Discovery

Discovery Target Retirement Date Funds

Market background

US Treasury bond yields continued to trade lower in July, while earnings continued to beat expectations. Market sentiment was weaker on fears stemming from growing concern of the rapidly spreading delta variant, prolonged supply chain disruptions, a cooling housing market and labour shortages, which economists see weighing on an otherwise robust recovery for the remainder of this year. China's regulatory clampdowns on its tech firms continued to weigh on investor sentiment in the region. In South Africa, civil unrest and the damage to infrastructure, property and disruption of businesses weighed on sentiment and also sparked a selloff in the rand.

Developed market equities (MSCI World Index) ended the month 1.8% higher, while emerging market stocks (MSCI Emerging Markets Index) endured a weak start to the second half, down a weighty 6.7% in light of pronounced weakness in China. Across regions, the US benchmark S&P 500 Index continued its stellar run of record highs, closing +2.3% higher for the month, while in Europe, a dovish European Central Bank (ECB) and upbeat earnings revisions fuelled bullish investor sentiment into the area's stock market (Euro Stoxx 600 Index, +1.4%). As noted earlier, Asian bourses found the going tough in July as China's crackdown weighed on risk assets; this saw mainland China's CSI 300 Index end the month down 7.4%, while the Japanese Topix also struggled, down 1% over the same period.

US Treasury yields continued to their descent to below 1.2% for the benchmark 10-year note during the month, while their European peers continued to move deeper into negative territory. The Bloomberg Barclays Global Aggregate Bond Index closed 1.3% higher for the month with investors largely pushing out the expected start of the interest rate hiking cycle following somewhat dovish comments from the US Federal Reserve (Fed), notwithstanding higher prints in inflation.

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All returns above are quoted in US dollars.

The South African stock market kicked off the second half of the year on the front foot, despite some strong headwinds, both domestically and from China, during the month. The benchmark FTSE/JSE All Share Index delivered a total return of 4.2%, while the Capped SWIX closed up 2.7% handle. At a super-sector level, resources led performance (+11.7%) while industrials eked out +0.9% and financials retreated 1.1% over the same period. Local bonds (JSE All Bond Index, +0.8%) tracked the rand lower during the month as non-residents continued to pare back positions in SA sovereigns amid social unrest and heightened fiscal concerns. Listed property (JSE All Property Index) returned to negative territory to end the month down 0.4%. Cash, as measured by the STeFI Composite Index, remained broadly stable at 0.3% for the month. In currencies, the rand depreciated against the greenback, euro, and pound sterling.

At the sector level, it was a broadly mixed picture across the bourse. Key sector leaders over the month included healthcare, which was buoyed by Aspen Pharmacare and Netcare. Consumer services delivered sound returns with the retailers and travel & leisure names managing to end on a positive note, despite the impact of the looting and destruction during the month. In basic materials, industrial metals and general mining delivered robust returns, precious metals miners (i.e., Anglo American Platinum and Harmony Gold Mining Co.) capped their best monthly gains since February this year. The mining sector was buoyed by a stronger gold price and the commencement of the reporting season, which has seen some of the major names reward investors through bumper dividends and/or share buybacks. Financials, on the other hand, found the going extremely tough in July as they tracked the weaker rand lower. Technology services and index bellwether Naspers (which holds a 29% stake in Chinese tech behemoth Tencent via its Prosus unit) was a drag on the JSE over the month as Chinese authorities clamped down on the education tech sector.

Performance review

For the month, the portfolio delivered positive absolute returns.

Key positive contributions:

- The allocation to the general mining stocks (Anglo American and BHP Group) and platinum-group metals (PGM) miners (Anglo American Platinum, Impala Platinum and Sibanye-Stillwater) performed well over the month. Performance was further enhanced by holdings in Richemont, Bid Corp and Aspen Pharmacare.
- The offshore exposure to US big Tech (Amazon, Alphabet, Facebook and Microsoft) added to performance. In addition, the allocation to quality compounders, particularly in the healthcare sector, also contributed to absolute returns.
- The allocation to the offshore component of the portfolio enhanced gains on the back of a weaker rand.

Key negative contributions:

- The position in the Naspers-Prosus stable detracted from performance over the month. The allocation to Standard Bank Group and Capitec Bank also detracted from performance.
- In the offshore selection, our exposure to Chinese equities proved to be the main detractor from performance for the month.

Portfolio activity

Within the local equity component, we banked some gains on our holding in Investec and used cash to take advantage of the attractive entry points which allowed us to add to our existing positions in ABSA Group, FirstRand and Woolworths.

Within the offshore equity component, we took profits on US banks' exposure and used the opportunity to add to quality compounders and US tech names at better entry levels during the month.

Outlook and strategy

As we have exited the early stage of the cycle and continue to transition to mid-cycle conditions, we expect volatile markets ahead but grinding higher, as we expect overall growth to remain above trend. Hopes for 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, with our tilt continuing to be towards cyclical companies where earnings have troughed and are recovering and valuations are reasonable. Our allocations to 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 regulation crackdown in China has impacted sentiment negatively and increased the risk

premium across the whole market, therefore impacting the companies we own. That said, we are comfortable that the earnings potential and trajectory of these companies remain intact and once the dust settles, we believe the investment theses will play out.

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 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 and have been adding to our exposure in 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 healthy allocation to global cyclical stocks (diversified miners, platinum miners, Sappi, Sasol and luxury goods maker, Richemont) geared to the global economic cycle and which continue 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 had feared and we therefore continue to have a healthy, growing allocation to SA banks, where earnings revisions have started to turn positive, and valuations are attractive. This sits alongside our exposure to apparel retailers and Motus Holdings which have good earnings revisions profiles, trading at reasonable valuations. Exposure to local defensive businesses historically been via 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 have initiated positions in Life Healthcare and Netcare, as the earnings revisions profile appears to have troughed on the back of an improving occupancy profile into 2022, which should result 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 SARB is facing less pressure than other emerging market central bankers 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 believe bonds are supported by attractive valuations versus their own history as well as against emerging market 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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