Previously Investec Asset Management

Ninety One General Equity Fund

Market background

The start to the 2020 calendar year will most certainly be an unforgettable moment in time for those that have lived through it. The impact of coronavirus (COVID-19) is heavily impacting economies and societies as it has spread from China to other regions across the globe – at the time of writing, another 209 countries. This unprecedented period is reflected in financial market moves seen over the quarter. The Dow Jones Industrial Average Index declined 22.7%, its worst quarter since the 'Black Monday' crash of 1987, while US yields fell to new all-time lows. In South Africa, the FTSE/JSE All Share Index declined 21.4% over the quarter [Capped SWIX declined 26.6%], the second worst quarterly performance in 45 years.

While retrospective market comments may seem inapt amid the fluid economic environment as the world grapples with the disease, it still provides an important context of each country's standing prior to the outbreak and what idiosyncratic considerations may differentiate each one in overcoming the crisis in the coming months.

In South Africa's case, the country unfortunately already began 2020 on a weak footing. The economy had already slipped into its second recession in as many years, shrinking by an annualised 1.4% quarter on quarter in the final three months of 2019 – well below economists' forecast of -0.1% and mainly due to the rolling power outages which constrained several industries.

To add to the weak sentiment, Moody's Investors Service downgraded South Africa's sovereign credit rating to sub-investment grade. In the context of the weaker local and international growth outlook due to COVID-19, this did not come as a surprise.

Both fiscal and monetary policy moves have been commendable amid the outbreak. National Treasury's budget policy delivered in February had a more realistic outlook on the economy, with a clear target to tackle arguably the most important and challenging issue: public sector wages. This is critical to settle and stabilise the country's budget deficit outlook – more than ever before, given the pending growth shock expected in the first half of this year. Meanwhile, on the monetary front, the South African Reserve Bank (SARB) took proactive action in cutting the benchmark interest rate by 100 basis points (bps) in March. We expect more supportive policy action to be taken by the SARB in the coming months.

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Lastly, perhaps the most commendable action taken by the country's institutions was in the presidency. The swift action to contain the COVID-19 disease outbreak in South Africa by announcing a national lockdown (far earlier than developed markets had at similar points) may impact economic growth, but surely avoids a larger economic contraction had the government not taken action at the time it did.

Performance review

For the quarter, the portfolio outperformed the benchmark.

Market volatility saw many shares and sectors fall out of favour over the quarter as share prices reflected the lower growth reality and higher risk outlook. Not having exposure to Redefine (-69%) and Growthpoint Properties (-42%) helped relative performance with the listed property sector coming under severe strain due to the lockdown implications on rental income as buildings were placed under enforced shutdowns. The underweight position in Sasol, which fell a remarkable 88% over the quarter, also boosted relative gains. Concerns over Sasol's high debt balance, the lower oil price and the US Lake Charles Chemicals Project (LCCP) continuing to experience operational problems all weighed on the company's share price. Our overweight positions in British American Tobacco and Reinet fulfilled their expected defensive attributes and positively contributed to performance over the quarter.

Overweight positions in Impala Platinum and Anglo Platinum detracted from performance. Other detractors included our underweight positions in Vodacom and Shoprite, two of the handful of stocks that ought to perform well under lockdown conditions.

Portfolio activity

During the quarter, we bought Gold Fields, whose earnings will benefit from the firmer gold price and expected steady operational performance. We also added to our holdings in British American Tobacco, whose earnings forecast will remain largely intact and with an earnings revisions profile which is attractive relative to the market. We reduced exposure to luxury goods maker Richemont, a global cyclical name whose earnings will disappoint as falling economic growth, less tourism and waning consumer confidence will weigh on consumers' propensity to buy luxury goods.

Outlook and strategy

These are extraordinary times. Wherever you may be reading this (most likely in your homes) as South Africa's lockdown period elongates, we are conscious that the impact of COVID-19 could have a lasting impact on how the world conducts business. Currently, the market's near-term focus is on signs of the pandemic being brought under control and the subsequent outlook scenarios on risk and global growth. Any data showing a slowdown in the COVID-19 progression will likely move markets positively, and the opposite could see further selling of risk assets. We expect volatility to persist, which now is at its highest levels since the Global Financial Crisis.

What is clear, is that the world is set to experience a significant shock to growth in the first half of the year – particularly in the second quarter, where some estimates are for global growth to contract by as much as 8%. What blurs the economic outlook is that growth is likely to be asynchronous, with each country facing its own recovery timeline back to normalisation. This poses a risk to any forecast of economic growth with high confidence.

In South Africa the economic contraction is expected to be more pronounced, with estimates of a 12% contraction in the second quarter leaving the calendar year with negative growth of potentially 6%. All prior forecasts of the budget deficit have been lowered and debt-to-GDP metrics increased.

In such an environment, we believe it is paramount we remain focussed on our disciplined investment process through the cycle (picking stocks with positive earnings revisions at a reasonable valuation) even in the face of such event risks. Our combination of using objective factor-based screening with bottom-up fundamental research allows us to cut through market inefficiencies. Macroeconomic variables and event risk all have a significant impact on stock returns. It is thus tempting to forecast these and position the portfolio accordingly. Our experience, however, is that these variables and risks are extremely difficult to forecast (even more so in the current extremely volatile and fluid environment), and the outcome is typically binary.

There is no doubt that corporate earnings forecasts will be revised lower internationally as well as locally. In an environment of broad-based negative earnings revisions, the ability to find corporates that are receiving overly bearish/bullish expectations presents exciting investment opportunities. The bearish investment environment in which we find ourselves tends to lead many investors to make behavioural errors and poorly assessed earnings forecasts that in turn lead to mispriced equities.

“Mispriced” in this environment becomes a critical judgement to make. The concept of reasonable valuation captures many measures and may vary between industries. One of the most pertinent ones at present, in our opinion, is an assessment of balance sheet risk and whether the market has correctly factored that risk into a stock’s valuation or not. This without a doubt applies to all industries. Sadly, such an environment could very well lead to corporate failures across the world. Avoiding those stocks is just as important as finding the outperformers.

Both the assessment of earnings expectations and reasonable valuations requires rigorous analysis and scenario reviews – our investment team and investment process are highly experienced and specialised in in this regard. The deep, negative market returns thus far in 2020 is disappointing for all investors. We believe our investment process and philosophy should ensure consistency in our portfolio construction and help us navigate the challenging terrain. Our aim is to continue to deliver alpha over the medium term, including and in-spite of the volatility we have thus far experienced in early 2020.

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