Discovery

Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

Financial markets endured extreme volatility in the first quarter (Q1,) notably from late February after Russia initiated military action against Ukraine. Western governments responded with sanctions on the Russian state and some individuals linked to the state machinery. Prior to this, the market had been focused on the potential for aggressive central-bank interest-rate hikes to address high inflation in Europe and the US. Developed market stocks (MSCI World Index) recouped some losses in March but still ended the quarter down 3.0%, while emerging market stocks (MSCI Emerging Markets Index) extended losses, down 5.0% over the period. Regionally, the US benchmark S&P 500 (-4.7%) and Euro Stoxx 600 (-8.13%) both rounded off their first quarter in the red since the Q1 2020 selloff, with the latter impacted by the economic implications of geopolitical turmoil and scorching inflation. In Asia, China's blue-chip CSI 300 Index (-13.5%) and Japan's Topix (-7.5%) struggled in Q1 as both countries wrestled with the highly virulent Omicron variant on top of geopolitical headwinds. Fixed Income markets had one of the most brutal selloff quarters amid higher inflation expectations and more hawkish central-bank rhetoric in response. The Bloomberg Barclays Global Aggregate Bond Index (which measures total returns of sovereign and corporate debt) has thus far capped the biggest drawdown since the Global Financial Crisis and was down 6.2% over Q1. All returns are quoted in US dollars.

Meanwhile, South Africa's equity markets have had a notably strong start to the year. The benchmark FTSE/JSE All Share Index (ALSI) rose 4.6% over Q1, while the Capped SWIX fared better, up 6.7%. South Africa has been one of the best performing markets year to date, particularly when accounting for the rand strengthening 9.2% against the US dollar, thus boosting returns in dollar terms. At a super-sector level, it was a consistent theme of resources (+19.0%) and financials (+16.7%) driving performance, while industrials struggled throughout, declining -3.1%, weighed down by the Naspers-Prosus stable underperforming. The local bond market (JSE All Bond Index) capped consecutive months of gains and in dollar terms was the second best-performing among emerging market peers as yields remained attractive to foreign investors. Despite paring back some losses in March, the listed property sector

Discovery Life Investment Services Pty (Ltd): Registration number 2007/005969/07, branded as Discovery Invest, is an authorised financial services provider.

struggled for most of the quarter, down 1.6%. Cash, as measured by the STeFI Composite Index, returned 1.03% for the quarter. In currencies, the rand was one of the best-performing EM currencies behind the Brazilian real over the quarter, up 9.2% against the US dollar.

Performance review

For the quarter, the portfolio delivered negative absolute returns.

Key positive contributions:

- On the local front, South African banks, platinum-group metals (PGMs) miners (Anglo American Platinum and Impala Platinum) and diversified miners (Anglo American, BHP Group and Glencore) contributed strongly to performance over the quarter. Performance was further enhanced by holdings in MTN Group, Sappi and Sanlam.
- In a weak quarter for global equity markets, the offshore equity component benefitted from exposure to oil and healthcare companies.

Key negative contributions:

- The allocation to Naspers and Prosus came under pressure over the quarter. Positions in Mondi and Quilter also weighed on performance.
- In the offshore portion of the portfolio, it was the exposure to Chinese and European equities that was particularly detrimental to returns.
- The overall allocation to the offshore component of the portfolio detracted due to a stronger rand.

Portfolio activity

Earlier in the quarter, we trimmed our exposure to offshore equities in favour of local equities, as the bottom-up opportunities in the South African market were stacking up stronger than those we were seeing offshore.

Given the large price spike around the speculation on Russian supply being sanctioned (with our channel checks suggesting that metal was flowing freely), we exited commodity ETF positions in platinum and palladium, while also taking some profits on positions in PGM miners (Anglo American Platinum, Impala Platinum and Northam Platinum). We trimmed the allocation to diversified miners (Glencore and Anglo American) into strength. We used the proceeds to add to our position in gold miners (AngloGold Ashanti and Gold Fields) and British American Tobacco. On the back of strong performance, we also banked some gains by exiting the position in Bidvest Group and trimming some exposure to the SA Banks. The proceeds were used to top up existing holdings in Sanlam, Mondi and

Investec, which were offering attractive entry points. We also topped up the allocation to SA bonds on valuation grounds.

Within the offshore equity component, we continued to add to existing holdings in the healthcare and utilities sectors at the expense of more cyclical exposures in the financials, consumer discretionary and semi-conductor sectors.

Outlook and strategy

Looking forward, we are monitoring the unfortunate events in Russia/Ukraine and its impact on the inflation and growth outlook. With supply chains attempting to normalise post the COVID-related disruptions, they have been further disrupted due to the geopolitical events with the resultant upward pressure on the inflation outlook. This is likely to have a negative impact on growth and also creates an issue for the US Federal Reserve policy actions as they have to tighten financial conditions at a faster pace.

To navigate through this, we continue to have 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, which is driving us to moderate our exposure to pro-cyclical assets in favour of more defensive assets.

The offshore allocation to equity has been reduced (some in early January and then some in early February) and we continue to prefer SA equity. In the context of a rising interest rate environment and potential quantitative tightening, one cannot rely on the expansion of valuations to contribute to returns. Earnings and dividends will drive the bulk of the return for investors in that backdrop. The South African equity market has more valuation support as it did not enjoy the multiple expansion seen in Developed Markets. This, coupled with strong earnings revisions profiles across our holdings, has tilted the portfolio to the domestic market.

Regionally, in our offshore equity allocation, we continue to have a positive skew towards Asia as Chinese markets continue to exhibit reasonable valuations after the high risk premium embedded in the stocks post the regulatory crackdown in 2021, while earnings have substantial upside over the medium term, in our view. The Chinese government policy is on an easing path versus the US, where policy is being tightened over the year. We have also trimmed our overall exposure to cyclicals (taking some profits in the financials and consumer discretionary sectors) in favour of more defensive compounder companies in the healthcare and utilities sectors.

The local equity composition is well diversified, and the portfolio remains tilted towards select cyclical exposures at the expense of more defensive holdings. Our defensive exposure is in our holdings in the Naspers-Prosus stable, where earnings revisions appear to be troughing and sentiment is weak. We also continue to build a position in British American Tobacco, where we believe the earnings revisions,

profile is at an inflection point, as the loss-making businesses start to improve, as well as the business being in a position to signal potential share buybacks going forward. Additionally, we have topped up our exposure to Gold Fields. This sits alongside an allocation to global cyclical stocks (diversified miners, Sappi, Mondi, and a reduced allocation to Sasol and luxury goods maker, Richemont) geared to the global economic cycle and continuing 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. We also continue to have a healthy allocation to South African banks, where earnings revisions are strongly positive (with recent results confirming our investment case), and valuations are attractive. This sits alongside our slightly reduced exposure to select apparel retailers which display good earnings revisions profiles and trading at reasonable valuations. The South African consumer has proven to be more resilient than the market initially feared, but caution is warranted as there is a lack of momentum in the labour market. Our exposure to local defensive businesses has increased steadily over the past 12 months. This is mainly via holdings in MTN Group, Life Healthcare and Shoprite, as we exited our position in Bidvest, as the earnings revisions have overshot our expectations. The earnings revisions profile of Life Healthcare appear to have troughed on the back of an improving occupancy profile into 2022, which results in strong positive operating leverage that the market appears to be underestimating, in our view. We also continue to have a position in Shoprite holdings where they continue to take meaningful market share through their Checkers brand, as well as evidence of improved capital allocation by the management team that bodes well for future returns.

We continue to maintain the material allocation to local sovereign bonds, especially within the context of the global fixed income universe. Within fixed income, South African government bonds continues to perform relatively well, and we believe the high income will continue to buffer the asset class through volatility from global fixed income markets. The South African Reserve Bank will continue its hiking cycle into a normalised neutral rate for South Africa. Growth is likely to revert to trend, and we continue to look for signs on investments in the power sector and consumption supported by a normalisation in employment. With higher soft commodity and oil prices, we do see some upside risks from second-order effects to headline inflation. Terms of trade are currently still supportive for the rand but the currency is fairly valued now. Overall, we expect this to be a supportive environment for domestic investments.