Coronavirus outbreak

Discovery Balanced fund range commentary

With the coronavirus (COVID-19) outbreak having spread beyond China, global financial markets have seen a significant increase in volatility and related sell-off. The Balanced fund range managers are constantly reviewing what the coronavirus outbreak means for the global economy and the implications for the portfolios. See the commentary below.

Market backdrop

Following a protracted period of calm and upward-trending markets in 2019, volatility has reared its head again driven by fears over the impact that the novel coronavirus outbreak may have on global economies, precipitating a sell-off in global equity markets. However, at this stage it is impossible to predict how prolonged or severe the eventual economic effects will be. Due to the fluidity of the situation, forcing governments to review their containment and management policies day by day, it is very unclear how the outbreak itself will play out; whether it can or will be contained, or how well governments and industries can handle the crisis.

It is fair to say that the market reactions we have witnessed so far have been a product of investor sentiment rather than any evidenced appraisal of the economic impacts. While the outbreak began in China and as such the infection and mortality statistics remain heavily skewed to China, significant outbreaks have now spread across the globe. In a highly interconnected world and facing a virus with such a long, contagious incubation period, this was perhaps inevitable. The fact that other world governments have had far greater warning than China may prove beneficial in managing the fallout, but that is yet to be seen.

Positively, however, the situation in China appears to be stabilising, as the rate of new infections reported by the health authorities is now falling. It seems that China may be past the worst as the government switches focus from fighting the virus to getting the economy back on track, which could influence the return of some positive sentiment in the Chinese market at least. In fact, market concerns are now focused so clearly on the spread of the disease that stocks in the rest of the world have now performed worse than Chinese equities over the year to date. For broader market positivity, we may have to wait until we see evidence of infection rates in other parts of the world similarly shift from growth to decline.

What does this mean for the Discovery Balanced fund range?

Although the volatility has had a dampening effect, the drawdowns experienced by Discovery Balanced funds have been more muted than equity markets — the Funds has benefited from its diversification given that it has exposure to different regions and asset classes.

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.

All market cycles experience bouts of underperformance for varying reasons — including short-term noise which ignores the underlying fundamentals of assets. Typically, investment views that are implemented in portfolios can take time to come to fruition. As a result, this can contribute to short-term underperformance, hence it is often important to maintain a long-term mindset before the portfolios deliver on their long-term objectives.

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 Discovery Balanced Fund 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. Therefore, the correlations between different assets are considered when constructing the portfolio and evaluating any new investment ideas to enhance risk-adjusted returns. Overall, we believe our investment process and philosophy should ensure consistency in our portfolio construction and help us navigate the challenging terrain.

Outlook

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. Policy remains supportive at the margin as most central banks have exhibited a dovish bias (although the efficacy of policy on growth and markets is increasingly being questioned), while Asian nations (China, Japan and South Korea) continue to deploy fiscal tools to support their economies — the debate around the latter strategy seems to be gathering more steam in other developed economies. We believe it is prudent to remain somewhat cautious given the potential growth impact from the Coronavirus as well as other geopolitical risks.

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 commensurate with the prevalent level of risk over the medium term. 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. The former acts as an attractive shock absorber in times of heightened market volatility and risk of material 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.

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, 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 Absa Group, FirstRand and Sanlam.

We continue to hold a sizeable allocation to local bonds. In the domestic fixed income spectrum, it remains our preferred asset class given how attractive the yield over cash is. That said, worsening local fiscal dynamics are concerning from a rating action perspective. This narrows the window in which local authorities can carry out policy reforms which can reset South Africa on a more positive trajectory in the medium term by halting and reversing the negative trend in public debt metrics, failure of which could then 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 (as we have witnessed with the 25 bps rate cut in January) given the backdrop of tepid growth. We do, however, expect the South African Reserve Bank (SARB) to remain cautious.

DISCLAIMER

Nothing contained here should be construed as financial advice.

CIS disclosures: Long only portfolios (CIS in securities)

Risks (portfolio specific)

Derivatives: There is no assurance that a portfolio's use of a derivative strategy will succeed. A portfolio's management may employ a sophisticated risk management process, to oversee and manage derivative exposures within a portfolio, but the use of derivative instruments may involve risks different from, and, in certain cases, greater than, the risks presented by the securities from which they are derived.

Exposure to foreign securities: Foreign securities within portfolios may have additional material risks, depending on the specific risks affecting that country, such as: potential constraints on liquidity and the repatriation of funds; macroeconomic risks; political risks; foreign exchange risks; tax risks; settlement risks; and potential limitations on the availability of market information. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down. Investors are reminded that an investment in a currency other than their own may expose them to a foreign exchange risk.

Money market portfolios: A money market portfolio is not a bank deposit account. A constant price (CNAV) is applied to a participatory interest. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument, and 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. Excessive withdrawals from the portfolio may place the portfolio under liquidity pressures, and in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed.

Fund of funds: A fund of funds is a portfolio that invests in portfolios of collective investment schemes (unit trusts) that levy their own charges, which could result in a higher fee structure for the fund of funds.

Feeder funds: A feeder fund is a portfolio that invests in a single portfolio of a collective investment scheme, which levies its own charges and which could result in a higher fee structure for the feeder fund.

Drawdown: The potential magnitude of loss - the largest peak-to-trough decline in returns over the period, also known as the maximum drawdown.

Liquidity: The risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss (or make the required profit).

Equities: The value of equities may vary according to company profits and future prospects, as well as more general market factors. In the event of a company default, the owners of their equity rank last in terms of any financial payment from that company.

Bonds: The value of fixed income investments (e.g. bonds) tends to decrease when interest rates and/or inflation rises. Bonds issued by major governments and companies, will be more stable than those issued by emerging markets or smaller corporate issuers. If an issuer experiences financial difficulty, there may be a risk to some, or all, of the capital invested. Any historical or current yields quoted should not be considered reliable indicators of future performance.

For a detailed description of these risks, and other risks that are relevant to the portfolio, please refer to the CIS risk disclosure document, available on the website **www.discovery.co.za**.

General

Collective Investment Schemes (unit trusts) are generally medium to long-term investments. The value of participatory interests (units) or the investment may go down as well as up. Past performance is not necessarily a guide to future performance. Collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending (i.e. borrowing and lending of assets). The manager does not provide any guarantee, either with respect to the capital or the return of a portfolio. Any forecasts and/or commentary in this document are not guaranteed to occur. Different classes of participatory interests apply to these portfolios and are subject to different fees and charges. A schedule of all fees and charges, inclusive of VAT and maximum commissions, is available on request from us or from your financial adviser. Forward pricing is used.

Redemptions

The collective investment scheme may borrow up to 10% of the market value of the portfolio to bridge insufficient liquidity. The ability of the portfolio to repurchase, is dependent upon the liquidity of the securities and cash of the portfolio. A manager may suspend repurchases for a period, subject to regulatory approval, to await liquidity, and the manager must keep the investors informed about these circumstances.

Yields

The yield for bond, income and money market portfolios is historic and is calculated quarterly.

Prices

The latest prices and TERs are published daily in the Business Report (South Africa's National Financial Daily) and are made available on our website **www.discovery.co.za**.

Performance fees

Performance fees are not levied on the portfolios.

Performance returns

Lump-sum performance returns are being quoted. Income distributions, prior to deduction of applicable taxes, are included in the performance calculations. NAV to NAV figures have been used for the performance calculations, as calculated by the Manager at the valuation point defined in the deed, over all reporting periods. Investment performance calculations are available for verification upon request by any person. Reinvestment of income is calculated on the actual amount distributed per participatory interest, using the ex-dividend date NAV price of the applicable class of the portfolio, irrespective of the actual reinvestment date. The performance is calculated for the fee class. The individual investor performance may differ, as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. The rate of return is calculated on a total return basis, and the following elements may involve a reduction of the investor's capital: interest rates, economic outlook, inflation, deflation, economic and political shocks or changes in economic policy. Annualised returns are period returns re-scaled to a period of one year. This allows investors to compare returns of different assets that they have owned for different lengths of time. All period returns greater than one year have been annualised. Returns for periods less than one year have not been annualised. A cumulative return is the aggregate amount an investment has gained or lost over time, independent of the period of time involved. Actual annual figures are available to the investor on request. Illustrative investment performance is for illustrative purposes only.

Valuations and transaction cut-off times

Pricing date is daily, except weekends and public holidays. Valuation point is at 16h00 on each pricing date, except at month-end, where it will be at 17h00. Offers to repurchase participatory interests must be received by 16h00 on each pricing date.

Additional information

For additional information on the portfolio, refer to the following documents, available on our website, from your financial adviser, or on request from the manager, free of charge.

- Application forms
- Annual report
- Fee schedule
- Quarterly General Investor Report

Complaints and conflicts of interest

The complaints policy and procedure, as well as the conflicts of interest management policy, are available on our website **www.discovery.co.za**. Associates of the manager may be invested within certain portfolios, and the details thereof are available from the manager.

Closure of the portfolio

The manager has the right to close certain portfolios to new investors, in order to manage them more efficiently, in accordance with their mandates.

Contact details

CIS Manager

Discovery Life Collective Investments (Pty) Ltd, registration number 2007/008998/07, 1 Discovery Place, Sandton, 2196, www.discovery.co.za. The manager is registered as a manager of collective investment schemes, in terms of the Collective Investment Schemes Control Act. The manager, through Discovery Holdings Limited, is a member of the Association for Savings and Investment South Africa (ASISA).

Trustee

Standard Chartered Bank (Johannesburg Branch), registration number 2003/020177/10, 2nd Floor,115 West Street, Sandton, 2196, P O Box 782080, Sandton, 2146, www.standardchartered.com/za. The trustee is registered as a trustee of collective investment schemes, in terms of the Collective Investment Schemes Control Act.

Investment Manager of the Discovery Aggressive Dynamic Asset Optimiser Fund of Funds, Discovery Conservative Dynamic Asset Optimiser Fund of Funds, and the Discovery Moderate Dynamic Asset Optimiser Fund of Funds

Riscura Invest (Pty) Ltd, registration Number 2009/015999/07, FSP number 40909, Monclare Place corner Campground & Main Road, Claremont, Cape Town, P O Box 23983, Claremont, 7735, 021 6736999.

Investment Manager of all other portfolios

Investec Asset Management (Pty) Ltd, registration number 1984/011235/07, FSP number 587, 36 Hans Strijdom Avenue, Foreshore, Cape Town, 8001, www,investecassetmanagement.com, 0860 110 161.

The investment managers are authorised financial services providers (FSP), as discretionary FSPs, in terms of Section 8 of the Financial Advisory and Intermediary Services Act (FAIS). This information is not advice, as defined in FAIS. Please be advised that there may be representatives acting under supervision.