Discovery Flexible Property

Market background

Global equity markets enjoyed a rebound in October, rallying from third-quarter lows to deliver a return of 7.2% for the MSCI All Countries World Index, led by developed markets and in particular, the US benchmark S&P500 Index, which had its seventh-best month since the Global Financial Crisis, rising by 8%. Unfortunately for emerging markets, returns over the month remained negative. The MSCI EM index declined 3.1%, dragged lower by Chinese equities which suffered a dramatic sell-off in the wake of the Communist Party's 20th National Congress, where China's President Xi Jinping consolidated his power, while key market-friendly members will be replaced in the coming months. Hong Kong's Hang Seng Index ended the month down 14.7% and year to date has declined 35.2%, a reflection of the increased regulatory risks and the economically restrictive 'zero-COVID' policy. All returns are quoted in US dollars.

In lockstep with global markets, South African equities rose strongly with the Capped SWIX up 5.3% for the month. At a super-sector level, financials (+12.8%) were the main source of strength, followed by SA listed property (+11%), while technology (-15.6%) saw weakness over the month due to China weakness (as mentioned above) flowing through into Naspers/Prosus. The JSE All Bond Index was less buoyant, returning 1.1% for the month. Cash, as measured by the STeFI Composite Index, delivered a 0.5% return over the same period. The rand spent the month on the backfoot with the local unit weakening by 1.5% for the month.

Performance review

For the month, the portfolio outperformed the benchmark.

Underweight positions held in both Fortress REIT B-share and Equites Property Fund contributed to performance. While the former continues to battle against a complicated capital structure, the latter is impacted by the current turmoil taking place in the UK and the impact that may have on interest rates and the property market.

An overweight position held in Capital & Counties Properties and an underweight position in Fortress REIT A-share detracted from performance. Fortress B-share has traded inversely to the A-share, although the current capital structure does not allow for either share to be valued with any level of certainty. Hence, we remain underweight until such a time better clarity on the capital structure outcome is provided.

Portfolio activity

We have taken the opportunity to increase our exposure to the UK names which have been particularly hard hit given the aforementioned volatility in that market. The UK retail companies have shown the ability pass on inflation in the form of higher rentals in the current market given the reset of the rental base through the COVID-19 period. The balance sheets of these companies have also been reset and remain reasonably geared during this period of uncertainty.

The portfolio also increased its holding in Redefine Properties, as the company continues to improve its capital structure while maintaining a high level of earnings. This combination of attractive yield and growth, as well as an improving balance sheet, aligns well with our philosophy of sustainable earnings and growth.

Outlook and strategy

After a strong 2021, in 2022, the listed property sector has been impacted by sentiment surrounding rising interest rates. However, the sector's operations have shown significant recovery since their COVID-induced lows, particularly in retail and industrial, while office continues to suffer from an oversupplied market (although stabilising as well). We have also started to see the first signs of operational improvements. Retail supply continues to diminish while vacancies decline, which is likely to drive rental growth in the medium term, and office vacancies appear to have peaked as a return to the office has removed large levels of shadow vacancies. The operational finance cost impact of rising interest rates is also expected to be relatively muted given that most real estate companies did not benefit from lower interest rates over the past two years and majority of their debt was hedged at historically high levels. Thus, earnings will continue to be driven by property fundamentals.

In our view, the challenging fundamentals are offset by supportive valuations. The sector trades on a forward yield of c.10.5% (c.11% for SA only) and a c.30% discount to net asset value (NAV). While dividend yields have been reduced due to pay-out ratios in favour of liquidity and balance sheet support, they are now also likely to be more sustainable and in line with international best practice. In 2022, companies have shown a return to consistent dividend payments, which is more sustainable as companies' cash flows and balance sheets are largely restored.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by a more sustainable cash-covered yield, together with a supportive valuation that reflects near-term operational and balance sheet concerns. Over the medium term, we remain constructive of a return to earnings and distribution growth off a sustainable income base as the economy recovers.

In the current environment, we continue to assess the portfolio risks and actively screen for opportunities that market dynamics such as these are likely to offer. Ultimately, we aim to provide our clients' portfolios with the best risk-adjusted medium- and long-term outcomes.