitment to reopen in China, this is unlikely to be a smooth ride and while the markets and the Fed are on the same page with regards to the rate hikes to come, the disagreement lies with whether rates will be held higher for longer (Fed is communicating this to be the case) versus a pivot/cutting cycle (which the market has started to price in in the second half of 2023). This is likely to cause volatility in markets in the year ahead.

To navigate through this, we currently have a lighter overall equity exposure with a preference for SA Equity over offshore equity, as we continue to believe the valuation support (SA did not enjoy the multiple expansion seen in developed markets), coupled with strong earnings revisions profiles across our holdings, has tilted the portfolio to the domestic market. Developed market equity assets have derated and are now more reasonably valued but do not yet reflect the high likelihood of earnings downside and ongoing tight liquidity conditions. The offshore stock selection has favoured an increased position in China equities and developed market exposures are tilted to more defensive sectors (healthcare, utilities and real estate), given the earnings risk in cyclical sectors such as consumer discretionary and industrials.

The local equity composition is well diversified, with our defensive exposures through Naspers and Prosus, British American Tobacco, Bid Corp and a newly initiated position in AB-InBev where we believe earnings revisions are supportive. This sits alongside a still healthy allocation to global cyclical stocks (diversified miners, PGM miners and Richemont) continuing to exhibit favourable earnings revisions profiles. We continue to have a healthy allocation to South African banks (with a preference for ABSA, FirstRand and Capitec) where earnings revisions remain positive, and valuations are attractive. This sits alongside our exposure to select apparel retailers (Pepkor and Woolworths) that display good earnings revisions profiles. Our exposure to local defensive businesses is mainly due to our holdings in Life Healthcare, Shoprite and MTN Group.

The valuation argument for local sovereign bonds still holds and we maintain a large overall allocation. As we near the end of the hiking cycle, we also continue to build our position in defensive government bonds, with our positioning focused on high-grade nations with leverage and housing imbalances (Australia, New Zealand, South Korea and Canada).

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