

Discovery Flexible Property

Market background

Financial market returns were broadly negative in May, as investors kept a close eye on the debt ceiling negotiations in the US, while weighing up the likelihood of the world's largest economy defaulting on its debt obligations.

President Joe Biden and House Speaker Kevin McCarthy eventually reached an agreement regarding the debt deal, which once approved, would see the debt limit suspended until 2025 and prevent the US from defaulting on its debt obligations. By month-end, the bill had passed through the House of Representatives and was en route to the Senate for approval. Meanwhile, the US Federal Reserve (Fed) raised the Fed Funds rate by 25bps to 5%-5.25%, bringing borrowing costs to their highest levels since September 2007.

Both the Bank of England (BoE) and the European Central Bank (ECB) raised their key interest rates by 25bps in May, largely in line with expectations. In the Euro Area, ECB President Christine Lagarde noted that the central bank still had more ground to cover and that it would not be pausing its rate-hiking cycle anytime soon.

On the local front, the South African Reserve Bank (SARB) published the first edition of its 2023 Financial Stability Review, noting that nationwide loadshedding is expected to detract two percentage points from overall growth this year. The SARB also warned against the impact of secondary sanctions on South Africa as a result of its perceived 'neutral' stance on Russia regarding the war in Ukraine. The rand reached a new record low against the US dollar on the back of the government's decision to grant diplomatic immunity to participants at the upcoming BRICS meeting later this year, which includes Russian President Vladimir Putin. South Africa's relationship with Russia came under the spotlight during the month, following accusations by the US that the South African government had loaded weapons onto a US-sanctioned vessel while docked in local waters. This stoked fears that the country's eligibility to remain a beneficiary of the African Growth and Opportunity Act (AGOA) may be at risk. In other economic news, the SARB increased the repo rate by 50bps to 8.25%, above market forecasts of a 25bp hike.

Local equities closed the month firmly in the red, with the FTSE/JSE All Share Index and Capped SWIX falling 3.9% and 5.8% respectively. The FTSE/JSE All Property Index fell 5.8% for the month, while the JSE All Bond Index declined by 4.8%. Cash, as measured by the STeFI Composite Index, delivered +0.7%. In currencies, the rand closed the month weaker against the US dollar, euro and pound sterling



Performance review

For the month, the portfolio outperformed the benchmark.

Not surprisingly, off the back of local volatility and underperformance, the portfolio's overweight exposure to international counters both on and off benchmark contributed to performance. Underweight exposure to a range of predominantly South African focused companies invested across real estate sub sectors, including Growthpoint Properties, Resilient REIT, and Equites Property Fund, similarly also contributed positively to relative performance.

Outlook and strategy

The sharp increase in interest rates over 2022 resulted in a steep derating of the listed property sector, both locally and abroad. These negative impacts, however, were offset by a significant recovery of earnings from its COVID lows. While 2023 has seen continued rate hikes, earnings have remained robust and even stronger than expected in some cases, resulting in reasonably resilient valuations given the circumstances. Sector fundamentals continue to improve and support earnings into the future, particularly in the retail and industrial sectors. Rising interest rates will impact real estate companies to some degree, but we expect the effect to be muted, as most real estate companies did not benefit from lower interest rates over the last two years given debt being hedged at historically high levels. While increased loadshedding has added another curve ball, the listed real estate sector has been ahead of the curve, as most companies have the majority of their portfolios covered by backup power or renewable energy.

In our view, the improving fundamentals are further supported by relatively attractive valuations. The sector trades on a forward yield of c.11% (c.12% 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 showed a return to consistent dividend payments which were more sustainable as their cash flows and balance sheets are largely restored.

We believe the sector offers attractive value over a medium- to long-term time 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 with the best risk-adjusted medium- and long-term outcomes.