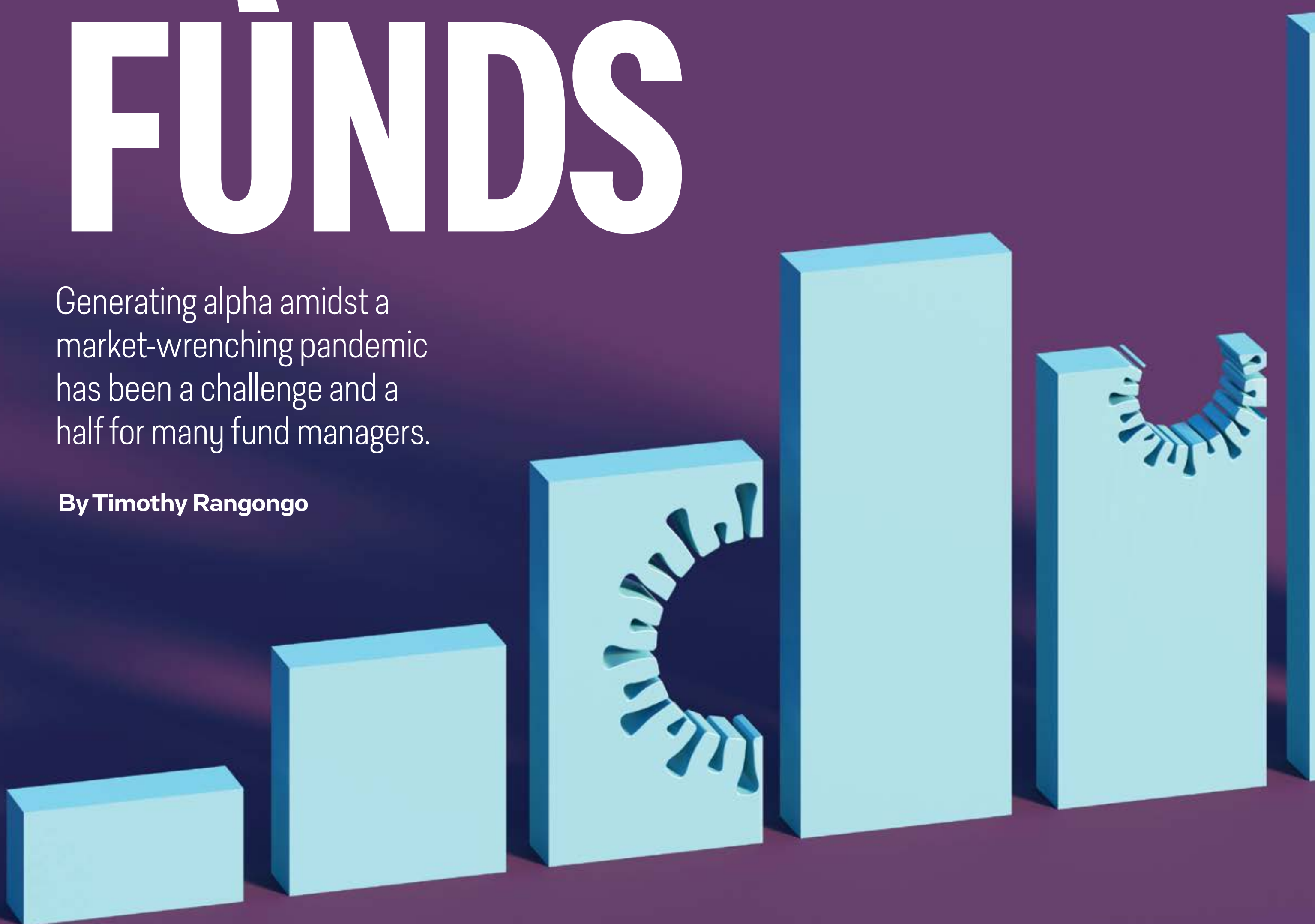
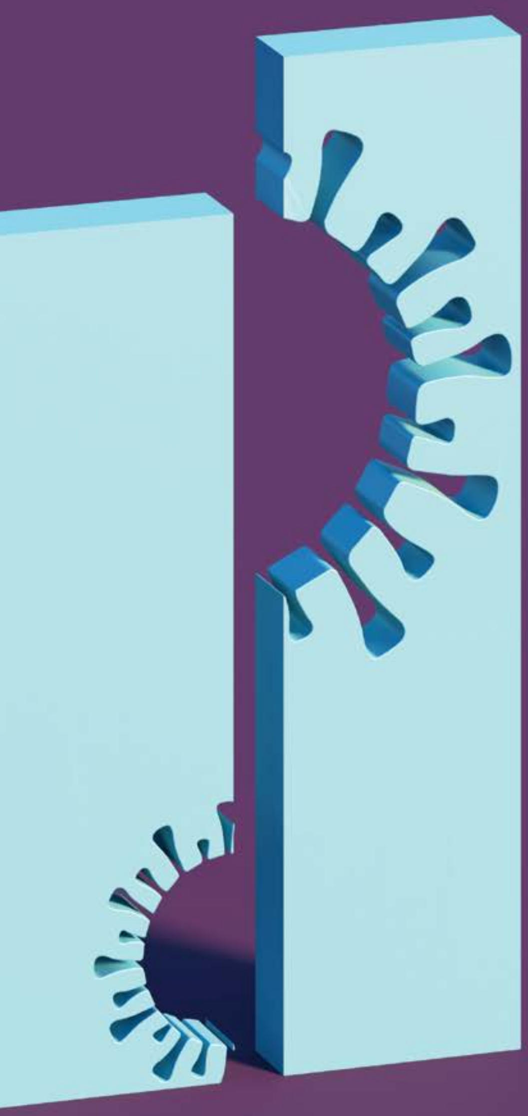
SA'S TOP EQUITY FUNDS

Generating alpha amidst a market-wrenching pandemic has been a challenge and a half for many fund managers.

By Timothy Rangongo





Week in and out, the arduous search for funds to review for *finweek*'s Fund in Focus page, for which outperformance is part of the criteria, has attested to the challenge of generating alpha (the additional performance when compared to the general market or benchmarks). The pursuit of outperformance has been no different to that of searching for needles in haystacks.

For the past year-to-date, returns in minuses and red have been custom and this is across almost all asset classes save for the commodities and multi-asset managers who were spared the wrath of Covid-19.

In this article, we will look at the investment strategy and approaches employed by a handful of SA equity funds that have successfully manoeuvred the lingering market uncertainty and ensuing losses, how they went about picking unbeaten stocks and where they are searching for their next alpha.

Forensic accounting analysis as key competitive advantage

The investment strategy of Steyn Capital's Equity Prescient Fund is premised on maximising investor capital by buying securities with trading values materially lower than their intrinsic values.

Steyn Capital applies developed market research techniques gleaned from experience garnered by US hedge funds (which manage billions of dollars) into a less efficient market like South Africa, to generate alpha over time, according to the fund manager and founder, André Steyn.

André Steyn
Fund manager and founder of Steyn Capital

He says Steyn Capital has a team of forensic accounting analysts who pore over company financial statements to convert reported data into economic reality and populate a proprietary research screen, which they use as a starting point for their intensive research process.

Their research process follows a 15-step checklist approach focusing on valuation, quality of earnings, business quality, and management alignment with investors. He says the forensic accounting analysis is a key competitive advantage, and this approach helps to identify short-sale candidates which they short in their hedge fund and avoid in their long-only funds.

"We typically spend more than 200 hours researching a stock prior to initiating a position, and we seek to demonstrate a variant perception on each of our holdings. We ignore indices in our portfolio construction and build the portfolio solely by including our highest conviction ideas, while managing risk from the top down."

Gaming stocks

While performance has been broad-based in several stocks over the past year, Steyn says their core positions in gaming stocks Tsogo Sun and Sun International added considerable alpha.

"We had existing positions in these high-quality, local monopoly-type businesses ahead of Covid-19, which initially hurt our performance during the first part of 2020. However, our research strongly suggested that these businesses had much lower financial risk than was generally perceived, partly due to the inability of banks to easily foreclose on licensed casinos, and would bounce back quickly once restrictions were relaxed."

In addition to scrutinising cost reduction plans with management, Steyn says they performed case studies on international casino reopenings and combined reported company data with regulatory data and big data scrubbed daily from a variety of online sources to produce a model of daily revenue, which allowed them to have the conviction to materially increase their positions at the 2020 lows.

"In addition to buying aggressively on market, we co-underwrote the Sun International rights issue for R200m, earning an additional underwriting fee for our investors in the process."

Reratings

The team anticipates that many of the listed investment companies in SA, such as PSG, Ethos Capital and Reinet, will rerate from their current cyclically high discounts to intrinsic value.

Steyn says they have harvested certain of their SA Inc positions and reallocated to SA-listed companies with hard currency earnings such as Quilter and Pan African Resources, to take advantage of the somewhat stronger rand and diversify their risk.

Smart beta strategy

The Momentum Value Equity Fund deliberately targets focused exposure to shares that trade for less than their intrinsic value with the aim to maximise returns over the FTSE/JSE Capped SWIX over time. A smart beta strategy is employed.

The fund follows a predominantly quantitative approach to investing, according to Loftie Botha, co-manager of the fund. "We prefer stocks that are cheap based on parameters such as dividend yields, free cash flow yields, price-to-earnings, price-to-sales and price-to-book ratios."

He says they carefully consider risk implications on both portfolio and stock levels in their decision-making.

STEYN CAPITAL EQUITY PRESCIENT FUND

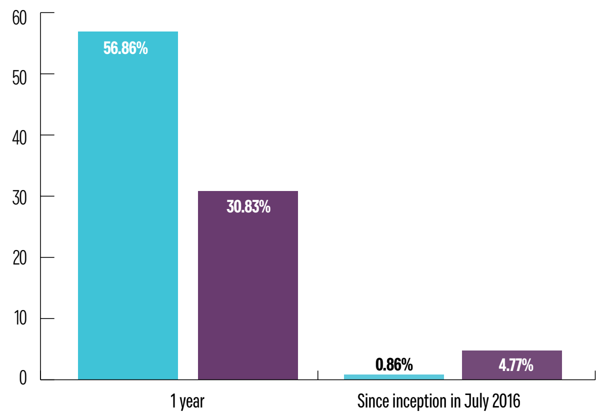
FUND INFORMATION:

Fund manager: André Steyn

Fund size: R910m

PERFORMANCE (ANNUALISED AFTER FEES)

As at 31 August 2021:



TOP 5 HOLDINGS AS AT 30 JUNE 2021:

1	Naspers*	10.62%
2	MTN	8.67%
3	Tsogo Sun Gaming	6.39%
4	Anglo American	5.40%
5	Sun International	5.13%

SMART BETA INVESTING

Smart beta investing combines the benefits of passive investing and the advantages of active investing strategies. The goal of smart beta is to obtain alpha, lower risk or increase diversification at a cost lower than traditional active management and marginally higher than straight index investing. It seeks the best construction of an optimally diversified portfolio. In effect, smart beta is a combination of efficient-market hypothesis and value investing.

(SOURCE: Investopedia)

Diversifying investment styles

With the value style being powerfully in play since the third quarter of 2020, paradoxically the main challenge right now is to manage investor expectations, says Botha.

He says the fact is that sometimes the value style may disappoint, as it did from mid-2019 until mid-2020, and sometimes it will deliver exceptional performance such as what they are currently experiencing.

Loftie Botha
Co-manager of the
Momentum Value Equity Fund

Photos: Supplied

MOMENTUM VALUE EQUITY FUND

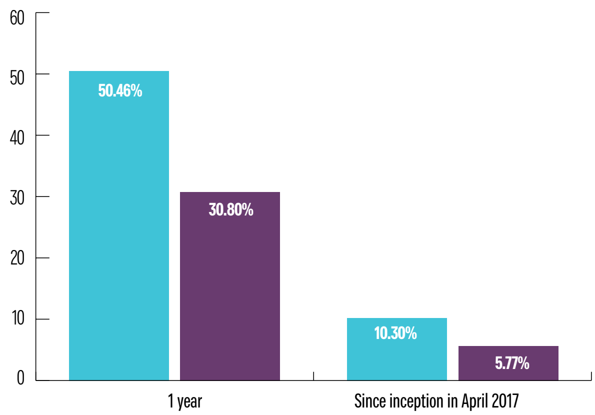
FUND INFORMATION:

Fund managers:	Loftie Botha and Imtiaz Mohammed Alli
Fund size:	R1.65bn

PERFORMANCE (ANNUALISED AFTER FEES)

as at 31 August 2021:

Momentum Value Equity Fund ■ Benchmark (FTSE/JSE Capped SWIX)



TOP 5 HOLDINGS AS AT 31 AUGUST 2021:

1	Anglo American	7.70%
2	MTN	6.58%
3	Standard Bank	5.96%
4	Impala Platinum	5.58%
5	British American Tobacco	4.83%

CLUCASGRAY EQUITY PRESCIENT FUND

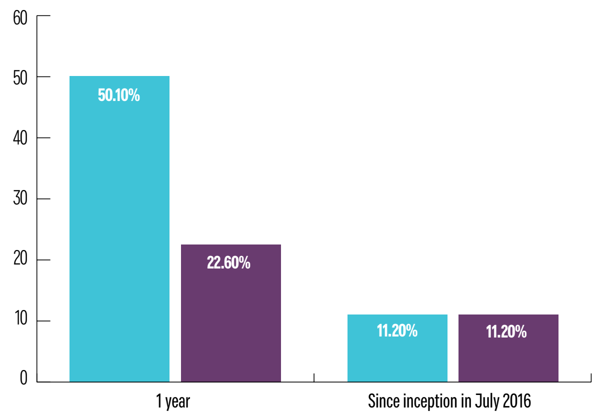
FUND INFORMATION:

Fund managers:	Andrew Vintcent and Grant Morris
Fund size:	R640m

PERFORMANCE (ANNUALISED AFTER FEES)

As at 31 August 2021:

ClucasGray Equity Prescient Fund ■ Benchmark (FTSE/JSE Capped SWIX All Share Total Return Index)



Botha's message to investors is that if they remember two things, they should do just fine. Firstly, history has proven that a value-based approach always rewards investors in the medium to long run. A case in point is the pleasing performance of the fund since inception back in April 2017.

He says investors should not pay too much attention to normal cyclical over- and underperformance, but rather focus on the longer term and stay invested. Secondly, Botha says to reduce the cyclicality of an investment portfolio without sacrificing long-term performance, investors should diversify over multiple investment styles. Value, momentum, and quality often outperform at different points in time.

25 stocks limit

The ClucasGray Equity Prescient Fund aims to hold no more than 25 stocks at any one time. Fundamental analysis, a valuation discipline, and a belief that inefficient markets create opportunities in mispriced assets underpin the portfolio management process.

Andrew Vintcent
Portfolio manager at ClucasGray

Grant Morris
Portfolio manager at ClucasGray

ClucasGray's winning formula is adhering to their fundamental investment process, assessing the interplay between a company's earnings prospects and the valuation multiples at which a company's stocks trade.

All investment decisions require comfort around valuation, according to the portfolio managers Andrew Vintcent and Grant Morris. They say they assess the ability of an investment to deliver an acceptable three-year prospective annualised return.

Mining exposure reduction

One of the challenges for the fund after the Covid-19 crisis has been to attempt to look through the short-term earnings results of companies and weigh this up against their ability to return to levels of profitability which they enjoyed pre-pandemic, according to Vintcent and Morris. They say this has required a robust interrogation of business models, normal earnings prospects and the current valuation or rating.

Though the performance of commodity shares over the last few years has been spectacular, in January 2021, the fund started to reduce elevated weightings to the commodity sector as the team felt the underlying commodity prices and earnings in most JSE-listed companies were peaking.

They decided to exit some of the iron ore-exposed companies and added to AECI – a mining services and industrial company that in their view was mispriced. The fund's current exposure to pure mining companies has been materially reduced.

Attractive valuation levels

Vintcent and Morris believe there are a range of attractive opportunities for investors in SA equities, across the market cap spectrum and not only those that are solely exposed to SA.

According to the duo, some companies trade at significant discounts to their sum-of-the-parts and have levers to pull to unlock some of this value through share buy-backs, dividends, or unbundling.

"Others are seemingly trading on multiples that are too low for our assessment of their earnings prospects. In addition to the large cap exposure of the fund, the fund holds a number of differentiated holdings in the mid-cap space, many of which we believe have the ability to deliver outsized returns from current levels."

They say the more recent levels of corporate activity on the JSE are a supportive indication that valuation levels remain attractive.

3M process

The PSG Equity Fund team uses a 3M process that sees them focusing on three parts of the investment case: moat, management and margin of safety. The qualitative aspects (moats and management) give careful attention to the business' competitive advantage, the strength of the management team and the ability to grow profits over the long run. They believe that the price paid is integral to future returns and they always try to buy with a margin of safety.

The team admits that this has been a very challenging time to manage money, owing to a lot of macro-economic uncertainty, yet markets have been reaching all-time highs. Global markets are wrestling with several issues which include Chinese policy contagion, when the world will fully exit from Covid-19 lockdowns and what that world will look like after the pandemic, says fund managers Shaun le Roux and Gustav Schulenburg.

They say they are also seeing pockets of inflationary pressure which have consequences for future monetary policy and threaten the rampant bull markets in US and growth stocks.

Shaun le Roux
Fund manager at PSG

Gustav Schulenburg
Fund manager at PSG

Piet Viljoen
Fund manager at Counterpoint

Photos: Supplied

On the domestic front, they say the economy remains challenged and the JSE has been weighed down by poor performance from large constituents, especially Naspers*/Prosus and precious metal stocks.

PSG has a tried and tested process that has seen them through turbulent times in the past. The team says they are quite clear on the type of investments they seek for their clients and are prepared to be patient.

"Our clients own undervalued stocks where the market is underappreciating the inherent quality of the business. The outlook for these kinds of stocks is very exciting, even after the strong performance by our funds over the recent past."

Differentiated stock-picking

The team finds current market conditions favourable for identifying investment opportunities which meet their criteria, both domestically and abroad. The anomaly of current market conditions is that out-of-favour stocks are very cheap while market indices are expensive, according to Le Roux and Schulenburg.

If you are prepared to look beyond what is popular, such as US stocks, visible growth and technology, opportunities are abundant, especially in SA, they say, adding that clients own good local businesses with excellent prospects despite the weak economic conditions. They think the opportunity for differentiated stock-picking is as good as it gets.

Valuation bias

Counterpoint's SCI Value Fund comprises a portfolio with a valuation bias.

At present, Counterpoint is of the view that many small or mid-cap stocks are extremely cheap. Investment holding companies that trade at a big discount to NAV and are run for shareholders, not management, which whittles the universe down by a lot, according to fund manager Piet Viljoen, are also "promisingly priced".

"We also think that companies that are perceived to be unable to tick many ESG boxes are priced quite attractively."

In terms of approach, Viljoen says the best one can do is carefully assemble a bundle of twigs and look after that bundle carefully. "What will happen to each individual twig – or stock – in the portfolio is unknowable before the fact. But bundled together, they are quite robust."

PSG EQUITY FUND

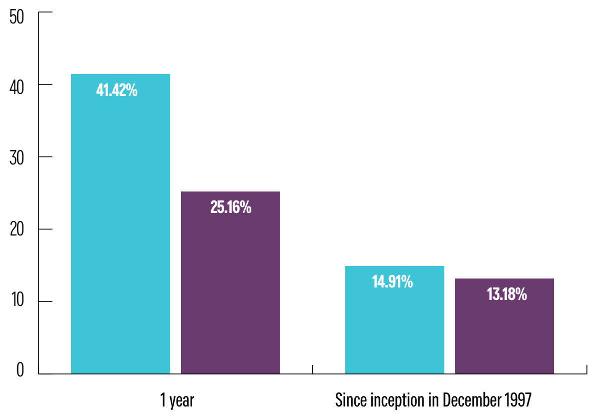
FUND INFORMATION:

Fund managers:	Shaun le Roux and Gustav Schulenburg
Fund size:	R5.2bn

PERFORMANCE (ANNUALISED AFTER FEES)

As at 31 August 2021:

PSG Equity Fund ■ Benchmark (FTSE/JSE Capped SWIX All Share Total Return Index)



TOP 5 HOLDINGS AS AT 31 AUGUST 2021:

1	Discovery	7%
2	Remgro	6.40%
3	Glencore	6.10%
4	AECI	5.10%
5	AB InBev	4.50%

COUNTERPOINT SCI VALUE FUND

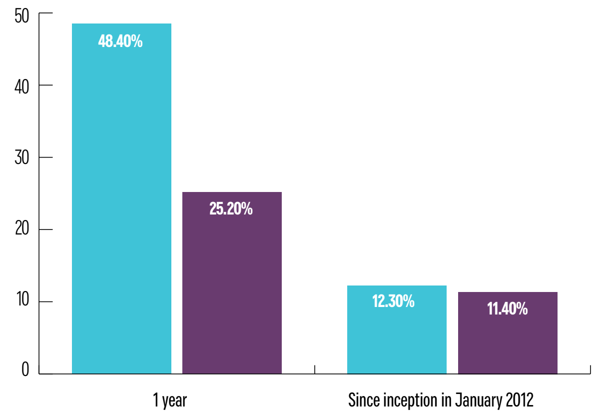
FUND INFORMATION:

Fund manager:	Piet Viljoen
Fund size:	R278m

PERFORMANCE (ANNUALISED AFTER FEES)

As at 31 August 2021:

Counterpoint SCI Value Fund ■ Benchmark (FTSE/JSE All Share Index)



TOP 5 HOLDINGS AS AT 31 AUGUST 2021:

1	MTN	6.30%
2	Nedbank	4.90%
3	Shoprite	4.80%
4	Exxaro	4.80%
5	Absa	4%

MTN reigns supreme and other winning stocks

MTN emerged as the most cited stock to have boosted funds' performance over the past year.

Steyn Capital is finding opportunity in telecommunication stocks with underappreciated fintech assets such as MTN, while Loftie Botha, portfolio manager of the Momentum Value Equity Fund says MTN was among the stocks that "did exceptionally well for our clients".

MTN was among the holdings the ClucasGray Equity Prescient Fund benefitted from, according to fund managers Andrew Vintcent and Grant Morris. It is also no surprise that MTN is currently the Counterpoint SCI Value Fund's top holding.

Other SA-listed stocks fund managers say delivered solid returns in the past year/year-to-date include:

- Motus
- Distell
- Absa
- Momentum
- Sabvest
- Massmart
- Exxaro
- Reunert
- Tsogo Sun
- Sun International
- Glencore
- Aveng
- Santova
- ADvTECH
- PPC
- Combined Motor Holdings
- Thungela Resources
- Grindrod Shipping
- Truworths
- Imperial

Sticking to own views

The biggest challenge for the fund has been "to stick to our view amongst the market volatility", says Viljoen.

"Our view was, and continues to be, that SA stocks are some of the cheapest in the world and a diversified exposure to the equity of SA businesses will do well over the long term."

The team believed that stocks linked to the Chinese economy were highly risky, despite their large representation in the index. "This was a particularly difficult view to stick to," Viljoen says. ■

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