Quarterly Commentary

M&G Investments

M&G SA Equity Fund

Equity

Q1 2024

Market overview

The first quarter of 2024 (Q1) brought a continuation of the relatively bullish investor sentiment towards global equities seen in the last months of 2023, as prospects for growth in the US were buoyed by positive company earnings reports and supportive economic data that increased the likelihood of a "soft landing" for the economy. On the other hand, global bonds were weaker as inflation proved higher than expected and major central banks kept interest rates on hold, prompting pundits to move out their rate cut expectations to the second half of the year. Still, they and the US Federal Reserve are roughly aligned in their forecasts of a 25bp interest rate cut in each of Q2, Q3 and Q4, starting at the Fed's 11-12 June FOMC meeting.

The Japanese and US equity markets were the stand-out performers, while the UK disappointed and China continued to experience losses, although the magnitude of these fell as the quarter progressed, helped by small gains in March. Emerging markets were broadly in the red, with the exception of India, and South African equities remained in the doldrums on the back of slow growth and the approaching May national elections.

Global equity (as measured by the MSCI ACWI) delivered a total return of 8.2% in Q1 compared to 11.0% in Q4, while developed market equities produced 8.9% and emerging market equities returned only 2.4% (MSCI Emerging Markets Index – all in US$). Global bonds posted -2.1% (Bloomberg Global Aggregate Bond Index, in US$). In South Africa, the FTSE/JSE All Share Index and Capped SWIX Index underperformed, both delivering -2.3% in rand terms. The local market was dragged down by a 7.6% loss in Financials, while Industrials returned 0.6%, Resources 0.8% and Listed Property 3.5%, the latter continuing its rally from the previous quarters.

South African bonds recorded a -1.8% return for the quarter. This saw the yield on the 10-year SA government bond rise to 12% by quarter-end. Meanwhile, the rand lost 3.5% against the US dollar, 2.7% versus the UK pound and 0.9% against the euro.

At its March policy meeting the SA Reserve Bank voted unanimously to keep the repo rate steady at 8.25%, as expected. Governor Lesetja Kanyago remained hawkish regarding stubbornly high inflation (with CPI rising to 5.6% y/y in February from 5.3% y/y in January, well above the expected 5.4% y/y) and relatively high inflation expectations for 2024 among businesses and consumers. The economy managed to eke out growth of 0.1% (q/q annualised) in Q4 2023, worse than expected, for an annual rate of 0.6% for 2023 as a whole. The SARB has projected GDP growth at 1.2% in 2024 and 1.3% in 2025, the acceleration due largely to improved electricity supply. Equity returns remained depressed by the country's low growth prospects and uncertainty over the upcoming national elections, both of which are keeping foreign investors on the sidelines.

Performance

The fund delivered a return of -2.8% (net of fees) for the first quarter of 2024, slightly underperforming its benchmark which delivered a return of -2.3%. For the 12 months ended 31 March 2024, the fund returned -0.3% (net of fees), underperforming its benchmark by -3.1%. It is particularly pleasing to report that over the 3-year period ending 31 March 2024, both the absolute and relative performance of the fund has been strong, with an absolute return of 8.5% per annum over this period, outperforming the benchmark by 1% per year.

The fund's overweight investment in the Multichoice Group was a major contributor to performance for the quarter. We think the company is very attractively valued and has also caught the attention of Canal Plus which operates a similar business in French-speaking Africa. French-based PayTV operator, Canal Plus, has been steadily increasing its shareholding in the company, recently lifting it above 35%, thus voluntarily triggering an offer to minorities. Negotiations between Canal Plus and the Multichoice board have resulted in the French operator increasing its offer, from R105 to R125, for all the shares it does not already own in Multichoice.

Multichoice retains a quasi-monopoly over sports rights in South Africa, ensuring it continues to maintain relevance for its subscribers in SA and rest of Africa. The SA subscriber base growth has slowed, but remains a cash generative business, while the Rest of Africa continues to scale its subscribers and drive towards sustained profitability. Multichoice's overall subscriber base gives it a dominant position in its core markets and enables it to continue to outbid competitors for key content broadcast rights.

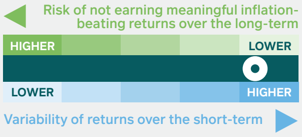
Similar to MTN, the recent sharp devaluation of the Nigerian Naira has been a setback for Multichoice, with a need for tariff increases to offset the rise in hard currency content costs and satellite transponder leases. Cost-cutting initiatives are underway to cushion the impact. Furthermore, loadshedding in South Africa has had a negative impact on the South African subscriber's ability to watch TV, leading to them suspending the service and an associated loss of revenue. As a result, profitability and earnings expectations for the current year have had to be lowered and this has negatively impacted the share price this year.

Annualised performance	B class	Benchmark[1]	F class
1 year	0.9%	2.9%	-0.3%
3 years	9.7%	7.5%	8.5%
5 years	8.0%	7.6%	6.8%
7 years	7.6%	6.3%	6.3%
10 years	7.3%	6.2%	-
20 years	14.0%	12.7%	-
Since inception	14.3%	12.5%	-

[1] The Fund's benchmark changed from the FTSE/JSE All Share Index (TR) to the FTSE/JSE Capped SWIX All Share Index (TR) on 1 July 2017.

Sources: M&G Investments, Morningstar & Deutsche Securities

Risk profile


Risk of not earning meaningful inflation-beating returns over the long-term
HIGHER
LOWER
LOWER
HIGHER
Variability of returns over the short-term

Fund facts

Fund managers

Ross Biggs
Chris Wood
Leonard Krüger
Aadil Omar

ASISA category

South African - Equity - General

Benchmark

FTSE/JSE Capped SWIX All Share Index

Inception date

21 September 2000

Fund size

R41 758 075 907

We have maintained our position in Multichoice with the current share price trading at a discount to the Canal Plus indicative offer of R125, and one is arguably only paying for the group's profitable South African business, with no value being attributed to Rest of Africa or its other investments (sports betting, Irdeto technology and Showmax).

Our overweight position in British American Tobacco (BAT) was the second largest relative contributor to performance for the quarter. We believe that the investment case remains very strong as the company is trading with an exceptionally attractive dividend yield of 9%. We anticipate continued strong cash flows from BAT to drive a repayment of debt, enable significant share repurchases, as well as continue to fund investment into next generation low risk products. BAT has also been able to recently take advantage of its very highly rated Indian associate company, ITC, by selling down approximately 4% of its stake, such that it still owns 25% of ITC. Due to the exceptionally high rating of ITC, the 4% sale raised approximately GBP 1.5 billion. This sale has enabled BAT to reduce debt and restart its share buyback programme. Shareholders are therefore receiving an exceptionally attractive 9% dividend yield as well as a share buyback program to further enhance this yield.

BAT is at the forefront, together with Philip Morris International, of offering its customers alternative products which reduce harm, and we expect this trend to continue. We think that BAT can continue to grow profits while helping its customers switch to much lower-risk and less harmful products. We think BAT is a high yielding "insurance"-like asset due to its defensive cash flows.

The fund's investment in Richemont was the third largest contributor to performance over the quarter. The market has been concerned around the slow economic recovery in China and the possibility of a recession. As these concerns have receded recently, so Richemont has rerated sharply.

Richemont's sales were surprisingly resilient over the COVID period and have been growing well above expectations since then, especially at the watch and jewellery maisons of Cartier and Van Cleef and Arpels. We think that these are exceptionally strong brands and that their brand value with consumers has never been higher. In particular, sales of Richemont products in the United States have been exceptionally strong and Richemont has been having to expand retail capacity to meet demand. With recovery underway post the COVID lockdown, we are likely to see even higher sales. We think that the sales growth is likely to continue to lead to improving margins, earnings and dividends ahead of what we consider are conservative market expectations. The company has an exceptionally strong balance sheet with a substantial net cash position. We think that cash flows and dividends from Richemont will be a lot higher in five years' time. After many years of restructuring the watch businesses inside the company, there is potential for this business to surprise the market on the upside.

The fund's overweight position in MTN was the largest detractor from performance over the quarter. The market has been very concerned about the risks of doing business in Nigeria, where MTN has a significant business. While we do not disagree that investing in Nigeria requires a higher risk premium, we think that MTN presents excellent value and continues to be one of the larger overweight positions in the fund. MTN is trading on a dividend yield of over 6%, which we think should be able to grow over the next five years. MTN has been steadily reducing debt levels on its balance sheet by realising non-core assets like their tower assets. We think that this process will not only ensure a stable and growing dividend but will also reduce any balance sheet risk. Our investment thesis for MTN has not changed, but we do acknowledge the Naira has devalued more than we had initially anticipated. In our opinion, the current MTN Group share price is attributing little, if any, value for MTN Nigeria, despite it historically being the group's largest contributor to both operating profit and group value. The market has chosen to focus on the near-term negative impacts of the weaker Naira on MTN Nigeria's operating costs – primarily its tower leases – and appears to assume that none of the increased cost can either be recovered from the consumer or shared with its service providers. Our view, based on what transpired in MTN Ghana post a similar sharp currency devaluation in 2022, is that profit margins in Nigeria will recover, both through renegotiation of tower lease contracts and regulatory approval for an industry-wide tariff increase. The underlying demand for voice and data services continues to be robust across most of MTN's markets, including Nigeria, while there is upside opportunity from the scaling of the group's mobile money offering.

The other main detractors from performance were both in the resources sector. Our overweight position to Exxaro detracted from performance. We think Exxaro is exceptionally attractively valued relative to the cashflows it receives from its stake in the Sishen Iron Ore Company and its large coal business mainly supplying coal to Eskom power stations. Coal prices were elevated post the start of the war in Ukraine, enabling significant cash flows and outsized dividends to shareholders. On the ESG front, we have been very engaged with Exxaro to understand their coal transitions and how they are utilising the cash flows from thermal coal to invest in renewable energy and the potential opportunities and risks to invest in battery commodities.

Also detracting from performance this quarter was the fund's underweight to the gold sector and in particular, Harmony Gold. We tend to be underweight to the gold sector over the long term in this fund, due to the very poor cash flows generated by gold companies and consequently the very poor dividend growth that gold companies have exhibited over a long period of time. We have also been concerned that the gold price faces significant headwinds given the substantial rise in real interest rates over the last two years in the US, where real rates have moved from negative 1% to positive 2%. We have, however, witnessed a substantial increase in the purchase of gold by central banks, particularly the People's Bank of China, over the last two years, which we think has caused a dislocation between real interest rates and the gold price. The fund does hold substantial positions in Anglogold and Gold Fields and we have reduced our underweight to the gold sector.

We have generally been reducing risk within the Resources sector, having reduced our underweight to the gold sector and our overweight position in Sasol to a slight underweight position. While Sasol's earnings are being supported by oil prices, chemical prices and refining margins have fallen substantially. While Sasol is currently paying a high dividend yield, we are concerned that the dividend may be cut due to cash flows coming under pressure over the next five years, given the substantial capex projects required to transition the business to reduced carbon emissions.

It is worth mentioning that when we construct our portfolios, we

Sources: M&G Investments, Morningstar & Deutsche Securities do not do so based on a particular view or outcome as we think it is not possible to consistently predict what oil prices or inflation rates might do… or when and where countries may go to war for instance. We rather look to construct portfolios with many different and diversified ideas, all which we think have favourable pay-off profiles. In this way, we hopefully have portfolios which can deliver good returns under many different economic environments.

We acknowledge that while it is very difficult to forecast the future and we do not make any attempt to do this, we do spend a lot of time thinking about the economic cycles that various sectors are in, and where valuations are. In this way, we aim to make money for our clients through these cycles and continue to try and buy companies that have proven dividend and cash-flow track records, and which can withstand the normal upheavals that occur in markets over time. We aim to continue building risk-cognisant portfolios that seek to add value through stock selection relative to the benchmark.

Strategy and positioning

We remain optimistic regarding the South African equity market's returns over the medium term due to the prevailing excessive levels of pessimism reflected in share prices and valuations. The price-to-book value ratio of the JSE remains close to 1.7X as at the end of March 2024, which we think is a very attractive valuation level. We also note that within the South African market, many commodity companies are starting to see material declines in their revenues and earnings from elevated levels, as the prices of platinum group metals and coal have fallen materially.

South African assets appear to be undervalued relative to emerging and developed markets. We do, however, highlight the risk of rising interest rates and bond yields in the United States and many developed and emerging markets. While South African bond yields are already elevated and remain attractive, we think that rising bond yields in the US present headwinds to equity valuations. The hurdle rate has increased. This higher rate not only decreases equity valuations, but also increases the real financial risk to companies via a higher cost of debt.

The focus of the fund continues to be on finding companies that are undervalued and which can grow earnings and dividends over the long run. □

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Application forms

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Sources: M&G Investments, Morningstar & Deutsche Securities