Coronavirus

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Previously Investec
Asset Management

SA 4Factor

SA Balanced and General Equity strategies

> It has been a roller coaster ride since we started following news reports from Asia that moved to Europe and North America before formally entering South African reality on 5 March. We understand there is a lot of news out there, both real and fake. We also know there will be anxiety and panic. But we are committed to playing our role in keeping you informed and sharing the best information and data out there. This is a time for all of us to pull together and beat this virus.
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> Daily Maverick, 18 March 2020

The first six months of 2020 will be remembered for the rest of our lives. The facts as they stand are indicating that the coronavirus (COVID-19) is worse than the flu, more contagious and already widespread. The only thing we can try to control is how fast this virus spreads. We are still within the window of opportunity to slow it down and the next 10 weeks will be critical.

With the coronavirus outbreak having spread beyond China, global financial markets have seen a significant increase in volatility and related sell-off. At the time of writing, equity markets are down -25% to -40%, with our own FTSE/JSE All Share down -32% year to date. From commodities to credit to equity, there seems to be no end in sight regarding the freefall, with markets trading through a series of 'circuit breakers' (temporary trading halts). The reality is that a massive wave of stimulus has been unleashed globally but has done little to calm down fearful asset markets. The loss in asset values for investors in these markets is a tough and painful experience for us all.

Given the fluid nature of the situation, we are actively monitoring trusted information sources, including government authorities and the World Health Organisation, to ensure any threat to our business operation is quickly identified and responded to accordingly.

Our global operating model ensures that we are able to provide uninterrupted client service, while ensuring the health, safety and security of our employees. As a global organisation with multiple operational centres, key functions are transferable across locations; we have broad-based remote working capabilities across all teams in the business and a large part of our workforce is mobile as a function of their roles. We have to take the wellbeing of our people even more seriously than usual and we have put measures in place that will make sure we play our role to help with firebreaks. Most important, we have to do everything we possibly can to prevent community transmission.

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From an investment standpoint, we have navigated client capital through many bouts of turbulence since our inception in 1991. As fundamental active managers, we are constantly reviewing what the coronavirus outbreak means for the global economy and the implications for client portfolios.

Market backdrop

After several weeks of complacency, financial markets tipped into full-blown panic on 24 February 2020 as the coronavirus continued to spread. As a result, markets have been scrambling to price in the impact on the global economy of both a supply and demand shock.

The supply shock is driven by the closure of a large portion of Chinese manufacturing capacity for several weeks in late January 2020. This has been followed by the implementation of travel bans by the US, Europe and South Africa – among others.

The data shows a big decline in manufacturing output in China in January and February. Exports were down 17.2% from a year earlier in February. The PMI fell from 51.9 in January 2020 into deep contractionary territory of 27.5 in February 2020. Though supply chains were carrying inventory into the Chinese lunar new year, these will likely be quickly be depleted. While factories in China have now reopened, the prospect of economic shutdowns across most of Western Europe and the US, over the near term, is increasingly becoming base case in order to contain the spread of the virus so that healthcare systems can cope with the resultant, mostly elderly, pneumonia victims.

The recent lockdowns in China, Italy and Spain, partial shutdowns in France and Germany and potential shutdowns in a range of other countries are generating a negative global demand shock as people have limited their trips to shopping malls, self-quarantined or cancelled travel plans.

The initial decline in oil prices was due to the demand shock as fuel demand plunged. For example, Lufthansa has cancelled 50% of all flights, Virgin has cancelled four out of five. The geopolitical battle between Russia and Saudi Arabia has exacerbated the problem greatly. These combined supply and demand shocks have created the conditions for a contraction in global growth in the first half of 2020. This will likely be aggravated by the possible halt to fixed investment in the coming months as companies are unable to make decisions amid the current chaos.

Going forward, markets will continue to grapple with the thought of how long such lockdowns and shutdowns may last. There are several forecasts of up to two months in parts of the US and Europe. The supply and demand effect of a prolonged halt to normal life will definitely be felt.

After the fall in equity prices, a global recession is increasingly being priced in – but this does not mean that markets have found a floor. Recent events have also begun to raise concerns about the sustainability of the corporate debt build-up, particularly in Emerging Markets and the US. The week of 9 March 2020 saw the biggest ever weekly outflows from investment grade and high yield credit markets as well as emerging market debt. Conversely this resulted in the biggest inflow ever into cash.

The primary source of the problem is the multiplying new cases of coronavirus infections. We would expect new countries to follow the path we have seen in Wuhan as the numbers accelerate for two to three weeks and then the growth rate starts to slow before the eventual numbers plateau. So long as the number of confirmed cases in a number of northern hemisphere countries continues to rise exponentially, there will be uncertainty on the shape of the recession or how long it will be until economies start to recover. Until that changes, we believe it will be very difficult for markets to rally. Medical experts indicate that a vaccine is at least a year away, though antivirals (which alleviate the symptoms of the virus) could be available in 2020 and are likely to have a big impact on the mortality and severity of coronavirus cases.

The conclusion is that when the coronavirus infection data stabilises, markets are likely to rally strongly. However, there is no clarity on how long that will take. It therefore seems prudent to be cautious for now.

What does this mean for our Balanced strategy?

From a portfolio management perspective, we are cognisant of the potential implications of this outbreak on some of our positions. That said, we believe it is paramount for us not to deviate from our disciplined investment process even in the face of such event risks — our process allows us to cut through inefficiencies, enabling us to avoid behavioural biases and to deliver repeatable and dependable returns over the long term.

Macro 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. Further, there is insufficient breadth in this type of risk taking — the outcome is typically binary. We prefer the breadth of asset selection and stock-picking where we are able to diversify risk across a wide range of assets. We believe markets are efficient over the long-term. However, inefficiencies occur due to behavioural biases (particularly in periods of increased market volatility) which can be exploited to the benefit of our clients. Generally, we believe risk assets deliver a return premium over time. To achieve the desired returns for the Balanced Strategy over time, our assets are skewed towards risk assets and are generally equity centric. In this respect, a long-term horizon is necessary in our view to weather the inherent short-term volatility of equity markets and to capture both the equity risk premium as well as the benefit of reduced volatility that comes from time diversification in markets. At appropriate times, emphasis will shift from capital growth to capital preservation and, in such instances, cash holdings will be tactically increased.

While the portfolio will always reflect our highest conviction investment ideas, we are cognisant of risk when constructing the portfolio. We believe that diversification is the best tool to manage risk and is an integral part of our decision-making process. We consider how a particular investment fits into the broader opportunity set which is reviewed regularly to create a consistent framework to assess new positions. Overall, we believe our investment process and philosophy should ensure consistency in our portfolio construction and help us navigate the challenging terrain.

Outlook for our Balanced strategy

The moderation in global economic activity was a prevalent theme for most of 2019, albeit signs of stabilisation surfaced in the final quarter of the year. However, the backdrop has swiftly changed given the coronavirus outbreak and its potential impact on growth — the risk of a global recession has risen quite sharply.

Policy remains supportive as most central banks have exhibited a dovish bias - although the efficacy of policy on growth and markets is increasingly being questioned. At the time of writing, stimulus measures had reached $1.9 trillion, with everything from lower interest rates, bond buying and quantitative easing (QE) being thrown at the virus. Against this backdrop, we believe it is prudent to remain cautious given the downside risk to global growth as well as other issues such as the oil price shock.

Our offshore allocation remains favourably disposed to equities, wherein the exposure continues to be skewed towards European and Asian investments as well as corporates and markets that we believe are most likely to provide returns. Beyond the return potential, these two markets offer significant diversification benefits given their low correlation with the domestic equity market. We continue to prefer cash over global bonds. A third of the offshore component is held in cash. It acts as an attractive shock absorber in times of heightened market volatility and material market drawdowns.

The local growth outlook remains under severe pressure. Business and consumer confidence remain subdued, Eskom continues to be an albatross around the country's neck given its financial and operational concerns, while policy uncertainty and rising unemployment (and low real wage growth) compound the problem. South African businesses and consumers are also very quickly getting to grips with the short and medium-term implications of the virus — on how we live, work and play.

Thus, it is no surprise that earnings revisions remain under pressure across locally-oriented businesses (particularly food and general retailers as well as food producers) given the tough economic backdrop and operating environment, but we continue to focus on companies that are exhibiting improving earnings revisions profiles due to operationally-driven improvements or self-help measures. The local equity composition is diversified, with some capital invested in global cyclical companies geared to the global economic cycle and exhibiting favourable earnings revisions profiles such as Naspers (and Prosus) as well as platinum group metals (PGM) investments, alongside more defensive positions like AngloGold Ashanti, Bid Corp, British American Tobacco and Reinet Investments. We also have exposure to select 'SA Inc.' plays with decent relative earnings revisions profiles and trading at reasonable valuations, including FirstRand and Sanlam.

We continue to hold a sizeable allocation to local bonds. In the domestic fixed income spectrum, it remains an attractive asset class given how high the yield over cash is. That said, worsening local fiscal dynamics are concerning from a rating action perspective. But the recent budget statement was received positively by the market due to the planned cuts in public sector wage growth. However, we believe the execution risk is material and failure to implement the cuts as outlined could result in further negative rating action. We believe investors are largely compensated for these risks as domestic bond yields continue to trade at a material premium to their emerging market peers, but we continue to monitor the situation. Inflation looks set to remain range-bound with the 3-6% target band, while the global monetary policy backdrop is quite accommodative, potentially allowing the central bank room to manoeuvre given the backdrop of tepid growth.

What does this mean for our General Equity strategy?

From a portfolio perspective, we are cognisant of the potential implications of this outbreak on some of our portfolio positions. That said, we believe it is paramount for us not to deviate from our disciplined investment process (picking stocks with positive earnings revisions at a reasonable valuation) even in the face of such event risks — the combination of objective factor-based screening and bottom-up fundamental research allows us to cut through inefficiencies, enabling us to avoid behavioural biases and to deliver repeatable and dependable returns.

We believe thorough bottom-up fundamental analysis is required to understand the source of earnings revisions. It is important to establish whether changes to earnings estimates are due to permanent or temporary factors.

When building and managing our portfolios, we believe the best approach to mitigate company specific risk is through:

- Constructing well diversified portfolios
- Sticking to our investment risk management framework guided by the below four pillars:
  - Staying true to the investment philosophy and process
  - Positioning/quality of research: Appropriate research, analysis and fundamental views
  - Concentration and liquidity: Make sure the concentration and liquidity characteristics of portfolios is consistent with client mandates
  - Risk statistics: Risk being measured appropriately e.g. VaR, tracking error, stress testing
- ESG integration: Analysing factors pertaining to corporate governance is an integral part of our investment process. This does not guarantee the detection of fraud, but it is a focused effort for the promotion of good corporate governance and a conscious "measurement" of ESG risks being undertaken. Companies that score poorly on governance criteria will be ascribed lower valuation multiples in recognition of the prevalent risks.

Macro 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. Further, there is insufficient breadth in this type of risk taking — the outcome is typically binary. We prefer the breadth of a stock-picking strategy where we are able to diversify risk across a wide range of individual stock positions.

Our aim is to maximise the benefits of our individual stock insights; hence we are aware of and closely monitor any unintended macro risks which may unintentionally be embedded in the portfolio as a result of the aggregate individual stock selections. Where necessary we take action to manage macro risk.

Outlook for our General Equity strategy

From a bottom-up perspective, there are pockets of the market where we are picking up ideas based on our philosophy and process. Earnings revisions remain under pressure across locally-oriented businesses (particularly food and general retailers as well as food producers) given the tough economic backdrop and operating environment, but we continue to focus on companies that are exhibiting improving earnings revisions profiles due to operationally-driven improvements or self-help measures.

As a team we are also performing in-depth stress test scenario analyses for a worst case (three to six-month disruption period). We are looking at potential changes in earnings revisions profiles, but also the free cashflow impact on companies and the effect on their balance sheets. For the companies that we have under coverage, we are flexing our assumptions for the key COVID-19 uncertainties: duration of trade disruptions and severity of impact in different regions.

The General Equity Strategy's composition is diversified, with some capital invested in global cyclical companies geared to the global economic cycle and exhibiting favourable earnings revisions profiles such as Naspers (and Prosus) as well as platinum group metals (PGM) investments, alongside more defensive positions like AngloGold Ashanti, Bid Corp, British American Tobacco and Reinet Investments. We also have exposure to select 'SA Inc.' plays with decent relative earnings revisions profiles and trading at reasonable valuations, including Bidvest Group, FirstRand and Sanlam.

Concluding remarks

The phrase "black swan" is derived from a Latin expression. The black swan theory (or theory of black swan events) is a metaphor which describes an event that comes as a surprise, has a major effect and is often inappropriately rationalised after the fact with the benefit of hindsight.

In our view, the cause of this sudden growth shock had very little to do with conventional economics or any of the previously widely held views on excess leverage or artificially low interest rates. Instead, it came out of the left field after it had started in the city of Wuhan, China.

Managing and navigating through a financial crisis is no fun at all for anyone. No one should have to choose between medicine and other necessities. No one should have to use the emergency room with fear of contracting a virus every time a child or elderly person gets sick. And no one should have to live in constant fear that a medical problem will become a global crisis. To quote from a speech by Abraham Lincoln before he became the 16th president of the United States "And this, too, shall pass".

SA 4Factor

Property Equity strategy

Local fundamentals wane, but valuation is more attractive than ever

The South African listed property sector continues to recover from a series of headwinds which has impacted the sector over the past two years, including deteriorating fundamentals, governance and reporting-related concerns. Rebasing of distributions along with the introduction of pay-out ratios has also reduced expected income. Prior to the most recent global events, we believed that these factors, while unlikely to be resolved in the short term, appeared to be largely captured in valuations. Furthermore, valuations had also reflected a more sustainable earnings profile.

Clearly, the more recent sell-off due to the spread, impact, and uncertainty of the Coronavirus has made already attractively priced real estate counters even cheaper. While the effects on the various sectors are hard to ascertain, they are unlikely to be structural and infinite in nature. That said, given the nature of the virus, it is fair to expect that retailers and retail landlords could be the most impacted in the short term as countries implement lockdown measures to contain the spread of the virus.

While central banks around the world attempt to provide markets with a safety net via various monetary and fiscal stimulus packages, the benefits of these are unlikely to be appreciated until the true effect and extent of the virus is understood. The remaining concern would be any second-order effects, specifically in the debt/credit markets, which could dry up liquidity and negatively impact highly geared companies.

Locally, the South African government finally produced a budget that could be viewed as a step in the right direction, while the South African Reserve Bank took its first steps in a possible rate-cutting cycle. Both of these developments would have provided a good underpin to the South African listed property space. However, it is clear that local macro conditions will largely be overlooked in the short term and the market will take its cue from global events.

The sector has lost around a quarter of its value year to date, and local listed counters trade on average at a +15% dividend yield and a 40% discount to their book value. These are clearly attractive valuation metrics and should provide a highly attractive medium-term return profile. However, short-term volatility and downside risk is expected to remain high while the world continues to digest the impact of Covid-19.

What are the implications for your portfolios? How are you positioned?

Due to the tough economic backdrop and deteriorating fundamentals in South Africa recently, we continue to favour more offshore-focused property counters which provide a level of resilience in the face of global economic shocks. These counters exhibit sustainable income streams, relatively strong growth profiles, attractive valuations (more downside protection) and most importantly, in this market, secure balance sheets that are able to withstand the impending slowdown in markets around the globe.

While there is no doubt that landlords will feel the impact of the global slowdown, property is resilient in the way it earns its income via contractually based leases that are largely backed by national and multi-national corporations. This should provide decent cash generation and support for most property companies but will unlikely protect those already vulnerable from a cash flow and balance sheet standpoint. Thus, we believe there is little need to change our current philosophy and approach to investing, which is based on sustainable income and growth at reasonable valuations.

While markets and economic conditions are dynamically changing on a daily basis, we continue to actively assess our portfolios' risks, while actively screening for opportunities that market dynamics such as these are likely to provide. Ultimately, we aim to provide our clients' portfolios with the best risk-adjusted medium- and long-term outcomes.

SA Quality

Opportunity and Cautious Managed strategies

The defensive qualities of our portfolios provide support

Equity markets have been rocked by the rapidly spreading coronavirus (Covid-19) to other regions, with the daily infection rate increase now trending around 33%. The emergence of a price war in the oil market, after Russia refused to agree to production cuts proposed by Saudi Arabia, sent markets into free fall, and volatility spiking to levels not seen since the euro-zone debt crisis in 2011. The pick-up in sentiment on the back of stimulus plans by the US government did offer momentary solace, but this was short-lived. Governments around the world have enforced stricter containment measures and markets were sent tumbling once again as the US suspended travel from Europe, while the World Health Organisation finally declared the coronavirus outbreak a pandemic. Amid this turmoil, we believe it is critical to remain focused on the quality characteristics of any business that we assess. We would urge long-term investors to note the underlying strength of the businesses in which we invest, the inherent growth these businesses should deliver, and to strive to overcome any short-term negative sentiment that may result from the current market environment.

Diversification, active asset allocation and disciplined portfolio construction are important tools in managing downside risk. While not immune to the market sell-off, our Quality portfolios have demonstrated their relative resilience, with smaller drawdowns than the market in the short term.

What is our outlook and how are we positioned?

It is difficult to draw meaningful conclusions over such short time periods, particularly given the rapidly changing situation. While medical professionals continue to model increased incidences of coronavirus infections and mortalities worldwide, the reality is still that nobody knows how this will evolve. Extreme predictions will likely carry on receiving more airtime in the short term. We continue to believe that there won't be a classic V-shaped recovery.

We believe the correct forecasting of complex global macro outcomes is almost impossible. Rather, we maintain a balance of exposures which offer protection against a range of potential outcomes. Our preference is for high-quality global companies that have enduring competitive advantages, with strong and reliable cash generation, healthy balance sheets and lower cyclicality than the market. Locally, we prefer government bonds as they provide a natural hedge against the volatility of the rand and bring stability to the portfolios.

We have been quite bearish on the outlook for local equities and property for some time. While valuations are more attractive than they have been for some time, the prospects for many 'SA Inc.' businesses (firms which are highly sensitive to the South African economy) are still dependent on an economic recovery. Based on our scenario analysis, the range of future expectations is quite wide and thus we have low conviction in our ability to call the bottom. It is therefore important to be selective and disciplined around security selection on local growth assets.

We have a relatively large cash holding, which gives us the flexibility to remain disciplined and only deploy capital when attractive investment opportunities become available. We remain unwavering in our commitment to growing your capital in a judicious and discriminate manner.

SA Fixed Income

Flexible Bond strategy

The South African budget was a positive surprise – for the first time National Treasury set out a plan to deal with the real fiscal problem – the public sector wage bill. The political intent will be tested over the coming months, but we are cautiously optimistic. Moody's has recognised the "execution risks" in the budget, but we expect the rating agency to give it time and consider the progress of expenditure cuts in November. While this may mean a stay of execution at its March review, it is a very close call.

However, on the international front, a combination of a poor market set-up (i.e. stretched consensus positioning) and a deterioration in the global growth outlook on the back of Covid-19 escalation, has dominated hearts and minds. The virus spreading meaningfully outside of China has forced markets' previous assessment of this being a very temporary Chinese economic shock into something broader. The overwhelming consensus coming into this year was that global growth would rebound on the back of Phase 1 of the US/China trade deal, and indeed, the data was leaning very heavily in that direction. The market got over its skis in its positioning (long equities/long credit/emerging market search for yield), and the subsequent positioning adjustment has been brutal (taking SA assets with it). We think there is genuine economic damage here, unquantifiable at this stage, but monetary and fiscal policy should hopefully soften the blow. We have already seen decisive action by the US Federal Reserve, the Bank of England and the People's Bank of China.

Where does it leave us from a portfolio perspective? Our view this year has been:

1. A strong disinflation story in SA, making bond valuations look good and providing the potential for rate cuts by the South African Reserve Bank (SARB)
2. Fiscal risks well priced in the SA government bond curve
3. A supportive external environment on the back of stabilising growth and easy monetary policy
4. All of these come with an inordinate amount of risks – fiscal, political and downgrade risks on the local front; and internationally, lazy consensus positioning raising concerns about valuations, and a global economy remaining vulnerable to shocks

Going forward, we still believe in the disinflation view. Even though the rand has depreciated, which is mildly inflationary, we believe the decrease in the oil price and the disinflationary consequences of global demand due to the recent virus and market events, will balance that out. The SARB's inflation forecasts also started a bit high at the last monetary policy committee meeting, so there is a need for the Bank to move those lower. That leaves us still thinking there is a greater than 50% chance of a rate cut at the March meeting (especially post the budget good news), but we do recognise the SARB may hold off to see how global risk factors (and capital flows out of SA) evolve.

On the external front, experience tells us we need to respect the price action. The market is trying to price in a new paradigm, and in the process, clear a lot of 'stale' risk. It will take an uncomfortable period for the market to stop trading technically, consolidate, and start thinking fundamentally again. During that time, markets that are overcrowded, complex or illiquid will be vulnerable – and volatile. With the increased volatility it takes less risk to make the same returns. Therefore, we will be sticking to our core views and positioning, but generally we will look for opportunities to manage exposures a touch lower to compensate for the higher volatility.

SA Fixed Income

Credit Income strategy

The South African budget was a positive surprise – for the first time National Treasury set out a plan to deal with the real fiscal problem – the public sector wage bill. The political intent will be tested over the coming months, but we are cautiously optimistic. Moody's has recognised the "execution risks" in the budget, but we expect the rating agency to give it time and consider the progress of expenditure cuts in November. While this may mean a stay of execution at its March review, it is a very close call.

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The current market turmoil follows a prolonged downturn in local credit markets. Many companies were already struggling with anaemic revenue growth and rising costs. And consumers were under similar pressure, exacerbated by job cuts. The local credit markets are shielded to some extent by a reduction in lower rated issuers over the last few years, with better quality banks, insurers and corporates dominating the environment. In addition, bank regulations following the global financial crisis in 2008 resulted in increased capital and a better matching of assets and liabilities, which is positive for credit. Securitisation methodologies were also made more conservative, improving the credit profile.

Our positioning in Credit Income/High Income has been very defensive for some time, given the already tough economic backdrop. We have avoided lower rated corporates and property companies as well as sectors such as retail. Liquidity has been prioritised. Our focus now is both on downside risk and the opportunities that should arise from the stressed environment. We expect new issuances to be at higher spreads and we may see some forced sales of credit.

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