Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

Company earnings, expanding vaccinations and continued support from fiscal and monetary policy kept risk sentiment steady amid climbing Delta variant cases across regions.

Growth stocks continued to benefit from the trend lower in US Treasury yields. Developed market (DM) stocks (MSCI World Index) closed 2.5% higher, slightly trailing their emerging market (EM) peers (MSCI Emerging Markets Index) which delivered a +2.6% return. Across regions, tech and 'growth' stocks lifted the US benchmark S&P 500 Index (+3.0%) to a seventh straight month of positive gains; the index has nearly doubled since its nadir in March 2020. Across the Atlantic, the rebound in company earnings and a deluge of stimulus saw European stocks record their best streak of monthly gains in nearly eight years, with the Euro Stoxx 600 Index ending the month +2.2% higher. Despite initial weakness in EM markets (driven by China's regulatory crackdown), major Asian bourses closed higher on global growth optimism, with the Topix up 3.1%, while in China, bargain hunters seized on battered tech shares in the final week of August – overall mainland China's CSI 300 Index eked out a flat 0.1%.

In bond markets, there was very little movement either way amid the August lull. The Bloomberg Barclays Global Aggregate Bond Index saw a modest decline of 0.4%. US Treasury yields barely moved, declining 0.2%, while European bonds retreated on hawkish comments from the European Central Bank (ECB). EM sovereign bonds outperformed their DM peers with notably strong performance out of South Africa, Turkey, India and Indonesia as investors continue to search for yield in riskier markets.
All returns above are quoted in US dollars.

South African equities ended the month in negative territory, with the bumper earnings prints in the mining sector not enough to offset the regulatory headwinds weighing on the FTSE/JSE All Share Index's (ALSI) heavyweights (the Naspers-Prosus stable). The benchmark declined by 1.7%, while the Capped SWIX ended a +2% as capped indices fared much better during the month. At a super-sector level, resources (-4.8%) gave up the previous month's gains, as did industrials (-4.5%), while financials bounced back strongly, up 11.9% for the month. Local bonds (JSE All Bond Index, 0.8%) ended the month up 1.7%, tracking a firmer local currency on the back of a dovish Fed, while debt metrics improved following growth data revisions. The highly volatile listed property (JSE All Property Index) sector recovered from the prior month's losses with a +7.1% return in August. Cash, as measured by the STeFI Composite Index, remained broadly stable at 0.3% for the month. In currencies, the rand strengthened against the greenback, euro, and pound sterling.

At the sector level, it was another mixed bag of returns across the bourse. Key sector leaders over the month were found in healthcare, consumer services (retailers, travel & leisure) and financials (banks); 'SA Inc.' (companies that derive most of their revenue from South Africa) performed strongly over the period as lockdown restrictions were eased. Financials delivered robust returns as the banks tracked in lockstep with a firmer rand. Basic materials pared back last month's gains with general mining (BHP Group and Pan African Resources) and the precious metals miners (i.e., AngloGold Ashanti and Impala Platinum) all pulling back over the period.

Performance review

For the month, the portfolio delivered positive absolute returns.

Key positive contributions:

- The allocation to the SA banks (ABSA Group, Capitec Bank, FirstRand and Standard Bank Group) and SA apparel retailers (Pepkor and Truworths International) performed well over the month. Performance was further enhanced by our holdings in MTN Group and our holdings in the healthcare sector (Aspen Pharmacare, Life Healthcare and Netcare).
- Our offshore exposure to US big Tech (Alphabet, Facebook and Microsoft) and semi-conductors added to performance. In addition, the allocation to quality compounders, particularly in the healthcare sector and software services, also added to performance over the month.

Key negative contributions:

- Our holdings in Naspers and Prosus detracted from performance over the month. The allocation to platinum-group metals (PGMs) miners also detracted from performance.
- In the offshore selection, our exposure to Chinese equities was the main drag on performance over the period.
- Overall, the offshore component of the portfolio also detracted from performance due to the stronger rand over the month.

Portfolio activity

Within the local equity component, we sold our holding in MultiChoice and took some profits by trimming our exposure to The Foschini Group and Mr Price Group after a strong run and used the proceeds to take advantage of the attractive entry points which allowed us to add to our existing positions in Nedbank, Growthpoint Properties and Bidvest Group. We also trimmed positions in Sibanye-Stillwater and AngloGold Ashanti and used some cash to initiate positions in Exxaro Resources and Old Mutual during the month.

Within the offshore equity component, we took advantage of the market pullback during the month and used some cash to add to existing holdings in European financials (Erste and UniCredit) and United Healthcare.

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. The hopes for a continuation of a return to a pre-pandemic ‘normal’ coupled with improving momentum in global growth are supportive of markets. We remain vigilant in monitoring some of the potential risks of medium-term scarring in economies and government finances but also look for differentiation in recovery paths in the breadth of the different markets we invest in.

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. We largely maintain our tilt towards cyclical companies where valuations remain reasonable, and earnings continue to recover as global economic activity normalises. Holdings in semi-conductor and consumer discretionary companies continue to see upgrades to forecasts as the economic recovery takes hold. 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. China’s consumer industries have great growth potential given the low penetration levels in many consumer sectors, while increasing household wealth is driving consumption upgrades and industry leaders are seeing market growth, potential market share expansion and higher margins over time. The recent regulatory crackdown in China has impacted sentiment negatively and increased the risk premium across the whole market. This had 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.

The sluggish growth data and a persistent dovish slant from central banks, coupled with low US Treasury supply in July, saw sovereign bond yields broadly lower, led by the UK Gilt market. As central bankers continue to be more reactive and data-dependent, we expect volatility in bond markets to continue.

The local equity composition is well diversified, and the portfolio remains tilted towards select cyclical exposures at the expense of more defensive holdings. We still have capital, albeit less than previously, invested in global defensive companies, Naspers and Prosus, Bid Corp and Aspen Pharmacare, where there is still further scope for positive earnings revisions. These stocks also provide additional protection against any potential rand weakness. This sits alongside our allocation to global cyclical stocks (diversified miners, platinum miners, Sappi, Sasol and luxury goods maker Richemont) geared to the global economic cycle and continues 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. The South African consumer has been more resilient than the market initially feared and thus, we continue to have a healthy, growing allocation to South African banks, where earnings revisions have turned positive, and valuations are attractive. This sits alongside our exposure to apparel retailers and Motus Holdings, which display good earnings revisions profiles, trading at reasonable valuations. The exposure to local defensive businesses has previously only been through MTN Group, Pick 'n Pay Stores and Bidvest Group and has been limited as earnings revisions and valuations have not been as compelling in this space. However, in recent months we initiated positions in Life Healthcare and Netcare as the earnings revisions profile appears to have troughed given an improving occupancy profile into 2022 that results in strong positive operating leverage that the market appears to be under-estimating, in our view.

We have maintained the material allocation to local sovereign bonds especially within the context of the global fixed income universe. The South African Reserve Bank (SARB) is facing less pressure to raise interest rates (compared to central banks in countries like Russia, Turkey, Brazil and Mexico, which have already commenced hiking cycles to stem inflationary pressures) and are currently on hold. While we expect fiscal slippage from the wage bill, income grants and other fiscal support, we also expect fiscal revenues to be further supported by higher collections from corporate income tax. 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).

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