Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

The fourth quarter (Q4) started off strongly in October, recovering from the previous month, but this rally faltered on the discovery of the more transmittable Omicron variant at the end of November. Regardless, equity markets were resilient, with the S&P 500 Index capping its strongest quarterly returns in 2021. Continued strong economic data and worries about inflation led the US Federal Reserve (Fed) to start their tapering of asset purchases in November and even subsequently deciding to double the pace of tapering six weeks later. The Bank of England (BoE) also started raising rates for the first time since 2018. In commodities, precious metals, gold and silver outperformed industrial metals with the exception of copper.

Over the quarter, developed market (DM) equities (MSCI World Index, +7.5%) was the best performing asset class, especially US equities (SPX +10.9%, Nasdaq +11%) while their emerging market (EM) peers (MSCI Emerging Markets Index, -1.7%) struggled, driven by China, Brazil and Russia. Across regions, the pan European Euro Stoxx 600 (+5.5%) also had a decent quarter. In Asia, Chinese stocks (mainland China's CSI 300 Index, +1.5%) managed to stage a mild recovery, while Japanese equities (Topix, -5.1%) struggled from weak currency performance and outflows.

In fixed income, most bond markets were bear-flattened with front end yields rising in anticipation of early rate hikes in 2022. The belly and long end of the curve were well behaved, ending the quarter almost flat, as bonds regained their 'safe haven' status following the Omicron scare. The Bloomberg Barclays Global Aggregate Bond Index ended the quarter down another 0.7%.
All returns are quoted in US dollars.

South African equities had a strong quarter to end the year with the benchmark FTSE/JSE All Share Index (ALSI) up 4.7% in December and 15.1% over the quarter. In contrast, capped indices were lower as the Capped SWIX posted gains of 8.7% for the quarter. At a super-sector level, it was a reversal of the leaders and laggards from the third quarter as financials (+3.4%) trailed while resources (+21.6%) and industrials (+16.1%) delivered robust performance. In fixed income, the JSE All Bond Index rose 2.7%. The highly volatile listed property (JSE All Property Index) sector delivered a strong 8.3% total return over the quarter and was the best-performing asset class in 2021 (+38.6%) following a dismal 2020 (-35.5%). Cash, as measured by the STeFI Composite Index, remained broadly stable at 0.34% for the month and 0.98% for the quarter. The rand was one of the worst-performing currencies and lost 5.5% vs the US dollar.

Performance review

For the quarter, the portfolio delivered positive absolute returns.

Key positive contributions:

- On the local front, the allocation to platinum-group metals (PGMs) stocks (Impala Platinum, and Anglo American Platinum) and diversified miners (Glencore, Anglo American and BHP Group contributed strongly to performance over the quarter. Performance was further enhanced by our holdings in MTN Group and luxury retailer, Richemont.
- The offshore equity component benefitted from exposure to semi-conductor and software firms as well as our healthcare exposure.
- The overall allocation to the offshore component of the portfolio advanced on a weaker rand.

Key negative contributions:

- South African banks (ABSA Group, FirstRand and Standard Bank Group) came under pressure over the quarter. Positions in Naspers and Netcare also weighed on returns.
- Exposure to Chinese equities detracted from the offshore equity component of the portfolio.

Portfolio activity

Over the quarter, within the local equity component, we sold down our holdings in South African consumer companies (Mr Price Group, Woolworths and Pick n Pay Stores), which we believe are poised for negative earnings revisions as well as taking some profits by trimming our exposure to Pepkor, Capitec Bank and Aspen Pharmacare following strong performance. The proceeds were also used to initiate positions in Quilter and Nedbank Group, which were offering attractive entry points. We allocated more capital to Anglo American where the upside to market consensus forecasts remains high on the back of prevailing commodity prices. We also added to our existing positions in Impala Platinum and Anglo American Platinum as the semi-conductor supply chain impacts have started to ease and 2022 will see strong vehicle production given the low inventory levels, while strong demand which will be supportive of the PGM commodity basket. Furthermore, earlier in the quarter, we continued to take advantage of the weakness in the Naspers-Prosus stable and topped up our position, given that earnings revisions and sentiment 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 and US financials (Erste Group Bank, UniCredit and State Street) as well as adding to auto exposure by topping up existing holdings in Lear and General Motors. We sold some of our exposure to European oil companies following strong performance. We also added to overall US dollar exposure vs other DM and EM currencies.

Outlook and strategy

Looking forward, we still expect a strong economic environment in developed markets, and a stable but more challenging environment in emerging markets. With inflationary pressures and COVID-related economic constraints likely to ease, the macroeconomic backdrop is favourable towards markets being well supported. That said, the big risk to markets for 2022 is relates to the quantum of central bank policy actions as they begin to withdraw liquidity and raise interest rates. The other risk is around China, which continues to pursue a medium-term balanced growth policy. While we are seeing signs of policy easing and support, these have been moderate so far.

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 continues to play out. Our exposure to the auto sector will also benefit from easing supply chain constraints over the course of 2022, which will allow them to deliver into the strong demand environment. 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. While the regulatory crackdown in China has impacted sentiment negatively and increased the risk premium across the whole market (including the companies we own), 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.

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 continue to add to our holdings in Naspers and Prosus, where earnings revisions expected to trough and the valuation is reasonable. In addition, we have an allocation to Aspen Pharmacare, where there is still further scope for positive earnings revisions. 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. Our allocation to PGM miners (Impala Platinum and Anglo American Platinum) will benefit from the rising global auto production given low inventory levels and strong demand. Hence, we believe that the earnings revisions have bottomed. We also have a healthy allocation to South African banks, where earnings revisions are strongly positive, and valuations are attractive. This sits alongside our slightly reduced exposure to select 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 initially feared, but caution is warranted as there is a lack of momentum in the South African job market. Our exposure to local defensive businesses is through MTN Group, Bidvest Group and hospital stocks (Life Healthcare and Netcare). The earnings revisions profiles of the hospital companies appear to have troughed given an improving occupancy profile into 2022 that results in positive operating leverage that the market appears to be under-estimating, in our view. We also have a position in Shoprite holdings where they continue to take meaningful market share through their Checkers brand as well as evidence of improved capital allocation by the management team, which bodes well for future returns.

We continue to maintain the material allocation to local sovereign bonds, especially within the context of the global fixed income universe. Within fixed income, South African government bonds were one of the few exceptions with positive returns in 2021. We believe the high income will continue to buffer the asset class through volatility from global fixed income markets. The South African Reserve Bank has commenced its hiking cycle and we think they will continue to hike at a slow and steady pace as the South Africa economy faces a more challenging growth environment in 2022.

DISCLAIMER: