Discovery Flexible Property

Market background

While 2021 was dominated by COVID, 2022 appears to by headlined by monetary policy and geopolitics. February witnessed a continuation of this heightened market volatility, which led to a global sell off in risk assets. Western-imposed Russian sanctions created substantial moves in capital markets, while inflation pressure continued to mount driven by higher energy and commodity prices.

Global equites ended another period in negative territory with the MSCI All Countries World Index (ACWI) down 2.6%. Value as a style outperformed growth, while developed markets (MSCI World Index -2.5%) outperformed emerging markets (MSCI Emerging Markets Index -3%). Regionally, the US benchmark S&P 500 closed down a further 3%, weighed down by the tech names. The Euro Stoxx 600 was slightly worse off closing down 3.5% while Asian markets fared better, with Japan's Topix only losing 0.5% over the month. All returns are quoted in US dollars.

US economic growth managed to kick on in February as COVID cases slowed. Manufacturing activity also remained strong with the purchasing managers index (PMI) rising from 55.5 to 57.5 in February, while labour data continued to trend in a positive direction. Given the continued pressures on inflation, the Federal Open Market Committee looks poised to commence its interest-rate hiking cycle in March when officials gather for their scheduled meeting.

Europe took centre stage in February, as Russia launched its military action in Ukraine which has since escalated into to a full-scale invasion. This has thrown an additional spanner into the works for the eurozone, which was already battling rising inflation and expectations of tightening monetary conditions. In the UK, manufacturing activity remained positive with the PMI reaching a three-month high of 58 in February, supported by healthy domestic demand. Once again, tighter labour markets and persistently higher inflation is likely to force the Bank of England to reduce accommodative policy at a faster pace.

While still growing, China's economy recorded its slowest expansion in nearly two years over the fourth quarter of 2021, as major sectors slowed over the quarter. Consumer spending has suffered from Beijing's persistence with its 'zero-COVID' policy. Incoming data points to a continuation in these conditions as the Omicron variant continues to spread and as weakness persists in the property market. The People's Bank of China has vowed to keep its monetary policy flexible and responsive to changes in the economic situation, with the main goal of maintaining stability, however growth is likely to be hindered by the rise in commodity prices following the Russian military operation in Ukraine.

South Africa saw its inflation ease in January to 5.7% year on year, from a near five-year high of 5.9% in December. On the fiscal front, Finance Minister Enoch Godongwana delivered a market-friendly budget speech in which the corporate tax rate was lowered, while the windfall from the commodities rally boosted revenues and improved South Africa's debt metrics, but not without some increased expenditure. The minister, however, cautioned that these windfalls cannot be relied upon for the long-term health of the fiscus, stressing the need for the government to rein in expenditure and fast-track delivery of structural reforms.

South African equites as measured by FTSE/JSE All Share Index continued to buck the downbeat global trajectory, ending the month 3% higher. Resources appeared to be the main beneficiary, gaining 16.1%, followed by financials (2.7%), while industrials felt the brunt of the market, closing down 7.4%. The JSE All Bond Index closed 0.5% higher, despite rising interest rates concerns. The listed property (JSE All Property Index) sector continued a slow start to the year losing a further 3% over the month. Cash, as measured by the STeFI Composite Index, returned 0.32% for the period. In currencies, the rand managed to eke out a flat month against major currencies.

Performance review

For the month, the portfolio outperformed the benchmark.

The local real estate names continue to be the key contributors early on in 2022, buoyed by a strong rand. Top contributors included our overweight positions in the likes of Emira Property Fund and Redefine Properties, with the former producing another commendable set of results that had previously gone underappreciated by the market, including their consistent dividend payment profile.

Underweight positions held in Vukile Property Fund and an overweight position in MAS Real Estate detracted from performance. MAS continues to exude the characteristics that we prefer in the companies we invest in: innovative management, a conservative balance sheet, high-quality assets and sustainable earnings and growth potential.

Portfolio activity

We have taken the opportunity to increase exposure to our preferred offshore recovery names, including Merlin Properties Socimi and Land Securities. Both have started to see a recovery in all the key metrics, particularly earnings and net asset value (NAV), while still trading at high earnings yields and wide discounts to NAV.

The Fund also added to some of the names that offer more attractive medium- and long-term fundamental stories. These include Tritax Big Box and Capital and Counties PLC. The former benefitting from structural trends within the logistics space, while having the largest land bank for logistics within the UK. Tritax now trades at its NAV after producing 27% NAV growth in 2021.

Outlook and strategy

The listed property sector has seen a strong recovery in 2021 after a few years of dismal returns. While the recovery has been substantial, it remains one of the few sectors still below its pre-COVID levels. The COVID crisis 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 at least a bottoming in performance. While demand will likely continue to be subdued across most occupational markets (specifically office) and will result in muted rental growth prospects. 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.10% (c.11% for SA only) and a c.30% discount to 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. Early indications in 2022 also show the return of dividend payments is likely to remain consistent and 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 more sustainable cash-covered yield, together with a supportive valuation that reflects near term operational and balance sheet concerns. Over the medium term, we remain constructive of a return to earnings and 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.