PSG Equity Fund

Quarterly Portfolio Commentary as at 31 March 2018
by Shaun le Roux and Greg Hopkins

Current context

Equity market volatility rose sharply in the first quarter of 2018, contrasting starkly with the extraordinarily benign conditions of 2017. Global equity indices have mostly given back gains after a strong start to the year. The MSCI World Index lost 1.1% over the quarter, the FTSE/JSE All Share Index lost 6% and the S&P 500 Index lost 0.8%.

Declines in US equity markets coincided with an across-the-curve rise in US interest rates: the US 10-year bond yield has risen by 40 basis points in 2018 to the current level of 2.8%. Rising developed market interest rates could pose a test to global asset prices that have been underpinned by very loose monetary conditions, particularly if we witness the return of inflationary pressures.

Due to the dramatic improvement in the domestic governance outlook, the rand continued to strengthen in 2018, extending the trend that started in November last year when it traded at R14.50 to the US dollar. This staved off a sovereign bond rating downgrade and provided the South African Reserve Bank with ammunition to cut rates by 25 basis points in March. Consequently, South African government bonds have performed well in 2018: the All Bond Index has returned 8.1%. In contrast, the domestic listed property sector had a tough quarter, losing 19.6%. This was largely as a result of the troubles within the Resilient stable, which had a very high weighting in the index.

Our perspective

We are of the view that global assets are generally trading at elevated valuation levels, especially developed market bonds and the well-owned equities with which they have been competing for capital. Indeed, long-term asset class performance needs to be seen in the context of the 30-year bond bull market that is likely approaching its end. This follows recent bouts of extraordinary and unconventional monetary stimulus, including zero interest rate policies, negative real yields and quantitative easing (bond buying by central banks). This environment has been very favourable for the prices of long-duration assets, including equities – especially equities perceived to yield more sustainable or faster-growing cash profits.

We believe that portfolio returns (on a broad basis) from these levels will be disappointing compared to the returns South African (and other) investors have become accustomed to over the past 15 years – especially after the surge in equities in 2017. Due to much higher stock prices, we have been finding fewer opportunities to buy high-quality businesses at wide margins of safety over the past year and a half.

However, we continue to highlight the dispersion in valuations within equity markets – the anomaly of current market conditions. The difference between prices paid for expensive stocks that dominate indices versus cheap, out-of-favour stocks remains at levels we last saw in the dotcom bubble. We are positive about the long-term returns that can be derived from cheaper, uncrowded opportunities.

Portfolio positioning

Our equity holdings reflect our bottom-up views of where opportunities exist. We are avoiding stocks where we consider the risk of capital loss to be high and own very few popular stocks that are large in global indices. Instead, our portfolios contain high-conviction holdings that meet our 3 M investment criteria. We have used recent negative domestic investor sentiment to acquire several domestic stocks at attractive valuations on low levels of earnings. This bodes well for long-term returns. Similarly, we have built conviction in several uncrowded global stocks and sectors where valuations are compelling. For example, the sell-off in US and UK retail property Real Estate Investment Trusts (REITs) created an opportunity to build positions in higher-quality portfolios at wide discounts to our assessments of true worth.

We run a global equity process, and the fund has a 23% exposure to direct offshore equities. As we build conviction in individual opportunities, we expect this to approach the new regulatory limit of 30%.

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We run a global equity process, and the fund has a 23% exposure to direct offshore equities. As we build conviction in individual opportunities, we expect this to approach the new regulatory limit of 30%. The fund also acquired South African government bonds (the R2037, comprising 5% of the portfolio) during the quarter. This is in accordance with our view that we expect equity-like returns from the long end of the curve, given our assessment of fixed income markets. The fund continues to hold relatively high levels of cash and near cash (20.1% domestically and 2.9% offshore).

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Our funds have no domestic listed property exposure. This is because we have been unable to identify individual opportunities where long-term returns meet our requirements.

Portfolio positioning

Equity exposures in the PSG Balanced Fund currently comprise 63% of the portfolio (23% directly offshore and 40% domestic). Changes in domestic equity holdings over the last quarter included a reduction in the aggregate exposure to South African banks (from 7.4% to 4.8%) on the back of the FirstRand group reaching values we regard as fair, rather than cheap. We also trimmed our position in Discovery on the back of valuation considerations. We have maintained a position of 11% in South African government bonds despite a re-rating, as we believe the yield offered remains compelling. Immediately liquid cash and equivalents comprise 13% of the fund, which we stand ready to deploy when opportunities arise.

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Our funds have no domestic listed property exposure. This is because we have been unable to identify individual opportunities where long-term returns meet our requirements.

Portfolio positioning

Equity exposures in the PSG Stable Fund currently comprise 36% of the portfolio (12% directly offshore and 24% domestic). Changes in domestic equity holdings over the last quarter included a reduction in the aggregate exposure to South African banks (from 4.8% to 3.3%) on the back of the FirstRand group reaching values we regard as fair, rather than cheap. We also trimmed our position in Discovery on the back of valuation considerations. We have only slightly reduced the fund's position in South African government bonds (from 15% to 14%) despite a re-rating, as we believe the yield offered remains compelling. Immediately liquid cash and equivalents comprise 27% of the fund, which we stand ready to deploy when opportunities arise.

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by Ian Scott & Paul Bosman

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We continue to believe that the domestic fixed income market offers attractive opportunities, especially longer-dated government bonds. Even after the recent decline in domestic bond yields, we expect attractive real returns given our constructive outlook for domestic inflation and improved levels of governance. The SARB's Monetary Policy Committee remains hawkish in its outlook despite the recent reduction in the repo rate, keeping real (above-inflation) rates at attractive levels for investors in fixed income instruments.

Our funds have no domestic listed property exposure. This is because we have been unable to identify individual opportunities where long-term returns meet our requirements. We also have no exposure to the credit of listed property companies, as their credit spreads trade below our calculations of fair value.

Portfolio positioning

We have been allocating client capital over the various interest rate curves that have presented us with high real yield opportunities. We still find value in the one-year and longer-dated areas of the money market curve. We are also finding selective opportunities in the longer end of the government bond curve and have added to these positions. Other investments included selective participation in bank and state-owned enterprise credit issues, where we deemed credit spreads attractive relative to our fair value criteria. We also continue to invest in local and offshore equity opportunities. However, we are turning more cautious on credit names as spreads continue to decline. We believe the fund remains well positioned for investors and savers looking for high real yields at low levels of risk.

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Performance

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Pricing

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Conflict of Interest Disclosure

The Fund may from time to time invest in a portfolio managed by a related party. PSG Collective Investments (RF) Limited or the fund manager may negotiate a discount in fees charged by the underlying portfolio. All discounts negotiated are reinvested in the Fund for the benefit of the investors. Neither PSG Collective Investments (RF) Limited nor PSG Asset Management (Pty) Limited retains any portion of such discount for their own accounts. The fund manager may use the brokerage services of a related party, PSG Securities Ltd.

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Current context

Equity market volatility rose sharply in the first quarter of 2018, contrasting starkly with the extraordinarily benign conditions of 2017. Global equity indices have mostly given back gains after a strong start to the year. The MSCI World Index lost 1.1% over the quarter, the FTSE/JSE All Share Index lost 6% and the S&P 500 Index lost 0.8%.

Declines in US equity markets coincided with an across-the-curve rise in US interest rates: the US 10-year bond yield has risen by 40 basis points in 2018 to the current level of 2.8%. Rising developed market interest rates could pose a test to global asset prices that have been underpinned by very loose monetary conditions, particularly if we witness the return of inflationary pressures.

Due to the dramatic improvement in the domestic governance outlook, the rand continued to strengthen in 2018, extending the trend that started in November last year when it traded at R14.50 to the US dollar. This staved off a sovereign bond rating downgrade and provided the South African Reserve Bank (SARB) with ammunition to cut rates by 25 basis points in March. Consequently, South African government bonds have performed well in 2018: the All Bond Index has returned 8.1%. In contrast, the domestic listed property sector had a tough quarter, losing 19.6%. This was largely as a result of the troubles within the Resilient stable, which had a very high weighting in the index.

Our perspective

Following recent bouts of extraordinary and unconventional monetary stimulus – including zero interest rate policies, negative real yields and quantitative easing (bond buying by central banks) – we are starting to witness the unwind of accommodative policies globally, and the potential impact on our local cash and government curves.

The local backdrop changed dramatically for fixed income and cash investors over the last quarter. In addition to signs of stricter governance, a fiscally prudent budget delivered in February and an improved outlook from ratings agency Moody's have contributed to a more positive environment for local fixed income markets. Recent tax increases (especially in VAT) are good news for the bond market, as higher taxes reduce government's borrowing needs in local capital markets. Indeed, we have seen National Treasury reduce the weekly supply of bonds to the market by a third. This is good news after the high borrowing levels seen over the last few years to fund the budget deficit.

We continue to believe that the domestic fixed income market offers attractive opportunities, especially longer-dated government bonds. Even after the recent decline in domestic bond yields, we expect attractive real returns given our constructive outlook for domestic inflation and improved levels of governance. The SARB's Monetary Policy Committee remains hawkish in its outlook, despite the recent reduction in the repo rate, keeping real (above-inflation) rates at attractive levels for investors in fixed income instruments.

Portfolio positioning

We have been allocating client capital over the various interest rate curves that have presented us with high real yield opportunities. We still find value in the one-year and longer-dated areas of the money market curve, but are finding fewer opportunities in the front end of the government bond curve and have reduced these positions. We selectively participated in bank and state-owned enterprise credit issues, where we deemed credit spreads attractive relative to our fair value criteria. However, we are turning more cautious on credit names as spreads continue to decline. We have no exposure to the credit of listed property companies because their credit spreads trade below our calculations of fair value. We believe the fund remains well positioned for investors and savers looking for high real yields at low levels of risk.

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PSG Money Market Fund

Quarterly Portfolio Commentary as at 31 March 2018
by Lyle Sankar

Current context

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Declines in US equity markets coincided with an across-the-curve rise in US interest rates: the US 10-year bond yield has risen by 40 basis points in 2018 to the current level of 2.8%. Rising developed market interest rates could pose a test to global asset prices that have been underpinned by very loose monetary conditions, particularly if we witness the return of inflationary pressures.

Due to the dramatic improvement in the domestic governance outlook, the rand continued to strengthen in 2018, extending the trend that started in November last year when it traded at R14.50 to the US dollar. This staved off a sovereign bond rating downgrade and provided the South African Reserve Bank (SARB) with ammunition to cut rates by 25 basis points in March. Consequently, South African government bonds have performed well in 2018: the All Bond Index has returned 8.1%. In contrast, the domestic listed property sector had a tough quarter, losing 19.6%. This was largely as a result of the troubles within the Resilient stable, which had a very high weighting in the index. Cash returned 1.76%.

Our perspective

Following recent bouts of extraordinary and unconventional monetary stimulus – including zero interest rate policies, negative real yields and quantitative easing (bond buying by central banks) – we are starting to witness the unwind of accommodative policies globally, and the potential impact on our local cash and government curves.

The local backdrop changed dramatically for fixed income and cash investors over the last quarter. In addition to signs of stricter governance, a fiscally prudent budget delivered in February and an improved outlook from ratings agency Moody's have contributed to a more positive environment for local fixed income markets. As such, we continue to believe that the domestic fixed income market offers attractive opportunities, especially cash curves and longer-dated government bonds. Even after the recent decline in domestic yields, we expect attractive real returns given our constructive outlook for domestic inflation and improved levels of governance.

The SARB's Monetary Policy Committee remains hawkish in its outlook, despite the recent reduction in the repo rate. With lower interest rates expected going forward, this means that current cash rates in the negotiable certificate of deposit (NCD) market provide attractive real yields. Treasury bills were relatively unloved towards the end of 2017, due to fears around fiscal metrics. This presented the opportunity to buy government risk at higher yields than those offered by NCDs and corporates for instruments with the same maturities.

Portfolio positioning

In light of lower interest rate expectations, the fund was close to the maximum duration of 120 days to maturity as at end March. Fixed-rate instruments comprised 59% of the portfolio, with the fund's largest asset allocation to NCDs (66%), of which 44% is invested in fixed-rate NCDs. The fund currently has limited exposure to corporate credit (5.2%), as we have been unable to identify many opportunities that exceed our internal fair value spreads as corporate issuance has slowed. Treasury bills (also fixed-rate instruments) constitute 15% of fund. We have therefore locked in the inflation-beating yields currently on offer while maintaining an internal average fund credit rating of AA and a comfortable aggregate level of fund liquidity.

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Money Market
The PSG Money Market Fund maintains a constant price and is targeted at a constant value. The quoted yield is calculated by annualising the average 7 day yield. A money market portfolio is not a bank deposit account. Excessive withdrawals from the portfolio may place the portfolio under liquidity pressures and in such circumstances a process of ringfencing of withdrawal instructions and managed payouts over time may be followed. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument. In most cases the return will merely have the effect of increasing or decreasing the daily yield but in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio.

Regulation 28
The fund is managed according to Regulation 28 of the Pension Funds Act. The South African retirement fund industry is governed by the Pension Funds Act No. 24 of 1956. Regulation 28 of the Pension Funds Act prescribes the maximum limits in asset classes that an approved retirement fund may invest in. Exposures in excess of the limits will be corrected immediately, except where due to a change in the fair value or characteristics of an asset, e.g. market value fluctuations, in which case they will be corrected within a reasonable time period.

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Declines in US equity markets coincided with an across-the-curve rise in US interest rates: the US 10-year bond yield has risen by 40 basis points in 2018 to the current level of 2.8%. Rising developed market interest rates could pose a test to global asset prices that have been underpinned by very loose monetary conditions, particularly if we witness the return of inflationary pressures. From a macro viewpoint, while the most synchronised global growth environment in 50 years and strong corporate earnings are supportive, recent geopolitical tensions and threats of trade wars have clouded the horizon.

Our perspective

We are of the view that global assets are generally trading at elevated valuation levels, especially developed market bonds and the well-owned equities with which they have been competing for capital. Indeed, long-term asset class performance needs to be seen in the context of the 30-year bond bull market that is likely approaching its end. This follows recent bouts of extraordinary and unconventional monetary stimulus, including zero interest rate policies, negative real yields and quantitative easing (bond buying by central banks). This environment has been very favourable for the prices of long-duration assets, including equities – especially equities perceived to yield more sustainable or faster-growing cash profits.

We believe that portfolio returns (on a broad basis) from these levels will be disappointing compared to the returns investors have become accustomed to over the past 15 years – especially after the surge in equities in 2017. Due to much higher stock prices, we have been finding fewer opportunities to buy high-quality businesses at wide margins of safety over the past year and a half. This is reflected in the relatively high cash levels of the fund. We consider cash one of the most uncrowded and under-appreciated global asset classes, especially when yields are low and appetite for risk is high. The inherent value of cash is never evident in times of exuberance. Its true value shows itself when volatility rises, prices fall and liquidity is in short supply.

However, we continue to highlight the dispersion in valuations within equity markets – the anomaly of current market conditions. The difference between prices paid for expensive stocks that dominate indices versus cheap, out-of-favour stocks remains at levels we last saw in the dotcom bubble. We also welcome the recent pullback in markets, as the prolonged lack of volatility provided limited market-specific opportunities to acquire quality assets at cheaper prices.

Portfolio positioning

With markets rising strongly over the first few weeks of 2018, we continued to capitalise on opportunities to harvest existing holdings that exceeded our estimates of intrinsic value. We sold out of previous stalwarts Cisco Systems, Union Pacific, Capital One and Bank Rakyat Indonesia.

However, following recent market declines, several areas of the markets have presented excellent investment opportunities. One such area has been the US retail property sector, where concerns around historic overbuild, department store issues, fears of online cannibalisation and higher interest rates have driven valuations to low levels. People tend to paint specific sectors with the same brush and while mall traffic has come under pressure, top-quality, Class A retail properties remain sought-after assets. Consequently, we have been buyers of the US-listed Simon Property Group, the world's leading retail Real Estate Investment Trust (REIT) and owner of 325 properties, including five of the US's top 10 malls. The company has compounded its distributions per share by 8.5% per year over the past 16 years and currently yields 5.1% – a spread of 2.3% over US Treasury bonds. We have also found company-specific opportunities in Japanese financials, agricultural commodity producers, oil services, shipping and domestically focused South African companies.

By consistently applying our 3 M (Moat, Management, Margin of Safety) investment philosophy, we are positive about the long-term returns that can be derived by choosing selectively from cheaper, uncrowded parts of the market.

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Feeder funds
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Our perspective

We are of the view that global assets are generally trading at elevated valuation levels, especially developed market bonds and the well-owned equities with which they have been competing for capital. Indeed, long-term asset class performance needs to be seen in the context of the 30-year bond bull market that is likely approaching its end. This follows recent bouts of extraordinary and unconventional monetary stimulus, including zero interest rate policies, negative real yields and quantitative easing (bond buying by central banks). This environment has been very favourable for the prices of long-duration assets, including equities – especially equities perceived to yield more sustainable or faster-growing cash profits.

We believe that portfolio returns (on a broad basis) from these levels will be disappointing compared to the returns investors have become accustomed to over the past 15 years – especially after the surge in equities in 2017. Due to much higher stock prices, we have been finding fewer opportunities to buy high-quality businesses at wide margins of safety over the past year and a half. This is reflected in the relatively high cash levels of the fund. We consider cash one of the most uncrowded and under-appreciated global asset classes, especially when yields are low and appetite for risk is high. The inherent value of cash is never evident in times of exuberance. Its true value shows itself when volatility rises, prices fall and liquidity is in short supply.

However, we continue to highlight the dispersion in valuations within equity markets – the anomaly of current market conditions. The difference between prices paid for expensive stocks that dominate indices versus cheap, out-of-favour stocks remains at levels we last saw in the dotcom bubble. We also welcome the recent pullback in markets, as the prolonged lack of volatility provided limited market-specific opportunities to acquire quality assets at cheaper prices.

Portfolio positioning

With markets rising strongly over the first few weeks of 2018, we continued to capitalise on opportunities to harvest existing holdings that exceeded our estimates of intrinsic value. As a result, cash levels rose to a record high of 37% towards the end of January. We sold out of previous stalwarts Cisco Systems, Union Pacific, Capital One and Bank Rakyat Indonesia.

However, following recent market declines, several areas of the markets have presented excellent investment opportunities. One such area has been the US retail property sector, where concerns around historic overbuild, department store issues, fears of online cannibalisation and higher interest rates have driven valuations to low levels. People tend to paint specific sectors with the same brush and while mall traffic has come under pressure, top-quality, Class A retail properties remain sought-after assets. Consequently, we have been buyers of the US-listed Simon Property Group, the world's leading retail Real Estate Investment Trust (REIT) and owner of 325 properties, including five of the US's top 10 malls. The company has compounded its distributions per share by 8.5% per year over the past 16 years and currently yields 5.1% – a spread of 2.3% over US Treasury bonds. We have also found company-specific opportunities in Japanese financials, agricultural commodity producers, oil services, shipping and domestically focused South African companies. We have therefore utilised some of the cash built up in the prior year. As at end March, cash comprised 28% of the portfolio, down significantly from earlier in the quarter but still high.

By consistently applying our 3 M (Moat, Management, Margin of Safety) investment philosophy, we are positive about the long-term returns that can be derived by choosing selectively from cheaper, uncrowded parts of the market. We have significant amounts of cash waiting to do so.

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Company details

PSG Collective Investments (RF) Limited is registered as a CIS Manager with the Financial Services Board, and a member of the Association of Savings and Investments South Africa (ASISA) through its holding company PSG Konsult Limited. The management of the portfolio is delegated to PSG Asset Management (Pty) Limited, an authorised Financial Services Provider under the Financial Advisory and Intermediary Services Act 2002, FSP no 29524. PSG Asset Management (Pty) Limited and PSG Collective Investments (RF) Limited are subsidiaries of PSG Konsult. PSG Collective Investments (RF) Limited can be contacted on +27(21) 799 8000; (toll free) 0800 600 168, via email assetmanagement@psg.co.za.

Conflict of Interest Disclosure

The Fund may from time to time invest in a portfolio managed by a related party. PSG Collective Investments (RF) Limited or the fund manager may negotiate a discount in fees charged by the underlying portfolio. All discounts negotiated are reinvested in the Fund for the benefit of the investors. Neither PSG Collective Investments (RF) Limited nor PSG Asset Management (Pty) Limited retains any portion of such discount for their own accounts. The fund manager may use the brokerage services of a related party, PSG Securities Ltd.

Trustees

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Additional information

Additional information is available free of charge on the website www.psg.co.za/asset-management and may include publications, brochures, forms and annual reports.