Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

Despite the heavy background noise of soaring energy prices, rising input costs, rumblings of ‘hyperinflation’ / ‘stagflation’, weak US and Chinese economic data, the impending Fed tapering, and now further down the list of worries but still very much present – COVID, equity markets soared to record highs during the month on the back of an overall promising start to the third quarter (Q3) corporate earnings season. Bond markets saw inflation breakevens rise through the month, with curves bear-flattening as the front end rose precipitously through the month on inflation-driven hawkish concerns. Notably, Brent Crude was up 7.5% in October with the oil price topping US$85 a barrel in the final days of October.

Developed market (DM) equities (MSCI World Index) recovered from a bruising September, up 5.6% in October, while their emerging market (EM) peers (MSCI Emerging Markets Index) rebounded with a +0.9% return. Across regions, the US benchmark S&P 500 Index (+6.9%) and tech-heavy NASDAQ (+7.3%) booked record highs over the period, turbocharged by Tesla and a beat on expectations by more than 80% of reporting firms (at the time of writing). European shares recouped all their September losses on the back of strong Q3 earnings, with the pan-European Stoxx 600 up 4.6% for the month. Asian stock returns were mixed – with Japan’s Topix down 1.4%, while mainland China’s CSI 300 Index (1.0%) bounced back amid easing fears surrounding its heavily indebted property sector.

In fixed income, bond markets were whipsawed throughout the month as persisting supply chain bottlenecks and increasingly stubborn inflation pushed markets to price in earlier-than-expected normalisation of monetary policy. The yield on the US 10-year note rose to 1.56% at end of the month, while across the Atlantic, yields also climbed, with the German bund 10-year ending the month in less negative territory. The Bloomberg Barclays Global Aggregate Bond Index ended the month down 0.2%. All returns above are quoted in US dollars.

South African equities rebounded along with their global peers, with the benchmark FTSE/JSE All Share Index (ALSI) up a strong 5.2%, comfortably ahead of the Capped SWIX which could only manage +2.7%. At a super-sector level, resources did most of the hard yards, up 8.4%, supported by industrials (+6.7%), while financials ended the month down 2.9%. The JSE All Bond Index (-0.5%) continued to be buffeted by the external headwinds from China, intensifying inflation fears and hawkish pivots by major central banks, while we also saw local risks such as elections and power outages begin to dampen investor sentiment toward local bonds and the rand. The listed property (JSE All Property Index) sector booked another month of losses, down 1.4%. Cash, as measured by the STeFI Composite Index, remained broadly stable at 0.3% for the month. In currencies, the rand deteriorated against the greenback, euro and pound sterling.

At the sector level, key leaders included basic materials, led by industrial metals and forestry and paper (i.e., Sappi), while precious metals also bounced back, with platinum (Royal Bafokeng further boosted by news of the proposed Impala Platinum buyout) and gold miners (i.e., Gold Fields and AngloGold Ashanti) delivering strong gains over the month. Consumer goods were propped up by global cyclical bellwether Richemont, while consumer services also performed strongly, supported by a robust rebound by the travel and leisure sub-sector (Sun International and Tsogo Sun). On a more negative note, healthcare ended in the red as Aspen Pharmacare gave up its recent run of robust performance. 'SA Inc.' (companies that derive most of their revenue from South Africa) plays struggled over the period, with the banks struggling amid a weak local currency environment, while retailers and food producers found the going tough with the prospect of rising costs of capital and a weaker growth outlook spelling trouble for earnings.

Performance review

For the month, the portfolio delivered positive absolute returns.

Key positive contributions:

- Following a recent spell of weak performance, the resources sector performed well over the month. This includes our platinum-group metals (PGMs) miners (Impala Platinum and Anglo American Platinum), diversified miners (Anglo American, BHP Group and Glencore) and paper (Sappi and Mondi) exposure. Performance was further enhanced by our holdings in Naspers and Prosus.
- The broad-based regional and sector strength of offshore equities contributed to Fund performance over the month.
- Additionally, the offshore component of the portfolio enhanced gains on the back of a weaker rand over the period.

Key negative contributions:

- The allocation to the SA banks (ABSA Group, Capitec, FirstRand and Standard Bank Group) detracted from performance over the month. After a strong run, MTN Group and Aspen Pharmacare were also softer over the month.
- From an asset allocation perspective, the local bond component of the portfolio detracted from performance.
- In the offshore selection, exposure to Chinese credit was a leading detractor from performance for the month.

Portfolio activity

Within the local equity component, we took profits in Mr Price Group and Pick n Pay Stores positions following strong performance, while also trimming Aspen Pharmacare after a strong run and selling British American Tobacco and Bid Corp to zero. These proceeds were used to increase existing positions in PGM miners (Impala Platinum and Anglo American Platinum) and topping up MTN Group and Naspers/Prosus on weakness. Some funds were also allocated to buying more SA government bonds on weakness during the month.

Within the offshore equity component, we topped up existing exposures in European financials (Erste and UniCredit Spa) and US financials (State Street), while trimming some of our US tech exposure (Amazon and Facebook).

Outlook and strategy

We have transitioned to mid-cycle conditions in the last few months, and as expected, markets have been volatile, and we expect volatility to persist in the months ahead. However, we believe that they will continue to grind higher as we expect overall growth to remain above trend. The continuation of a return to a pre-pandemic ‘normal’ is supportive of markets. Global inventory levels are at very low levels given supply chain bottlenecks over the course of the year. We are monitoring these developments closely, as the easing of these constraints will be further supportive of growth as inventory needs to be restocked across global supply chains in addition to fulfilling normal demand. It will also have implications for inflation expectations, which is another key focus area for us.

To navigate through this, we continue to have a balanced and diversified exposure across asset classes, geographies, sectors and individual assets. In assessing the environment and making asset allocation decisions, we continue to tilt the portfolio to those asset classes (and underlying assets) that score well in terms of our compelling forces framework: fundamentals, valuations and market price behaviour.

The offshore allocation remains favourably disposed to equities, with a tilt towards cyclical companies where earnings have troughed, are recovering and valuations are reasonable. Our allocations to semi-conductor and consumer discretionary companies continue to see upgrades to forecasts as the economic recovery takes hold. We also have exposure to high-quality, attractively valued companies with improving operating performance. This includes quality compounders with pricing power or structural winners in healthcare and tech-related sectors. We believe these companies exhibit a long runway for strong, sustainable earnings growth that the market appears to be underestimating.

Regionally, we continue to have a positive skew towards Asia as Chinese markets continue to exhibit reasonable valuations, while earnings have substantial upside over the medium term, in our view. China's consumer industries have great growth potential given the low penetration levels in many consumer sectors, while increasing household wealth is driving consumption upgrades and industry leaders are seeing market growth, potential market share expansion and higher margins over time. The recent regulation crackdown in China has impacted sentiment negatively and increased the risk premium across the whole market and therefore impacting the companies that we own. However, we are comfortable that the earnings potential and trajectory of these companies remains intact and that once the dust settles, these firms are poised to deliver on their investment theses.

Bond markets have been the key drivers of volatility in markets, and we expect this to continue as accommodation eases through tapering, while inflation concerns continue to drive breakevens higher and the short end of sovereign bond curves reflects a high probability of an earlier lift off in interest rate hikes in 2022. Nevertheless, we hold that central banks will continue to maintain maximum optionality and that any further easing will be data dependent. We continue to monitor opportunities on mispricing in fixed income markets.

The local equity composition is well diversified, and the portfolio remains tilted towards select cyclical exposures at the expense of more defensive holdings. We continue to build up exposure to global defensive companies, Naspers and Prosus, where earnings revisions are expected to trough and the valuation is reasonable and continue to hold Aspen Pharmacare (but at a reduced weight after the strong performance) where there is still further scope for positive earnings revisions. These stocks also provide additional protection against any potential rand weakness. This sits alongside our allocation to global cyclical stocks (diversified miners, platinum miners, Sappi, Sasol and luxury goods maker, Richemont) geared to the global economic cycle. Most of the exposures in this bucket are benefitting from tight commodity markets and low inventory levels in our view. The South African consumer continues to be more resilient than the market had feared, and we thus maintain a healthy, growing allocation to South African banks, where earnings revisions are positive, and valuations are attractive. This sits alongside our exposure to select apparel retailers (Pepkor and Truworths International) and Motus Holdings, which have good earnings revisions profiles, n and are trading at reasonable valuations. We have reduced our exposure to Mr Price Group and The Foschini Group, as the markets earnings forecasts have caught up and are now mildly ahead of our forecasts. Our exposure to local defensive businesses has previously only been through MTN Group and Bidvest Group and had been limited as earnings revisions and valuations have not been as compelling in this space. However, in recent months we initiated positions in Life Healthcare and Netcare, as the earnings revisions profiles appear to have troughed given an improving occupancy profile into 2022, which results in strong positive operating leverage that the market appears to be under-estimating, in our view. We also have been building a position in Shoprite Holdings, as the management team continue to deliver on strategy and gaining strong momentum in taking market share through their Checkers brand in the middle and upper income consumer brackets, which is also at higher margin, while also improving cash flow and returns with better capital allocation.

We have maintained the material allocation to local sovereign bonds, especially within the context of the global fixed income universe. While the past six weeks has been difficult for domestic bond markets, it has outperformed its beta relative to other fixed income markets. With oil prices rising, we expect inflation to peak towards the end of the year and remain contained into next year. The fiscal position remains supportive, with external balances and debt/GDP lower than expected coming into the year. Risk-adjusted valuations remain attractive relative to other EM sovereign debt, though we expect that global bond volatility will continue to weigh on the asset class. It remains our preferred fixed income exposure.

For the full CIS disclosure and risk statement, go to:
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