PRIVATE WEALTH SMALL AND MID CAP FUND

Q3 2020

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MARKET REVIEW

The quarter started on a positive note as activity indicators began to recover, businesses re-opened and people began to return to work. However, a resurgence in coronavirus cases across Europe, the US and the UK over the last few weeks served as a stark reminder that Covid-19 will likely remain with us for some time to come. The renewed uncertainty, lack of progress around additional US stimulus and continued tensions between the US and China resulted in the global stock market recovery beginning to wane during September. The MSCI World and S&P 500 indices nevertheless ended the quarter 8,0% and 8,9% higher, respectively (despite retracing 3,4% and 3,8%, respectively, during the month of September).

Domestic equities lagged in its recovery compared to certain developed market peers, with the All Share index ending the quarter only 0,7% higher (as measured in rands). Returns were subdued across the market capitalisation spectrum, with the Top 40 +0,6%, Mid Caps +1,3% and Small Caps +3,5%. In terms of asset classes, cash (+1,2%) and bonds (+1,5%) were the only other asset classes to deliver positive returns, while listed property (-14,1%) and preference shares (-4,8%) continued their declines.

September data revealed some of the distressing consequences that Covid-related lockdowns had on the South African economy. Unemployment data showed 2,2m people lost their jobs and second quarter GDP declined 16,4% over the quarter. However, all hope is not lost, as preliminary third quarter data already indicates an improvement off the low base. The easing of lockdown restrictions following the country's move to Alert level 1 should further support a recovery in economic activity. More intervention is, however, required, and the country awaits cabinet approval (and implementation) of the economic recovery plan.

FUND PERFORMANCE

The Fund delivered a return of 1,6% for the quarter, underperforming the benchmark's return of 1,9%. The Fund's peer group delivered an average return of 4,0% for the period.

Positive contributors to performance included ADvTECH (+0,6%), Cartrack (+0,5%) and Adapt IT (+0,5%). This was offset by underweight positions in gold and platinum counters such as Royal Bafokeng Platinum (-0,8%), Harmony Gold (-0,7%) and Northam Platinum (-0,4%). The Fund's holdings in Libstar (-0,6%), Adcock Ingram (-0,6%), African Rainbow Capital (-0.5%) and Adcorp (-0.5%) further detracted from performance.

CHANGES TO THE FUND

Despite the turmoil caused by the Covid pandemic, increased volatility has created opportunities for the Fund to increase its exposure to higher quality companies at more attractive valuations. The Fund took advantage of share price weakness to increase its exposure to companies such as Bidvest, Santam and Mediclinic, while reducing its exposure to less liquid and potentially more vulnerable counters such as Adcorp and Imperial.

The Fund was previously prohibited from allocating more capital to Bidvest due to its classification as a Large Cap stock. However, after a recent JSE index review, Bidvest now again forms part of the Fund's investable universe following the share price decline earlier in the year. While we don't expect Bidvest to be spared from the consequences of the Covid-pandemic or the challenges faced by SA Inc, we think Bidvest is significantly better positioned than several of its JSE-listed small and mid-cap peers. The Fund therefore used the opportunity to consolidate some of it's less liquid domestically-focused holdings in Bidvest at a valuation which we think is unlikely to have presented itself had it not been for the recent market volatility.

Along a similar vein, Santam is a company that the Fund has long aspired to own, but a relatively demanding valuation prevented us from buying the share. Weaker investment markets and uncertainty around business interruption claims have, however, created an opportunity for the Fund to build a position in this high quality counter. Santam is a leading player in the South African short-term insurance market, and the company's recently reported 1H20 results again highlighted the resilience of the group despite the challenging operating environment. Although the risk of further business interruption and other Covid-related claims remain, the group is well-capitalised and we anticipate the group to continue generating strong returns on capital over time.

The Fund also established a position in Cartrack, a fast-growing telematics and mobile asset management provider, during the quarter. Cartrack's services include fleet management, stolen vehicle recovery and insurance telematics, with a strong focus on the use of technology to improve operating efficiencies and enhance customer utility. Although the group already has a sizeable South African following, it is still in the early stages of scaling up its Asian operations, which we think could drive significant growth over time. The competitive environment for Cartrack's offering in the region is highly fragmented, and management believes the addressable market remains substantially under-penetrated. The Fund established a position in the counter in July. However, Cartrack's share price has since almost doubled, partly on the back of a trading statement that suggested the company has largely shrugged off any adverse consequences from the pandemic and continued to charge ahead. While we continue to view the group's long-term prospects favourably, in our view the current share price leaves little upside on offer. The Fund has consequently decided to take profit and exit its holding shortly after the conclusion of the quarter.

LOOKING FORWARD

2020 has been an extraordinary year thus far, with remarkable highs and devastating lows. Market participants are still coming to terms with the aftermath of the Covid-pandemic, and the prospects for the South African economy remain unclear. That said, expectations are low, and this has manifested in some astoundingly undemanding valuations, particularly in the small and mid-cap segment. One example of this is Adapt IT (in which the Fund has a holding), which towards the end of the quarter traded on a P/E multiple of 1.5x. The share price has since more than doubled within a matter of days after a trading statement indicated that conditions are perhaps not as bad as certain market participants had feared.

Despite the general lack of optimism around the prospects for South African risk assets, the Fund continues to see ample opportunities for value creation. Although it is likely to require some patience, the Fund will continue to endeavour to deliver optimal returns for investors over time.