Portfolio description and summary of investment policy
The Portfolio invests in the cautious mandates of a minimum of three managers, all of which are managed to comply with the investment limits governing retirement funds. The Allan Gray Stable Portfolio has a target allocation of 35% (excluding cash) in the Multi-Manager Portfolio. This allocation can change as a result of performance within pre-defined parameters. The Portfolio is a pooled portfolio offered by Allan Gray Life and is only available to members of the Allan Gray Umbrella Pension Fund and the Allan Gray Umbrella Provident Fund (collectively known as the Allan Gray Umbrella Retirement Fund).

Portfolio objective and benchmark
The Portfolio aims to provide a high degree of capital stability and to minimise the risk of loss over any two-year period, while producing long-term returns that are superior to bank deposits. The Portfolio's benchmark is the Consumer Price Index, plus 3%.

How we aim to achieve the Portfolio’s objective
We have selected managers with a strong track record who have consistently executed on their investment approach over time. These managers have complementary investment styles which, when combined appropriately, should improve the Portfolio’s potential to deliver returns through different market cycles.

Suitable for those investors who
- Are risk-averse and require a high degree of capital stability
- Seek both above-inflation returns over the long term, and capital preservation over any two-year period
- Require some income but also some capital growth
- Wish to invest in a portfolio that complies with retirement fund investment limits
- Wish to diversify risk across multiple managers

Annual management fee
Each underlying manager charges a fee within their portfolio. Where performance fees are charged, this is based on the performance of the portfolio compared to its benchmark. The benchmarks of the underlying portfolios may differ from the benchmark of the Portfolio. Allan Gray charges a multi-management fee based on the net asset value of the Portfolio, excluding the portion invested in Allan Gray portfolios. This fee is 0.20% p.a. (which equates to approximately 0.13% p.a. on the entire Portfolio) and is included in the fee below.

Fee for performance equal to the benchmark:
- 0.62% p.a.
Quartely commentary as at 30 September 2020

Data released in September reflected the devastating impact of the COVID-19 pandemic on our economy. GDP contracted by 17.5% in nominal terms over the second quarter, while more than 2 million people lost their jobs. As a result of more countries relaxing lockdown restrictions, many are experiencing a second wave of COVID-19 infections. However, its severity seems to be less dire than the first with the possibility of economy-damaging lockdowns less likely. For the businesses that survived the shut-down, most are now free to operate. The higher demand for precious metals and stronger iron ore prices have boosted our mining sector production and exports. Agriculture, which bucked the trend during lockdown, continues to support a likely trade surplus. Some clothing retailers have re-evaluated their supply chains and, to be more resilient in the future, have gone on a shopping spree to buy local clothing and textile manufacturers. Sectors that are sensitive to the domestic consumer and economy continued to suffer.

The South African Reserve Bank dropped interest rates by a further 25 basis points (bps) in July, bringing the total rate cuts for the year to 300bps. This should ease the debt burden for many households and businesses, and in theory there should be more to spend on consumption and investment, which should aid economic growth. However, with the reduction in rates comes a lower yield offered by cash which is evidenced by the 3-month Jibar now trading below the repo rate of 3.5%. The FTSE/JSE All Bond Index (ALBI) returned 1.5% for the third quarter of 2020 (Q3) with longer-dated bonds and inflation-linked bonds performing poorly over the last 12 months.

During Q3 the FTSE/JSE All Share Index (ALSI) returned 0.7% with the Resources sector contributing approximately 6% to its return. Both Industrials and Financials detracted from the ALSI’s returns. Over the same period, the rand strengthened by 3.9% which would have diluted the returns generated by the multinationals listed under the Industrials sector (e.g. Naspers and British American Tobacco) and offshore investments. Of the Financials, the insurers performed poorly while banks delivered a positive return. The Property sector delivered double-digit negative returns of -14%, bringing its year-to-date return to -48% as at 30 September 2020. The global equities sector, as measured by the MSCI All Countries World Index, recovered all its losses for the year delivering a return of 8% in US dollars.

The Portfolio returned 0.7% for the quarter and 3.4% over the last year, outperforming inflation of 3.1%. However, the Portfolio has found it difficult to outperform its inflation-plus benchmark since its inception in January 2019, as very few asset classes have delivered inflation-beating returns. Contributions to returns over the quarter came from the Portfolio’s holdings (on a look-through basis) in local fixed interest, commodities, and local bank stocks while three of the Portfolio’s top four local shares, along with property and Africa ex-SA holdings, detracted.

During the quarter Allan Gray increased its exposure to local bonds (longer-dated and inflation-linked) from its cash holdings while Coronation increased its local equity exposure, mainly rand-hedge shares. The largest aggregate asset class exposure remains local bonds at 32%. However, the difference in investment views and styles can be evidenced by Nedgroup Investments’ allocation of 22% versus Coronation’s of 47%. Commentaries from two of the underlying fund managers follow.

Commentary contributed by Shaheed Mohamed
Allan Gray Stable Portfolio

The Portfolio’s performance over the past year has been disappointing. We aim to achieve a return that exceeds inflation by at least 3% with a high level of capital stability. At end September, the Portfolio return was 0.9% compared to inflation at 3.1%. This recent underperformance has weighed on the longer-term Portfolio return, with the three-year number now only slightly above inflation.

The premise of the Portfolio construction is a large weighting towards cash and bonds for downside protection, with a modest allocation to equities to capture the equity risk premium and generate real returns. Equity weight varies on the relative attractiveness of shares at any given point, with share selection based on our bottom-up stockpicking process.

The negative return from local equities has been a material detractor from the overall Portfolio return. In comparison, the FTSE/JSE Capped SWIX Index has returned -5% over the last year, recovering the bulk of the loss incurred in the sell-off in the first quarter of 2020. This recovery has been largely attributable to the large dual-listed and rand hedge companies, with the share prices of more domestically focused businesses still well below where they started the year.

The outlook for South Africa remains very uncertain and we aim to position the Portfolio for different scenarios. Companies that are more geared to the local economy account for approximately 14% of Portfolio. In the event of a more favourable outcome for the country, we believe there is material upside to this exposure, as share prices revert to fair value.

The 11% rand return from the Portfolio’s offshore investments should be viewed in the context of the MSCI World Index returning 10% (in US$) and the rand weakening 11% over the last year. Similar to our experience locally, stock selection by our offshore partner, Orbis, has detracted from performance. The recovery in foreign stock markets, particularly in the US, has been driven by an increasingly narrow set of shares. Indeed, the top five shares in the S&P 500 dominate even more today than in 2000, at the height of the tech bubble. The collection of shares that Orbis is invested in looks very different from the headline stock indices. In their view, these companies have similar or better fundamentals than the wider market but trade at steep discounts, providing a greater margin of safety. Given the market’s high starting valuation, this augurs well for future long-term outperformance.

The Portfolio’s local fixed interest assets have added value relative to the 3.6% FTSE/JSE All Bond Index return in the past year. The most significant recent change in asset allocation has been a move out of local cash into bonds, owing to the relative attractiveness of returns on offer. The difference between short- and long-term interest rates is at historic levels, reflecting the rapid deterioration in South Africa’s finances and doubts on whether the government can salvage a measure of fiscal discipline. We are cognisant of the risks, and while the Portfolio has increased its duration, we continue to tread with caution.

Coronation Inflation Plus

The Portfolio has steadily increased its global effective exposure from the beginning of the year to 26% currently. We have mainly increased our holding of global equities as the other asset classes look expensive (global bonds) or face structural headwinds (global property). While certain equity indices, such as the US S&P 500, look expensive and have rallied hard from the bottom, it has been a narrow market with a few shares delivering the bulk of the performance. There remain many compelling valuation opportunities in the broader market. We have also increased our equity allocation on the local side. Most of our exposure is to attractively valued rand hedge shares, such as British American Tobacco and Anheuser Busch InBev. Despite SA’s ban on the sale of alcohol and tobacco during the hard lockdown period, these businesses have generally managed to trade their products in many other countries. We think these businesses are defensive and can show real revenue and earnings growth in hard currencies over the medium term.

We have also been adding to domestic businesses that we think have resilient franchises, healthy balance sheets and can deliver earnings growth in a constrained economy. Low expectations are baked into market prices and if we see a better than anticipated recovery in earnings bases, we think there will be a robust real performance from our selected basket of equities. The Shoprite share price appreciated 30% during the quarter and contributed meaningfully to performance. We remain positive on the prospects for this high-quality business and have maintained a sizeable position in the Portfolio.

The increase in global and local equities has been funded from our SA fixed income allocation. SA bonds still offer very attractive real yields, especially in the long end of the curve, and the Portfolio still has a healthy allocation to a mix of government bonds, inflation-linked bonds and corporate credit. But we also recognise that a rising government debt burden and widening fiscal deficit will require some serious intervention by the finance ministry.

We remain very cautious on SA property and have not increased our exposure here. Most real estate companies entered the COVID-19 crisis with stretched balance sheets. Pressure on net rental income is likely to intensify and we think a capital restructuring will be necessary for many counters. We had a small allocation to SA property, and we have seen a significant de-rating of this sector. Despite this, we don’t think valuations are compelling enough to increase our allocation.
Disclaimer
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FTSE/JSE All Share Index and FTSE/JSE All Bond Index
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