Morningstar Investment Management South Africa
Monthly Market Commentary

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Victoria Reuvers
Portfolio Manager

Markets in review: what happened in December that was important?

Hello 2018, another exciting year that promises to keep us on our toes. If you are feeling slightly jaded and confused from 2017, you are not alone. The year was thick with scandals in both the public and private sectors, and as the year drew to a close, commentators were so intently focused on the ANC elective conference that they were seemingly blindsided by the Steinhoff debacle.

Yet, despite all of the above, South African investors were rewarded for investing in domestic equities, bonds and listed property in 2017 – proving the importance of diversification – as each asset class outperformed cash for the year. Specifically, over 2017, the JSE All Share Index returned 20.9%, Listed Property 17.2% and SA Government Bonds 10.9%. These were all meaningful gains that exceeded cash returns of 7.5%. This emphasizes the benefits of time in the market rather that timing the market, which is fraught with possible behavioural missteps and ultimately drives investor outcomes.

The three notable market movements in December were:
Steinhoff – The company's share price plummeted by 91.7% in December alone, with the collapse precipitated by news of investigations into accounting irregularities and the subsequent resignation of the now infamous CEO, Markus Jooste. We still don't know the real extent of exactly what will be uncovered, but we know for certain that the market does not like being lied to.

The Rand – The local currency gained 10.6% in December as market participants cheered in response to the election of Cyril Ramaphosa as Party President at the 54th ANC elective conference. In fact, the strength of the rand marks the second best monthly performance versus the US dollar since 2000.

SA Government Bonds: Domestic government bonds were the top performing domestic asset class in December, returning 5.7%. This represents the highest monthly return since January 2015 and the fifth best monthly return for the asset class since 2000. The strong rally implies that the market is now pricing in rapid fiscal consolidation and a possible avoidance of a Moody's credit rating downgrade (as well as a possible S&P upgrade) in 2018.

What impact did this have?

The impact of the calamitous collapse of the Steinhoff share price on portfolio returns was limited. While we cannot predict what will unfold from here, and therefore remain focused only on factors within our control. It is thus extremely important that we draw full benefit from portfolio diversification and stay true to our investment discipline to deliver long term real returns for investors.

Outside of Steinhoff, our healthy exposure to global assets has continued to benefit portfolios. Meaningfully, global equities continue to deliver solid returns within a favourable global economic backdrop that has promoted ever high levels of positive investor sentiment. While this has undoubtedly benefitted investors, we note that the sharp currency strength in December reversed some of these gains in rand terms.

Even within fixed income, allocations to duration and interest rate sensitive assets within Portfolios remain conservative in nature while reflecting exposure that is commensurate with individual risk budgets. Pleasingly, our allocation to listed property and fixed income assets contributed positively to the Portfolio performance this quarter.

Looking forward – the bigger picture

While asset prices now reflect a marked turnaround in confidence and sentiment over the past few weeks (albeit from very low levels), we remain cautious on premature assessments of the positive impacts that are thought to stem from of the change in the ANC's leadership.

For investors, this backdrop is better thought of in terms of value, risk and diversification.

- **Value.** The economy is not the market. What matters greatly to us is to not overpay for a stream of long-term cash flows. Many domestically-focused businesses remain out of favour due to the persistent gloomy economic outlook in South Africa in recent times. With the possibility of policy reform geared towards the goal economic growth, we are aware (albeit with a pinch of caution) of any unlocking that could potentially materialize from purchasing these assets well below fair value.

- **Risk**. Risk is the probability of falling short of one's objectives. This often means the risk of a permanent loss of capital, and in buoyant market conditions, we must not be distracted by any euphoric claims or the general feeling of calm. Our process is aims unlock value from unloved areas by focusing on what we can control – incorporating a disciplined approach and with a long-term outlook.

- **Diversification.** While value exists in certain areas of our market, we are conscious of staying true to our disciplined investment process, thereby minimizing the ill effects that behavioural biases can have on investor outcomes. Our asset allocation framework provides a tried and tested method for building portfolios that are not reliant on individual market outcomes. Our view is that a diversified portfolio tilted towards asset classes with higher expected returns, within appropriate risk constraints, provides the best chance of reaching our investors' objectives.

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+ t: (0)21 446 8300 + e: www.morningstar.co.za + 2nd Floor, Clock Tower Office Suites, V&A Waterfront, Cape Town, 8001, South Africa

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