Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

The third quarter (3Q) was a rollercoaster both externally and domestically. We started on the backfoot with Delta variant fears and the riots in South Africa, a recovery in August and then a difficult September as fears over China's growth, supply-side driven persistence in inflation, and hawkish sounding central bankers sparked a risk-off trade. In South Africa, falling commodity prices especially in the precious metals complex also sparked a sell-off across all domestic asset classes and the rand. Over the quarter, developed market (DM) equities (MSCI World Index, -0.0%) closed the quarter a shave lower, while their emerging market (EM) peers (MSCI Emerging Markets Index, -8.1%) absorbed most of the heavy blows from the global selloff and a torrent of negative newsflow from China. Across regions, September marked the worst month since March 2020 for the US benchmark S&P 500 Index, which plunged 4.7%, but still managed to book a sixth consecutive quarter (+0.5%) of gains. The spike in bond yields was especially brutal to high-growth tech stocks (which also comprise a heavy weighting on the S&P 500) with the tech-heavy NASDAQ sinking 5.3% for the month and 0.2% for the quarter. Across the Atlantic, European stocks suffered the same fate as the Euro Stoxx 600 closed 2% lower. In Asia, returns were mixed, with Chinese stocks (mainland China's CSI 300 Index, -5.9%) struggling amid Evergrande and weak data, while Japanese equities (Topix, +4.8%) were buoyed by investors piling into beaten down stocks, easing COVID infections and the pledge of a large-scale recovery package by newly minted Prime Minister Fumio Kishida.

In fixed income, inflation worries and the hawkish pivot by central bankers launched a plunge in prices reminiscent of Q1 2021 (yields rise as prices fall). US Treasuries, which serve as an important indicator for financial markets, saw yields on the 10-year note soar from 1.31% to 1.55% in a matter of days. The Bloomberg Barclays Global Aggregate Bond Index ended the quarter down 0.9%.

All returns are quoted in US dollars.

South African equities ended the month and quarter in negative territory, as positive domestic currents were largely offset by exogenous shocks. The benchmark FTSE/JSE All Share Index (ALSI) came under immense pressure (down 3% in September and 0.8% over the quarter), with regulatory headwinds from China making life extremely difficult for the heavy weighted Naspers-Prosus stable. In contrast, capped indices fared much better as the Capped SWIX ended posted gains of 3.2% for the quarter. At a super-sector level, financials (+12%) delivered robust performance, while for resources and industrials it was a bruising third quarter, as both closed 4% in the red. In fixed income, the JSE All Bond Index rose 0.8%, despite ending the quarter with marginally higher yields. The highly volatile listed property (JSE All Property Index) sector managed to pare back some of the riot-induced losses to close out the quarter up 6.5%. Cash, as measured by the STeFI Composite Index, remained broadly stable at 0.3% for the month and 0.95% for the quarter. In currencies, the rand struggled on the back of worsening sentiment towards precious metals, and a still positive but weaker-than-expected current account surplus.

Performance review

For the quarter, the portfolio delivered positive absolute returns.

Key positive contributions:

- On the local front, South African banks (Capitec, ABSA Group, FirstRand and Standard Bank Group) contributed to performance over the quarter. Performance was further enhanced by our holdings in MTN Group, Aspen Pharmacare and Sasol.
- The offshore equity component benefitted from exposure to European oil companies, semi-conductor firms and European financials (Erste Bank, Nordea and UniCredit) exposure.
- The overall allocation to the offshore component of the portfolio advanced on a weaker rand.

Key negative contributions:

- The allocation to the platinum-group metals (PGM) stocks (Impala Platinum, Sibanye-Stillwater and Anglo American Platinum) came under pressure over the quarter. Positions in Naspers and Prosus also weighed on returns.
- Exposure to Chinese equities detracted from the offshore equity component of the portfolio.

Portfolio activity

Within the local equity component, we sold down our holding in Sibanye-Stillwater, which is facing negative earnings revisions in favour of Glencore, Exxaro Resources and Mondi, where the upside to market consensus forecasts remains high given prevailing commodity prices. On the back of strong performance, we banked some gains by trimming exposure to The Foschini Group and Pick n Pay Stores and exiting our holding in MultiChoice Group and Investec. The proceeds were used to initiate positions in Shoprite Holdings and Old Mutual over the quarter, as well as topping up positions in ABSA, Nedbank Group and Growthpoint Properties, which were offering attractive entry points. Furthermore, we took advantage of the weakness in the Naspers-Prosus stable during the quarter and topped up our position towards quarter-end, given that earnings revisions appear to be bottoming.

Within the offshore equity component, we took advantage of the market weakness to deploy some of our cash to top up existing holdings in select European financials (Erste Bank and UniCredit), US tech (Microsoft, Alphabet and Facebook) and Healthcare (UnitedHealth Group, Johnson & Johnson). Within Fixed Income, we sold US Treasury duration, and added to Chinese credit. We also added to overall US dollar exposure vs other DM currencies.

Outlook and strategy

As we have exited the early stage of the cycle and continue to transition to mid-cycle conditions, we expect markets to be for volatile ahead but grind higher, as we expect overall growth to remain above trend. However, we expect China to continue to weigh on markets as they transition towards a more balanced quality-driven growth model. The tighter monetary conditions in DM, the slowdown in China and auto-driven pressure on PGM prices continue to be headwinds for our portfolios.

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 are recovering, and valuations are reasonable. Allocations to US and European financials as well as semi-conductor companies continue to see upgrades to forecasts as the economic recovery takes hold. Our European oil exposure is benefitting from the tight oil commodity markets, while the low capital expenditure profiles are resulting in strong free cash flow for these companies, thus increasing the potential for strong shareholder returns. 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. The recent regulatory crackdown in China has impacted sentiment negatively and increased the risk premium across the whole market. This has impacted the companies we own, but we are comfortable that the earnings potential and trajectory of these companies remains intact and once the dust settles, the future returns from these holdings look promising. China's consumer industries have great growth potential given the low penetration levels in many consumer sectors, while increasing household wealth (which is government's stated intention through its "common prosperity" initiatives) will drive consumption upgrades and industry leaders are seeing market growth, potential market share expansion and higher margins over time. The Chinese equity market also offers significant diversification benefits given their low correlations with the domestic equity market, thus exhibiting attractive risk-return attributes from a portfolio construction perspective.

As economic data continues to improve, the developed market central bankers are increasingly looking to remove their quantitative easing programs in order to maintain the right economic equilibrium. We saw both inflation breakevens and real yields rising across all markets, led by the UK Gilt market. We have moved from being negative to neutral on global rates at current yields and will continue to look for opportunities on policy divergences and market displacements.

The local equity composition is well diversified, and the portfolio remains tilted towards select cyclical exposures at the expense of more defensive holdings. However, we have started to add to our holdings in Naspers and Prosus, where earnings revisions appear to be troughing and sentiment is weak. In addition, we have an allocation to Aspen Pharmacare, where the market appears to be underestimating the vaccine manufacturing rollout. This sits alongside an allocation to global cyclical stocks (diversified miners, Sappi, Mondi, Sasol and luxury goods maker, Richemont) geared to the global economic cycle and continuing to exhibit favourable earnings revisions profiles. Most of the exposures in this bucket are benefitting from tight commodity markets and low inventory levels, in our view. We also have a healthy allocation to South African banks where earnings revisions have turned positive, and valuations are attractive. This sits alongside our slightly reduced exposure to apparel retailers and Motus Holdings, which display good earnings revisions profiles, trading at reasonable valuations. The South African consumer has proven to be more resilient than the market had feared. Our exposure to local defensive businesses had previously only been through MTN Group, Pick 'n Pay Stores and Bidvest Group and had been limited as earnings revisions and valuations have not been as compelling in this space. However, during the first half of the year, we built positions in Life Healthcare and Netcare as the earnings revisions profile appear to have troughed given an improving occupancy profile into 2022 that results in strong positive operating leverage that the market appears to be underestimating, in our view.

We have maintained the material allocation to local sovereign bonds especially within the context of the global fixed income universe. As we have seen play out in the last quarter, we continue to like the buffer provided by the income profile of local bonds and think bonds are supported by attractive valuations versus their own history as well as against EM peers (the domestic 10-year government bond has one of the highest real yields versus its counterparts, particularly those with a similar risk profile). With rising inflation towards the end of the year, and improving economic fundamentals, the South African Reserve Bank is closer to shifting towards a hiking cycle and we continue to prefer the belly of the yield curve. We recognise that global bond markets will weigh on the domestic market and will selectively take profit on selected parts of the curve as it reaches fair value, while continuing to be positive on the medium-term total risk-adjusted return profile for domestic bonds.

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