Discovery Flexible Property

Market background

Risk-off sentiment and volatility persisted throughout the month, but in the final week risk markets pared back some of the losses suffered earlier in the month as China eased some COVID-19 restrictions, allowing some key economic hubs to reopen. Meanwhile in the US, the tone of central bank meeting minutes was judged to be somewhat on the softer side, providing a short-lived shot in the arm for risk sentiment.

Developed market equities (MSCI World Index) returned to positive territory, up 0.2% for the month, but were somewhat outdone by their emerging market peers (MSCI Emerging Markets Index), which posted gains of 0.5%.

In fixed income, investors sought refuge in bonds as the focus shifted from (problematic) inflation to (weaker) growth. Government bond yields edged lower (yields fall as prices rise) amid growing concerns that aggressive quantitative tightening (QT) by central banks could tip economies into a recession. The bond market rally saw the global benchmark (US 10-year Treasury) yield settle back down from its three-year high of 3.20% earlier in the month to 2.84% at the time of writing. The Bloomberg Barclays Global Aggregate Bond Index ended the month up 0.3%.

All returns are quoted in US dollars.

The removal of all lockdown restrictions has helped growth return to pre-pandemic levels, as the economy expanded 1.9% q/q in the first quarter of 2022, compared to an upwardly revised 1.4% in the previous period, and well ahead of expectations of 1.2%. Headline inflation remained at 5.9% year on year (y/y) in April, unchanged from the March print and slightly below the consensus expectation of 6.0%. Core inflation (which excludes volatile items in the basket such as food, fuel and energy) rose to 3.9% in April, its highest reading since October 2019. The South African Reserve Bank (SARB) delivered a 50bps hike in the main lending rate at its May Monetary Policy Committee (MPC) gathering. The committee judged risks to growth to be balanced, while assessing risks to inflation to be on the upside. On 20 May, credit ratings agency S&P Global Ratings upgraded South Africa's rating outlook to positive, citing an

improved short-term economic outlook and better fiscal metrics. The country's long-term foreign debt rating was affirmed at 'BB-', three levels below investment grade.

South African stocks ended the month flat, with the FTSE/JSE All Share Index recording a third straight month of losses, down 0.4%, while the Capped SWIX eked out +0.5% for the month. Among yield-oriented assets, South African government bonds held the upper hand on their equity peers, with the JSE All Bond Index registering a 1.0% gain over the month, despite foreigners being net sellers over the period. Listed property saw losses, down 0.3% over the period.

Performance review

For the month the Fund underperformed the benchmark.

Underweight exposure to on-benchmark counters with majority offshore portfolios such as Sirius Real Estate, contributed positively to relative performance. In the same vein, positions in off-benchmark international counters such as Prologis and Tritax Big Box detracted. These remain key holdings, providing unique opportunities in the logistics and storage sectors.

The Fund's overweight positioning in Hyprop Investments, with sole exposure to retail, added positively to performance. We continue to seek out opportunities for further exposure to South African retail as data shows improvement and demand for this sub-sector.

Portfolio activity

We continued to increase exposure to our preferred offshore structural growth names, including Tritax Big Box and Prologis. Both have shown exceptionally strong operational and earnings trends in their Q1 updates, and relative weakness during the month provided trading opportunities.

We continuously look to seek out counters offering strong combinations of sustainable earnings and growth at reasonable valuations.

Outlook and strategy

After a strong 2021, in 2022, the listed property sector has been impacted by the sentiment in a rising interest rate environment. However, the sector's operations have shown significant recovery since their COVID-19 lows, particularly in retail and industrial, while office continues to suffer from an oversupplied market. The operational finance cost impact of rising interest rates is also expected to be relatively muted as most real estate companies did not benefit from lower interest rates over the past two years and majority of debt is hedged at historically high levels. Thus, earnings will continue to be driven by property fundamentals.

In our view, the challenging, but improving, fundamentals continue to be offset by supportive valuations. The sector trades on a forward yield of c.10% (c.11% for SA only) and a c.25% 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 have shown a return to consistent dividend payments, which is more sustainable as companies' 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' portfolios with the best risk-adjusted medium- and long-term outcomes.