The Navigator

Strategy and Asset Allocation Report
2nd Quarter 2020

COVID-19
Digital Edition

ANCHOR | NAVIGATING CHANGE

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Introduction

Written By:

NOLAN WAPENAAR AND PETER ARMITAGE
Chief Investment Officers

March 2020 will be remembered for a long time. The month when COVID-19 hit and OPEC+ appeared to fall apart will be studied, analysed and researched into oblivion by academic scholars. It will provide fertile ground for researchers in various disciplines including medicine, psychology, political science, architecture, engineering, economics, accounting, financial regulation and investment science.

March 2020 will also leave a negative legacy - we are already seeing record slumps in GDP expectations around the globe. Equity markets have set records for the swiftness of their sell offs and bonds have tumbled. Emergency stimulus packages of eyewatering proportions are being thrown at the problem by overindebted governments. Businesses are closing, people are losing their jobs and families are being left destitute. Many people have succumbed to the virus, but many more will succumb to the economic fallout before this difficult period in world history is over.

One day we will tell our grandchildren about the months when the world stood still. Before we do that though, we need to survive it. Anchor's role in trying to survive this is all about making sense of the world around us and what that means for the savings that our clients have entrusted to us. Pandemics, lockdowns and the oil wars are truly new events for all of us. There is no playbook for the governments that must lead, and historical experiences offer limited help for Anchor as we seek to navigate the maelstrom of uncertainty.

One day we will tell our grandchildren about the months when the world stood still. Before we do that though, we need to survive it.

Nevertheless, we do know that the risk-off reaction has created investment opportunities in all asset classes. Unfortunately, these opportunities come with great risks. Financial asset prices may well go down significantly from their current levels before they recover. Businesses with weaker balance sheets may find themselves unable to survive and consumer behaviour is likely to change as a result of March 2020. That said, if you can identify quality businesses that will survive and are taking a longer-term view the opportunity set is attractive.

Circumstances are changing around us all the time. The length of the lockdown may change, or it may not. We hear talk of additional stimulus packages in South Africa (SA) that may or may not come to fruition. We are seeing changes to our environment daily. Anchor has been publishing market updates and research notes as these major events have occurred. We urge you to look at some of these articles on our website as you digest the developments and the likely outcomes.

In this edition of the Navigator, we include some of the thoughts from our investment professionals on what this pandemic means to them and how they are seeing it develop in their various spheres of expertise.

We have seen China return to normal. We are also seeing signs of the infection curve flattening and the epidemic in Italy, Spain and Australia being brought under control. Humanity can, and will, beat this. China was the first country to exit a lockdown and if that country's experience holds elsewhere then the rebound can be quite strong once the pandemic has passed. One day in the future, in happier times, we will tell our grandchildren about that dark period that is long past – March 2020.

Asset Allocation

Asset Class	Anchor's asset allocation (AA) recommendations at the start of 2020 (for 1Q20)	The current AA of an investor, who followed Anchor's AA recommendations at the start of the year after 1Q20's market turmoil*	Anchor's AA positioning recommendation for 2Q20	Comments
DOMESTIC				
SA Equity	Neutral	Extreme Underweight	Neutral	We are looking to gradually increase exposure over the next few months, with the focus being on specific shares.
SA Bonds	Overweight	Extreme Overweight	Overweight	Real yields continue to be extremely attractive but, given relative moves, we are looking to reallocate some outperformance to other asset classes. Nevertheless, this is still one of the more attractive asset classes on a relative basis.
SA Property	Neutral	Extreme Underweight	Neutral	We are considering gradually increasing exposure back to neutral over the next few months, with the focus being on specific shares (allowing for the very fluid situation in the sector and potential changes in the regulatory environment to settle).
SA Cash	Overweight	Extreme Overweight	Underweight	Relative outperformance has taken cash to an extreme overweight position, but as local SARB rates drop, the relative attraction of cash has decreased - we are looking to deploy into risk assets over the next few months.
Total	Overweight	Underweight	Overweight	The extreme rand moves have left domestic assets underweight on a relative basis and we are looking to get back to overweight domestic assets over the next few months at a currently attractive exchange rate.
GLOBAL				
Global Equity	Neutral	Overweight	Neutral	Extreme rand moves and a relatively less extreme offshore equity sell-off (vs SA equities) have left this asset class slightly overweight on a relative basis, we are looking to take some profit and redeploy into domestic assets over the next few months.
Global Bonds	Underweight	Overweight	Underweight	Extreme rand moves and global central bank action have seen this asset class outperform substantially on a relative basis, but with record low yields on an absolute basis (and relative to SA yields) we're looking to take profit here and redeploy to more attractive domestic opportunities. Within this asset class relatively better opportunities exist in corporate bonds vs government bonds.
Global Property	Neutral	Underweight	Neutral	We are considering gradually increasing our exposure back to neutral over the next few months.
Global Cash	Neutral	Overweight	Neutral	Extreme rand moves and global central bank action have seen this asset class outperform substantially on a relative basis, but with record low yields on an absolute basis (and relative to SA yields) we're looking to take profit here and redeploy to more attractive domestic opportunities.
Total	Underweight	Overweight	Underweight	Extreme rand moves have left offshore assets overweight on a relative basis and we are looking to get back to underweight offshore assets over the next few months at a currently attractive exchange rate.

** If an investor was neutral bonds and equities at the start of 1Q20, but because of the 1Q20 market crash such an investor is now overweight bonds and underweight equities, then the second column is a reflection of what has happened to such an investor's portfolio during 1Q20 – i.e. if an investor followed Anchor's asset allocation at the start of the year and positioned themselves as per column 1, that investor's asset allocation is now reflected in column 2, due to the extreme market moves because of COVID-19. For 2Q20, our asset allocation recommendation is as per column 3. This will require some action on the part of the investor. As an example, if an investor currently has an extreme underweight position on SA equities, we suggest that such an investor gradually buys more SA equities in order to get the asset allocation of their portfolio back to our neutral recommendation – thus, column 3 is our asset allocation recommendation as to how an investor should be positioned in 2Q20.*

GENERAL COMMENTS

1. Our general approach is to use the extreme moves in the market as an opportunity to gradually add to risk assets at attractive levels over the course of the next few weeks and months. This will almost certainly be the right thing to do for long-term investors.

2. As with most crises, we completely expect to emerge on the other side of the COVID-19 crisis with winners and losers, while the above constitutes broad guidance at an asset class level, we expect many of the most meaningful opportunities to present themselves below that, at a company level.

3. Given that uncertainty remains at heightened levels, many of the most attractive opportunities are presenting themselves where there is the most uncertainty (and, as such, where we expect some of the biggest moves to occur over the short term - both positive and negative).

ANCHOR INSIGHTS

In this section, staff from across Anchor provide insights into our thinking, strategy and view of the world. This quarter, Casey Delport follows the timeline of the COVID-19 pandemic and asks what we can learn from it; Peter Little looks at the impact of COVID-19 in a note entitled *Economic shocks, booze restrictions and bear markets*; Glen Baker questions if investors bought listed property for dividends, *what happens now?*; Stephán Engelbrecht searches for opportunities in times of adversity, highlighting our current top share picks on the JSE following recent precipitous declines and, finally, Craig Michel advises investors on navigating change and fostering their financial health.

A COVID-19 timeline:

From government response to economic conjecture - what can we learn?

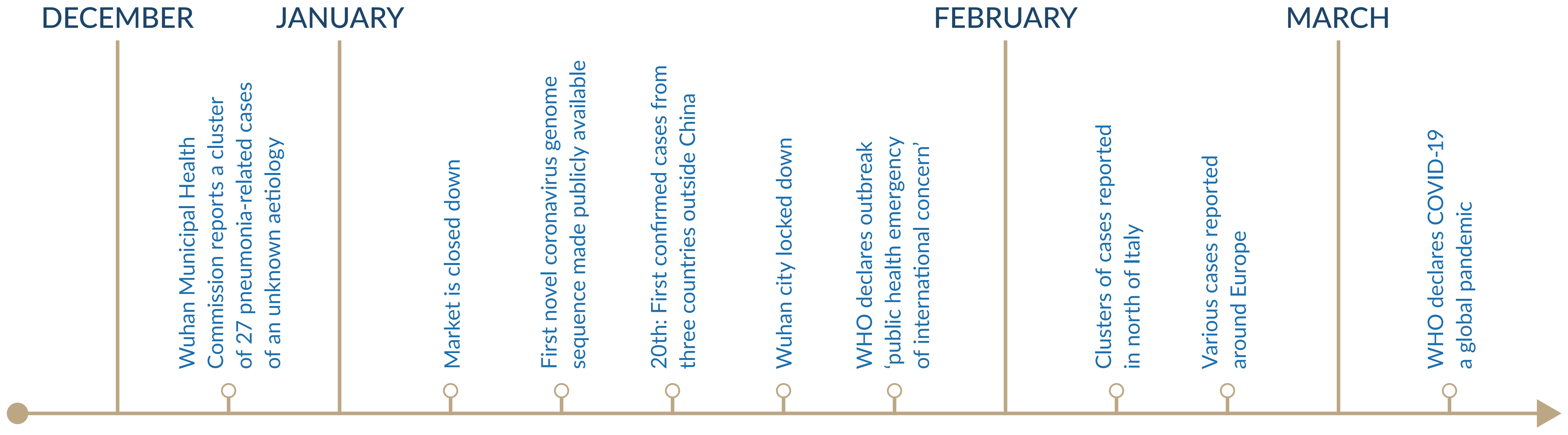
Written By:

CASEY DELPORT
Investment Analysis

Casey holds a MCom in Economics and joined Anchor in 2019. She brings her passion for economics into the fixed income space, particularly with regards to global and Africa country analysis.

On 31 December 2019, the Wuhan Municipal Health Commission in Wuhan City, China, reported a cluster of 27 pneumonia-related cases of an unknown aetiology, with a reportedly common link to Wuhan's Huanan Seafood Wholesale Market. Twenty days later, there were reports of confirmed cases from three countries outside China: Thailand, Japan and South Korea, with the cases all having been exported from China. On 22 February, Italian authorities reported clusters of cases in Lombardy and additional cases from two other regions, Piedmont and Veneto. Over the following days, cases were reported from several other regions. Transmission appeared to have occurred locally, in contrast to first-generation transmission from people returning from affected areas in other countries.

Figure 1: COVID-19 timeline
Source: Anchor, Thomson Reuters



As a further cause of concern, transmission events were also reported from hospitals, with COVID-19 cases identified among healthcare workers and patients. During the following week, several European countries reported cases of COVID-19 in travellers from the affected areas in Italy, as well as cases without epidemiological links to Italy, China or other countries with ongoing transmission cases. On 30 January 2020, the World Health Organisation (WHO) declared the outbreak a 'public health emergency of international concern'. In the weeks to follow, several countries implemented entry screening measures for arriving passengers from heavily effected areas, along with major airlines suspending flights from said areas. As cases continued to mount, hard-hit countries (particularly within Asia and Europe) began to install strict public health initiatives, including social distancing measures that led to the closure of many public entertainment spaces. On 11 March, less than a month and a half from the first reported cases, the WHO declared COVID-19 a global pandemic due to a rapid exponential increase in cases.

On 30 January 2020, the World Health Organisation (WHO) declared the outbreak a 'public health emergency of international concern'.

As policymakers around the world struggle to combat the rapidly escalating pandemic, they find themselves in uncharted territory. Much has been written about the measures and policies successfully used in countries such as China, South Korea, Singapore, and Taiwan to curb the spread of the virus but, unfortunately, throughout much of Europe and the US, it is already too late to contain COVID-19 in its infancy.

As a consequence, policymakers are struggling to keep up with the spreading pandemic and, in doing so, are repeating many of the early errors made in Italy, where the pandemic has since turned into a humanitarian disaster. Some aspects of this pandemic — starting with its timing — can undoubtedly be attributed to plain 'sfortuna' (or bad luck in Italian), that were impossible for policymakers to fully control. Other aspects, however, are symbolic of the profound obstacles that leaders in Italy (as well as elsewhere in Europe and now possibly the US) faced in recognising the magnitude of the threat posed by COVID-19, and thus organising a systematic response to it and learning from early implementation successes (or more importantly, failures).

It is, however, worth noting that these obstacles emerged even after COVID-19 had fully taken hold in China, and some alternative models for the containment of the virus (in China and elsewhere) had already been successfully implemented. What this suggests rather is a systematic failure to both absorb and to act upon existing information rapidly and effectively, rather than a complete lack of knowledge of what ought to be done.

The spread of COVID-19 is having a profound and extensive impact on the global economy and has sent policymakers into a relative frenzy looking for effective ways to respond. China's experience thus far shows that the right policies make all the difference in fighting the disease and mitigating its impact — but some of these policies come with difficult economic trade-offs. Unfortunately, success in containing the virus comes at the price of slowing economic activity, no matter whether social distancing and restricted movement are voluntary or enforced. In China's case, policymakers implemented strict mobility constraints, both at a national and local level. Whilst the human cost of the pandemic is clearly apparent, the economic costs are yet to be fully understood. By all indications, China's slowdown in 1Q20 will add significant downward pressure on economic growth and will leave a deep mark for the remainder of this year.

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What started as a series of sudden stops or 'blips' in economic activity, quickly cascaded through the global economy and morphed into a full-blown shock, simultaneously impeding supply and demand. This is clearly visible by the very weak January-February (and preliminary March) readings of industrial production and retail sales across the globe. The novel coronavirus shock is severe, even compared to the global financial crisis (GFC) in 2007/2008, as it has hit households, businesses, financial institutions, and markets all at the same time—first in China and now globally.

Figure 2: Global industrial production, YoY % change

Source: Anchor, Trading Economics

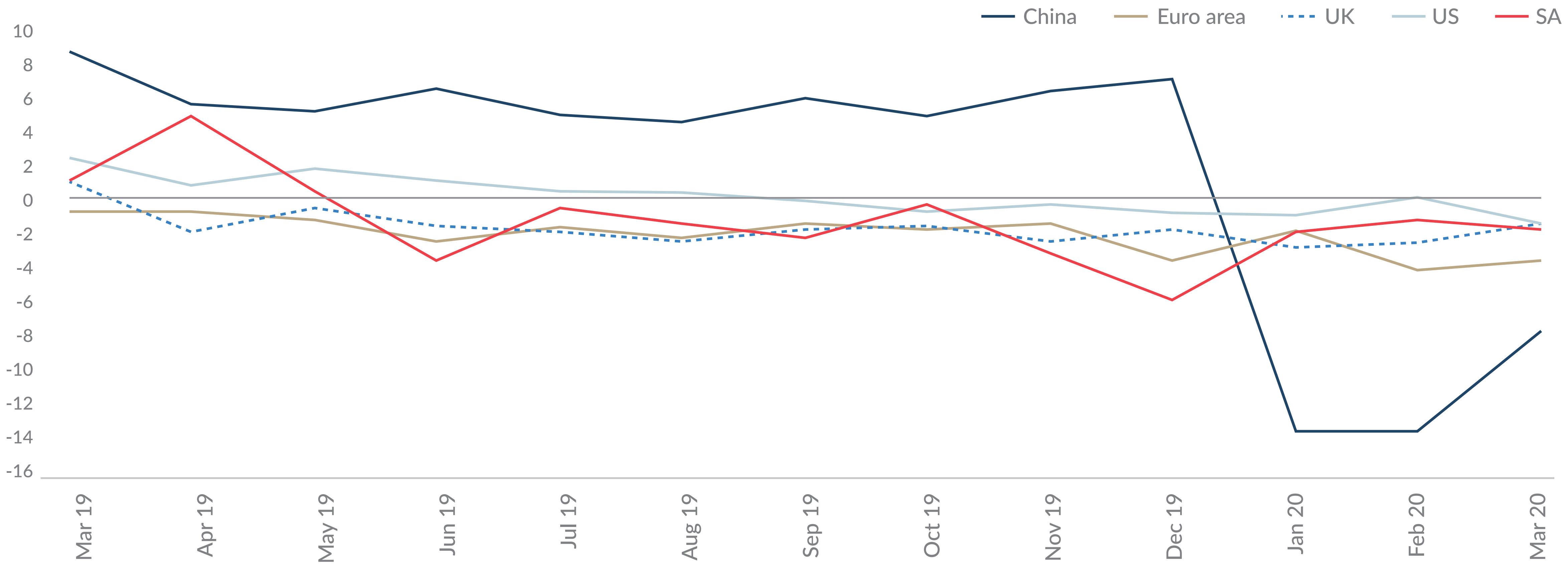
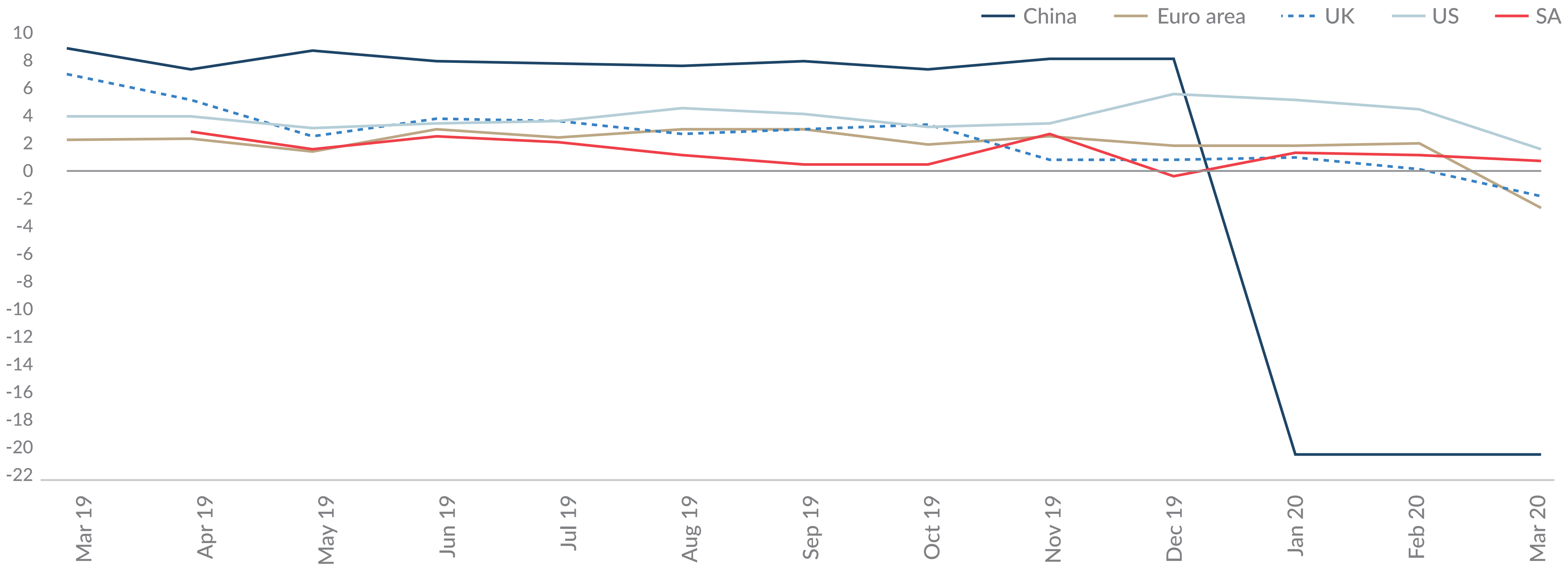


Figure 3: Global retail sales, YoY % change

Source: Anchor, Trading Economics



Mitigating the impact of this severe shock requires providing support to the most vulnerable. Chinese policymakers have implemented an estimated RMB1.3trn (c. $183bn or 1.2% of China's GDP) of fiscal measures to mitigate the economic impact of the virus. Some of these key measures include: (i) increased spending on epidemic prevention and control; (ii) production of medical equipment; (iii) the accelerated disbursement of unemployment insurance; and (iv) tax relief and waived social security contributions. The overall fiscal expansion is expected to be significantly higher, reflecting the effect of already announced additional measures (including higher infrastructure investment). The People's Bank of China (PBC) has further unleashed a swathe of monetary policy support, in addition to the government's provision of financial relief to affected households, corporates, and regions facing repayment difficulties.

Due to the rapid spread of the virus across Europe, the euro area has released a swathe of fiscal stimulus in a bid to alleviate the economic damage wrought by the virus across the continent. By end-March, fiscally, the EU had implemented a total of c. $315bn/2.3% of EU-27 (those EU countries after the UK left the EU) GDP worth of measures that aim to support public investment or hospitals, small and medium enterprises (SMEs), labour markets, and stressed regions.

Notably, the European Commission also activated the general escape clause in EU fiscal rules, which suspends fiscal adjustment requirements for countries not at their medium-term objective and allows countries to run deficits in excess of 3% of GDP. However, EU member nations continue to disagree over deploying a joint fiscal stimulus. Time will tell if the various stakeholders will deploy the necessary expansionary fiscal policy needed to assist the EU through this period of extreme volatility.

SA was quick to take its cue from other countries that have stringent measures in place to curtail the spread of the virus. The government has declared a national state of disaster and adopted various containment measures, accumulating in a nationwide lockdown from midnight, 26 March until 16 April, with only critical workers, transport services, essential food and medicine production and retail operating. In order to mitigate the economic fallout from such strict containment measures, government will assist companies facing distress through the Unemployment Insurance Fund (UIF) and special programmes from the Industrial Development Corporation (IDC).

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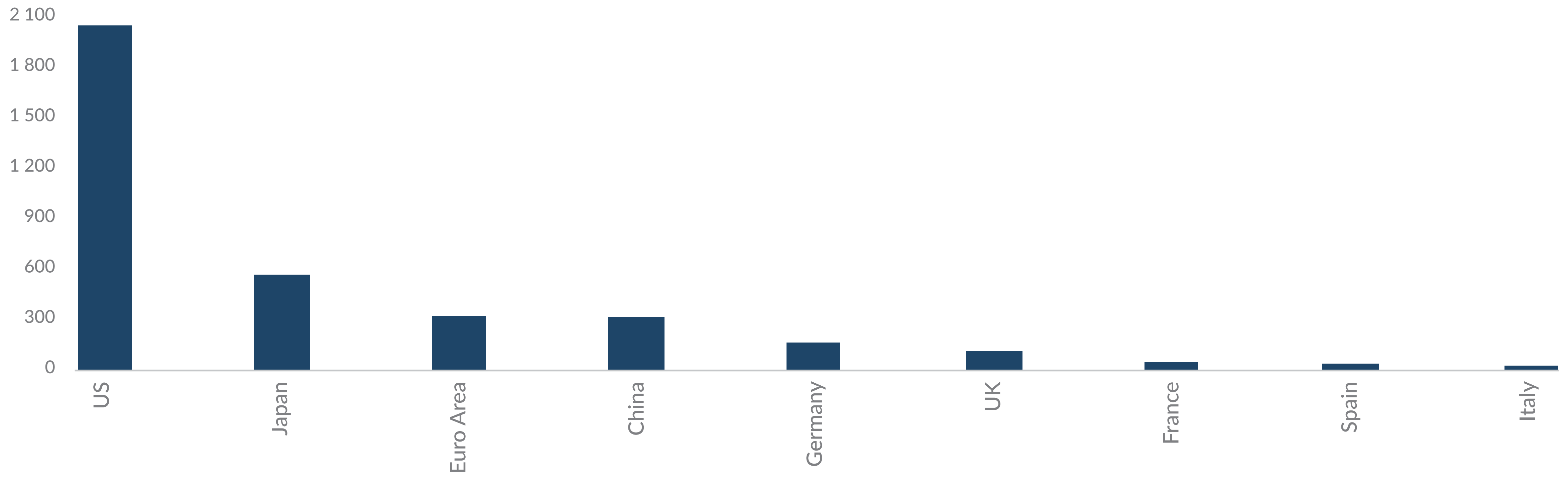
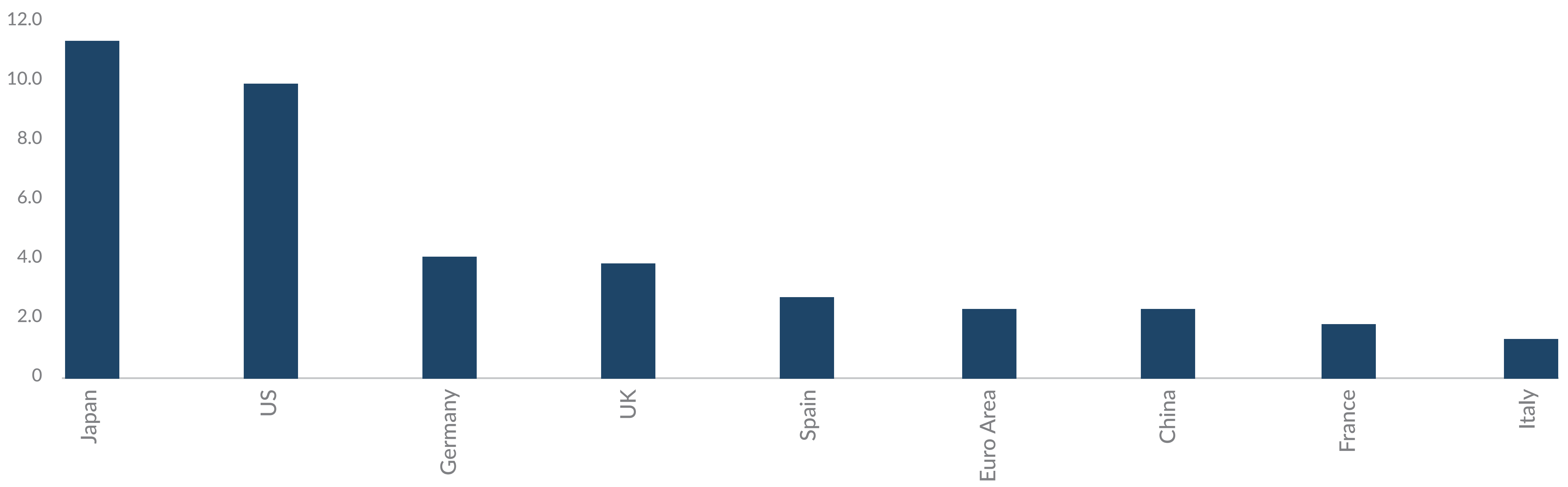
Funds will be made available to assist SMEs under stress, mainly in the tourism and hospitality sectors. Allocations will also be made to a solidarity fund to help combat the spread of the virus, which will be created with the assistance of private contributions. On the tax front, revenue administration will accelerate reimbursements and tax credits and allow SMEs to defer certain tax liabilities. The authorities have released partial cost estimates for the measures, so far amounting to R12bn (0.2% of GDP). The government is working on additional support measures to be presented to Parliament. Monetary wise, the SARB has cut interest rates and implemented various support measures that essentially amount to a form of quantitative easing (QE).

Figure 4: Global fiscal stimulus by country, $bn
Source: Anchor, Bloomberg, JP Morgan, UBS



In comparison, the US has run a disjointed, delayed and, at times, contradictory response to the implementation of containment measures against the outbreak. Under the leadership of President Donald Trump, the federal government has often been at loggerheads with various state leaders and the country's own medical experts surrounding what is deemed to be the appropriate level of containment response. Economically speaking, the US was more robust than most other DM economies before the crisis and thus has been able to ease policy more. There is, however, a catch-22 to this monetary easing - whatever US interest advantage was in place before the crisis has now been whittled away as the Fed has taken rates back to near zero. As the US is also closer to its Presidential election than most, it is a natural assumption that electoral factors will drive policy response to the pandemic. In particular, the possible rush to get the US economy back to work as recently touted by Trump could easily backfire if it takes the country longer to get on top of the outbreak. Fiscally, the US has released a swathe of measures, including a $2trn stimulus package to soften the blow of the crisis on the economy.

Figure 5: Fiscal stimulus (as a % of that country's annual GDP)
Source: Anchor, Bloomberg, JP Morgan, UBS



Despite much economic uncertainty, what is clear at least is that safeguarding financial stability requires assertive and well-communicated action. The past weeks have shown how a health crisis, however temporary, can turn into an economic shock where liquidity shortages and market disruptions can intensify and act as a catalyst to a far greater economic downturn. Of course, some of the fiscal and monetary relief tools come with their own set of problems. For example, allowing a broad range of debtors more time to meet their financial obligations can undermine financial soundness later on if it is not correctly aimed at the problem at hand and is time-limited; subsidised credit can be misallocated; and keeping already struggling companies alive could hold back productivity growth later. Evidently, wherever possible, using well-targeted and time-conscious instruments are key.

While there are reassuring signs of economic normalisation in China, significant risks remain. This includes new infections rising again as national and international travel resumes. As more countries face rapidly increasing spread of the virus and global financial markets continue to twirl downwards, consumers and firms may remain wary, depressing global demand for Chinese goods just as the economy is getting back to work. Given the global nature of the COVID-10 outbreak, many of these efforts will be most effective if coordinated internationally.

Since the start of the outbreak, economists and strategists alike are coming out with forecasts for economic growth, earnings, and asset prices. These forecasts tend to range wildly on any of these measures. In reality, all of the measures forecast depend heavily on how long both local economies and by large, the global economy, will stay shut down in response to the pandemic (e.g. estimates range from weeks to months or even quarters). The time that various economies across the globe are 're-started' depends on the dynamic of the virus itself and the choices politicians and society make in the process. Thus, the likely effect of COVID-19 on the global economy – with its countless international linkages and multiplier effects – is impossible to quantify with any degree of certainty.

Nevertheless, in responding to any crisis such as a virus pandemic or similarly, a threat of war, there is a trade-off which society needs to make. At the extremes, society can: 1) underreact - leading to the catastrophic impact of a pandemic or being unprepared for a military aggression: 2) overreact - and in the process cripple the economy/society or provoke an unnecessary war: or 3) decide on an optimal response, that stops the crisis, while incurring calculated damage which is significantly smaller than in the other two extreme outcomes. The foremost risk in both overreacting and underreacting to the current crisis is devastating damage to the economy. Subsequently, the natural question for policymakers across the globe is: How should one come to an optimal response in the case of the current epidemic? One needs to have as much epidemiological data as possible available on the virus itself, real-time dynamic data of its spread, effectiveness of measures already taken, and risks and unintended negative consequences of measures taken. More often than not, the response evolves initially from underreaction, then overreaction and then converges closer to the optimal response required.

Economic shocks, booze restrictions and bear markets

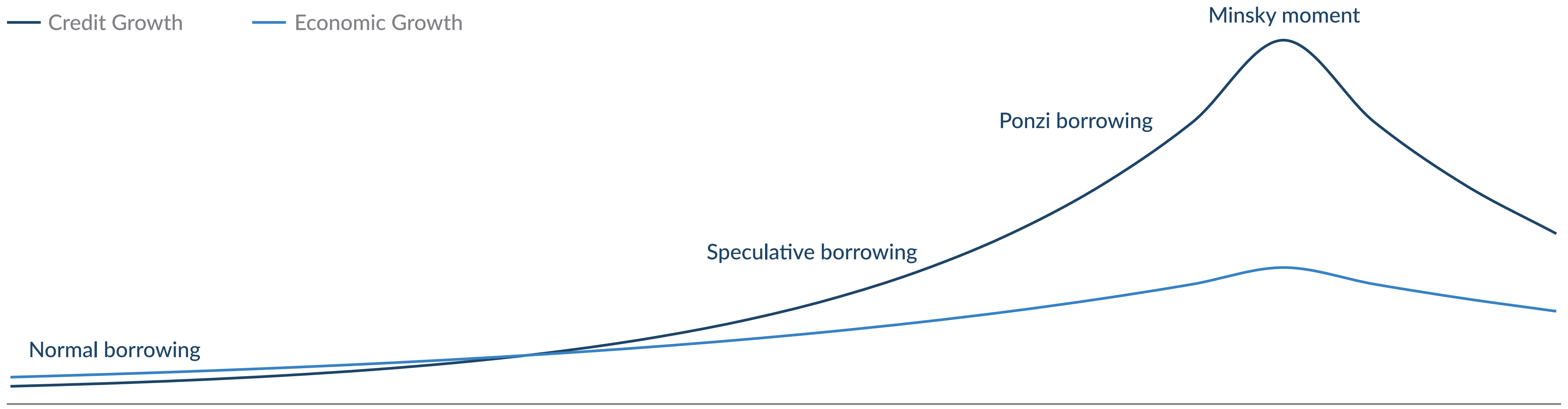
Written By:

PETER LITTLE
Fund Management

Peter has worked in financial markets for more than 20 years, initially in London (8 years) and then New York (8 years) before joining Anchor in South Africa in 2013. He has worked for a number of global investment banks including JP Morgan, Barclays & Royal Bank of Scotland. Prior to moving to South Africa, Peter was head of fund management for Credit Suisse's liquid hedge fund business. Peter is a CFA Charterholder.

Going into the year we would've probably rated the chances of a computer virus bringing the global economy to its knees higher than that of a flu virus, and we would've had both as extremely low probability events! We also wouldn't have expected OPEC+ (which includes Russia) to start increasing the supply of oil into a massive demand shock, but that's the world we find ourselves in now. Just to ensure that we're not too tempted to take the edge off that stark reality, the SA government has also banned the sale of liquor for the next three weeks during the lockdown. Usually, we have some idea of where risks are building in economies, things such as excessive corporate leverage in the current expansion or excessive housing debt in the previous one, but it's tough to pick the catalyst that turns the tide and exposes those with no pants! Economist Hyman Minsky described the phenomenon of financial cycles as follows: long periods of prosperity result in complacency and an increase in speculative behaviour, typically financed with borrowings that result in debt growing faster than economies until a catalyst (the so-called Minsky moment) causes credit conditions to tighten, resulting in bankruptcies and/or distressed asset sales.

Figure 1: Minsky moments
Source: Anchor



> *Going into the year we would've probably rated the chances of a computer virus bringing the global economy to its knees higher than that of a flu virus , and we would've had both as extremely low probability events!*

Not many would've correctly predicted the demise of 160-year-old investment firm Lehman Brothers as the catalyst for the GFC. The catalyst, though it might be newsworthy, is somewhat irrelevant, since it's the extent and the duration of the economic consequences that are likely to have the biggest impact on our personal and financial lives. In this note, we explore some potential outcomes for the global economy and compare the sharp moves in asset prices we've seen thus far to previous bear markets.

THE ECONOMIC IMPACT

Conventional wisdom suggests that developed markets (DMs), the US in particular, are consumer driven economies and that a pullback in consumer spending is the predominant cause of recessions.

It's true that household consumption is responsible for two-thirds of US economic output (and a similar portion for most developed and even many emerging markets [EMs]), but experience tells us that it's a sharp slowdown in the private investment portion of GDP which usually causes most of the economic pain. This, as companies hold off on big capital projects, cancelling or delaying projects to buy transportation equipment (planes, trains, trucks), machinery and IT equipment and the construction of new commercial buildings or houses. In fact, for the past three US recessions a drop in private investment has comfortably the biggest contributor to shrinking economic output.

Figure 2: US GDP contributions
Source: Anchor, Bloomberg

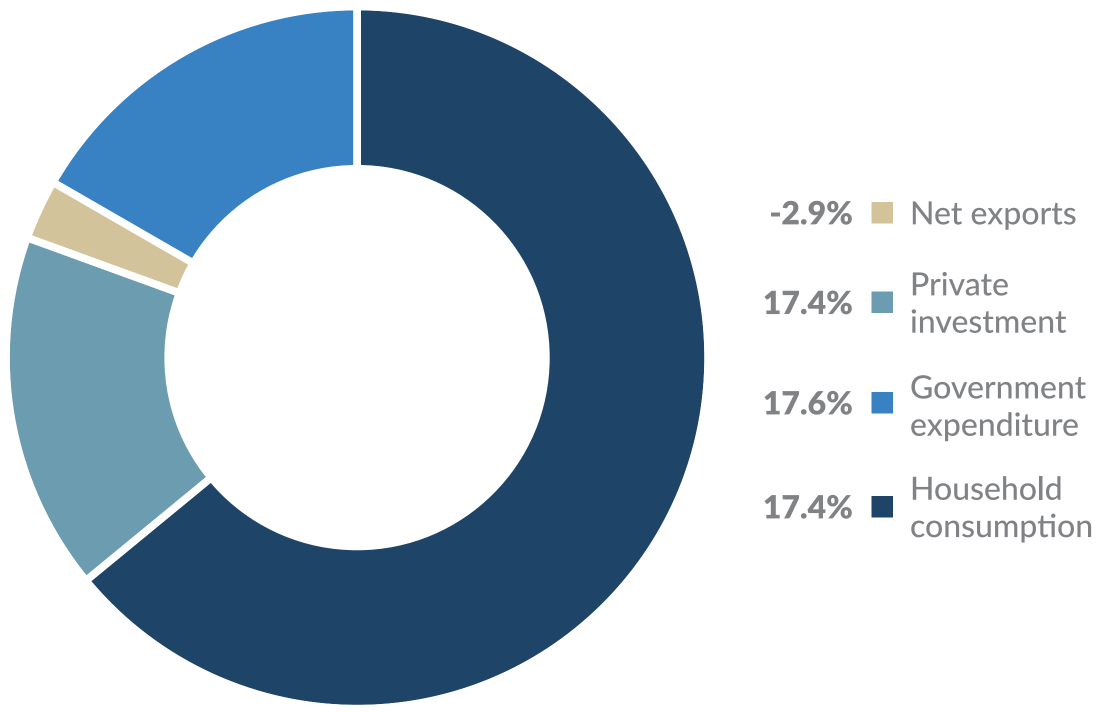


Figure 3: GFC 2008 - contributors to the average QoQ US GDP fall (-3.9%)
Source: Anchor, Bloomberg

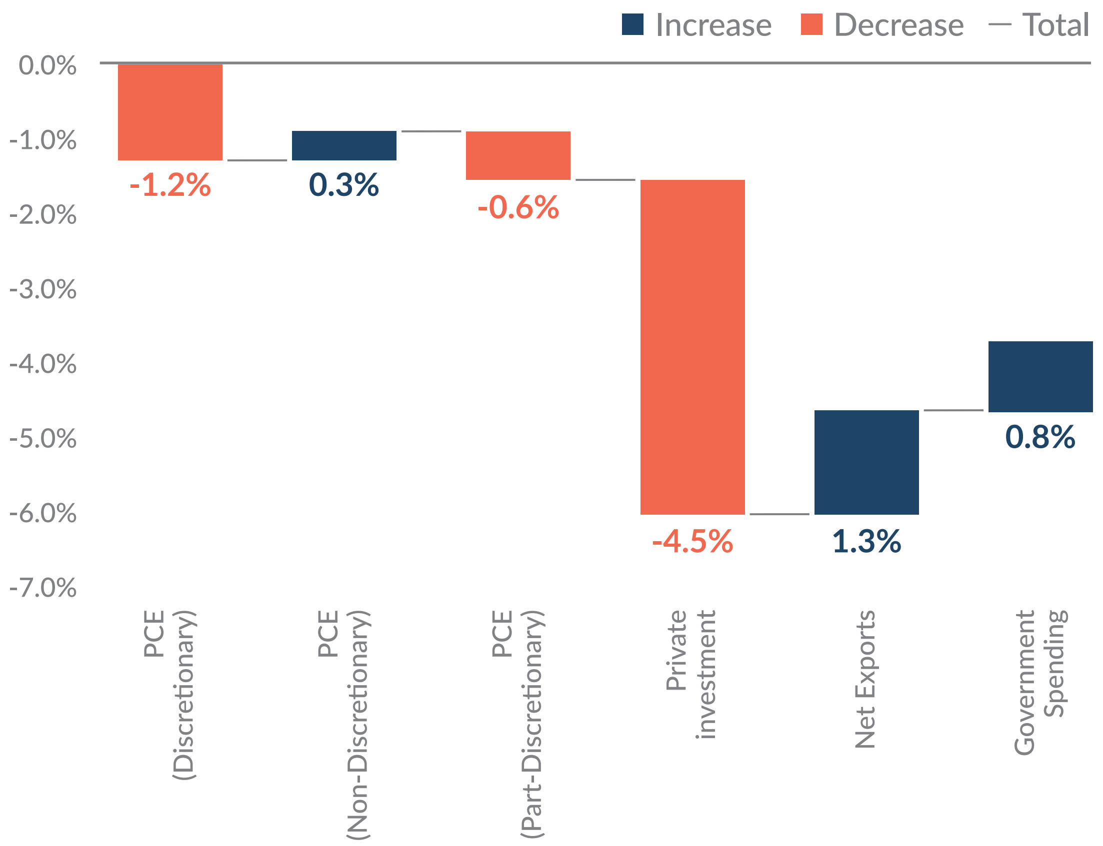


Figure 4: Tech bubble 2001 - contributors to the average QoQ US GDP fall (-0.1%)
Source: Anchor, Bloomberg

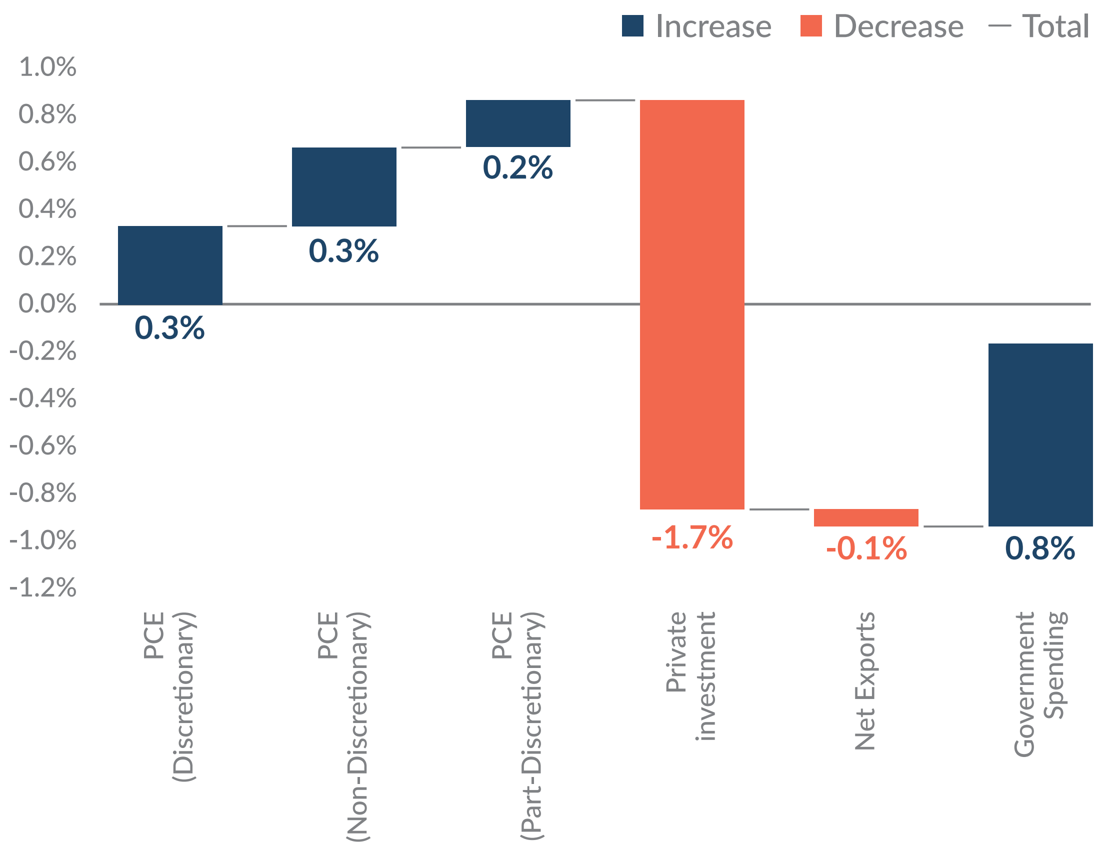
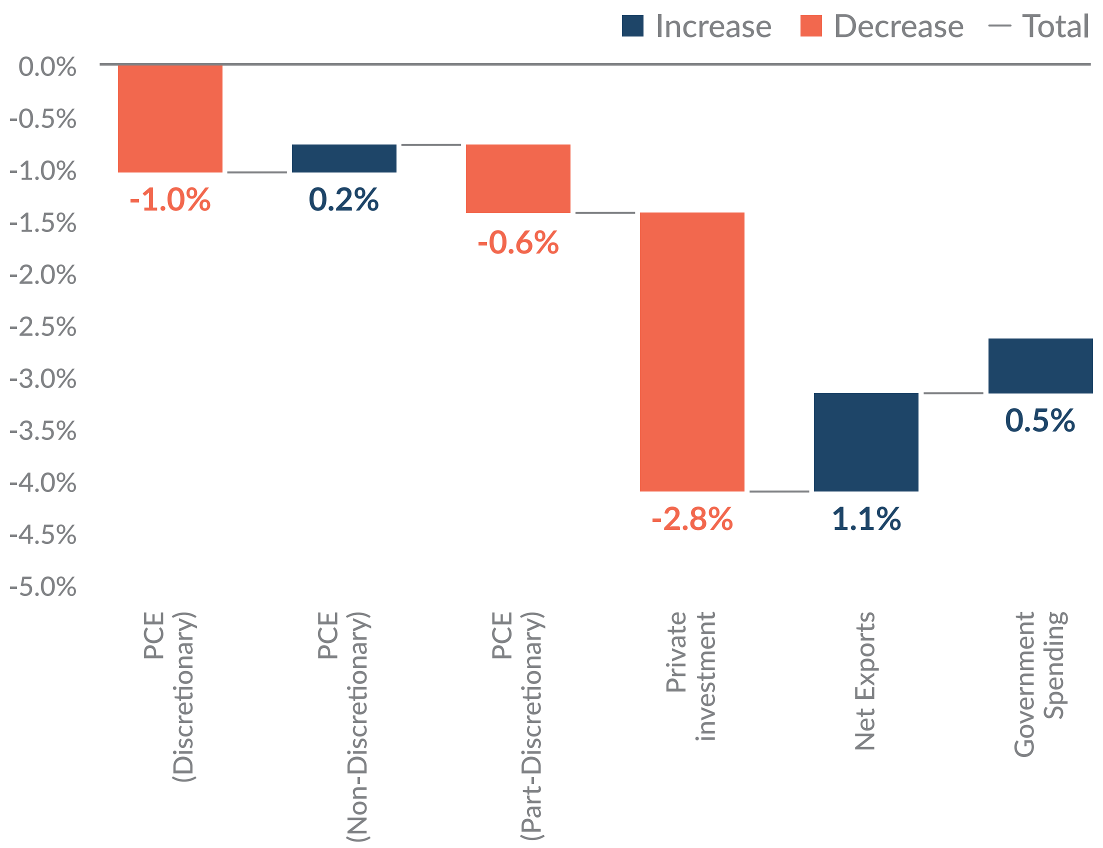


Figure 5: Oil shock 1990 - contributors to the average QoQ US GDP fall (-2.7%)
Source: Anchor, Bloomberg



Spending on private investment fell by between 8% and 25% over the course of the past three US recessions. Household consumption spending also tends to drop but with more than 50% of household consumption considered non-discretionary (which tends to grow marginally), the rest (which includes partially or fully discretionary elements) has tended to fall by about 5% (the exception being the tech bubble in 2001, when discretionary spending actually increased).

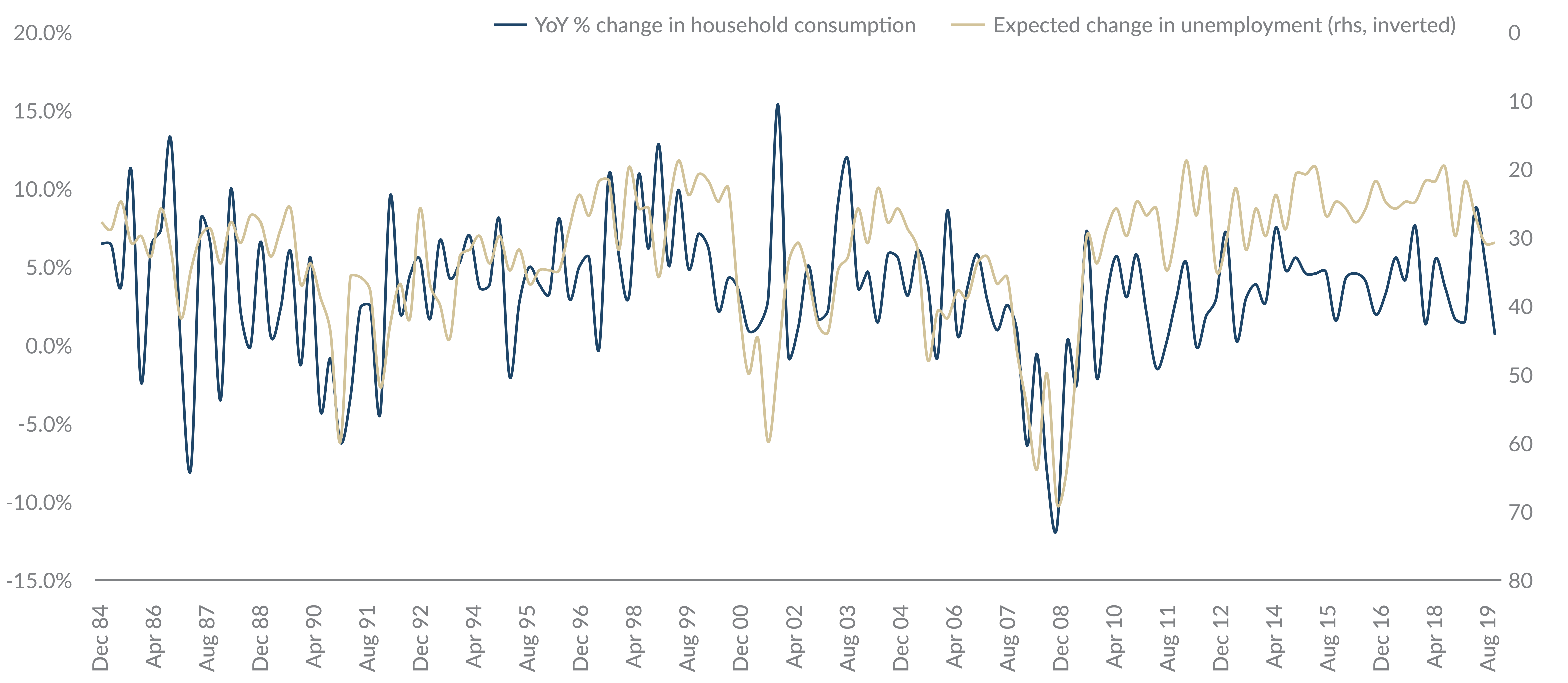
Figure 6: US household consumption
Source: Anchor, Bloomberg

HOUSEHOLD CONSUMPTION	% OF CONSUMPTION	REAL CHANGE IN GDP GROWTH (QTRLY AVG)		
	Last 5 years (avg.)	GFC	Tech Bubble	Oil Shock
		30 Jun 08	29 Dec 00	28 Sep 90
		4 qtrs	3 qtrs	2 qtrs
Discretionary	**27.5%**	**-6.1%**	**1.7%**	**-4.9%**
Motor Vehicles	3.6%	-11.3%	3.3%	-23.2%
Furnishing	2.7%	-13.2%	4.5%	-2.2%
Recreational equip and vehicles	3.3%	-8.4%	8.7%	2.2%
Other durable goods	1.7%	-5.4%	-5.8%	-3.5%
Clothing	3.2%	-8.3%	-1.4%	-0.2%
Recreation services	3.9%	-2.7%	-1.0%	-2.4%
Food services and accom	6.1%	-4.3%	-1.0%	-4.3%
Nonprofits	2.8%	4.0%	6.3%	10.2%
Non-discretionary	**52.7%**	**0.7%**	**1.0%**	**0.8%**
Food and beverages (cons off prem)	7.7%	-2.0%	0.2%	-1.6%
Energy	4.2%	0.6%	0.6%	-6.9%
Housing and utilities	18.2%	1.0%	1.1%	0.4%
Healthcare	15.4%	2.4%	5.5%	0.3%
Financial services and insurance	7.7%	-1.2%	-6.0%	10.6%
Part-discretionary	**19.8%**	**-4.1%**	**1.7%**	**-5.2%**
Other non-durable	7.8%	-3.1%	1.7%	-1.0%
Transportation	3.1%	-8.8%	-3.5%	-8.3%
Other services	8.6%	-3.3%	4.0%	-7.9%

Economists are almost unanimous that the US, and most of the world, will experience negative economic growth in 2Q20 as movement restrictions imposed to counter the spread of COVID-19 weigh on economic activity. The duration of the economic slump and the speed at which it bounces back is a subject of fierce debate and tends to correlate with the theories on how quickly the spread of the virus can be brought under control. This time, unlike during most recent recessions, it will be the inability of consumers to access various categories of spending (including restaurants, hotels, flights, movies etc.) that will result in a sharp slump in household consumption. Typically, in the past it would have been loss of income and savings or fear thereof which would drive consumers to curtail their spending. Categories of consumption that are inaccessible because of movement restrictions account for upwards of 10% of all US economic expenditure and many could see very little or no spending for a period. This implies the potential of a 10% drop in US GDP (similar to many other economies), depending on the scale of movement restrictions. That is likely to be at least partially offset by other categories of spending, particularly online, that stand to gain from the current restrictions on movement.

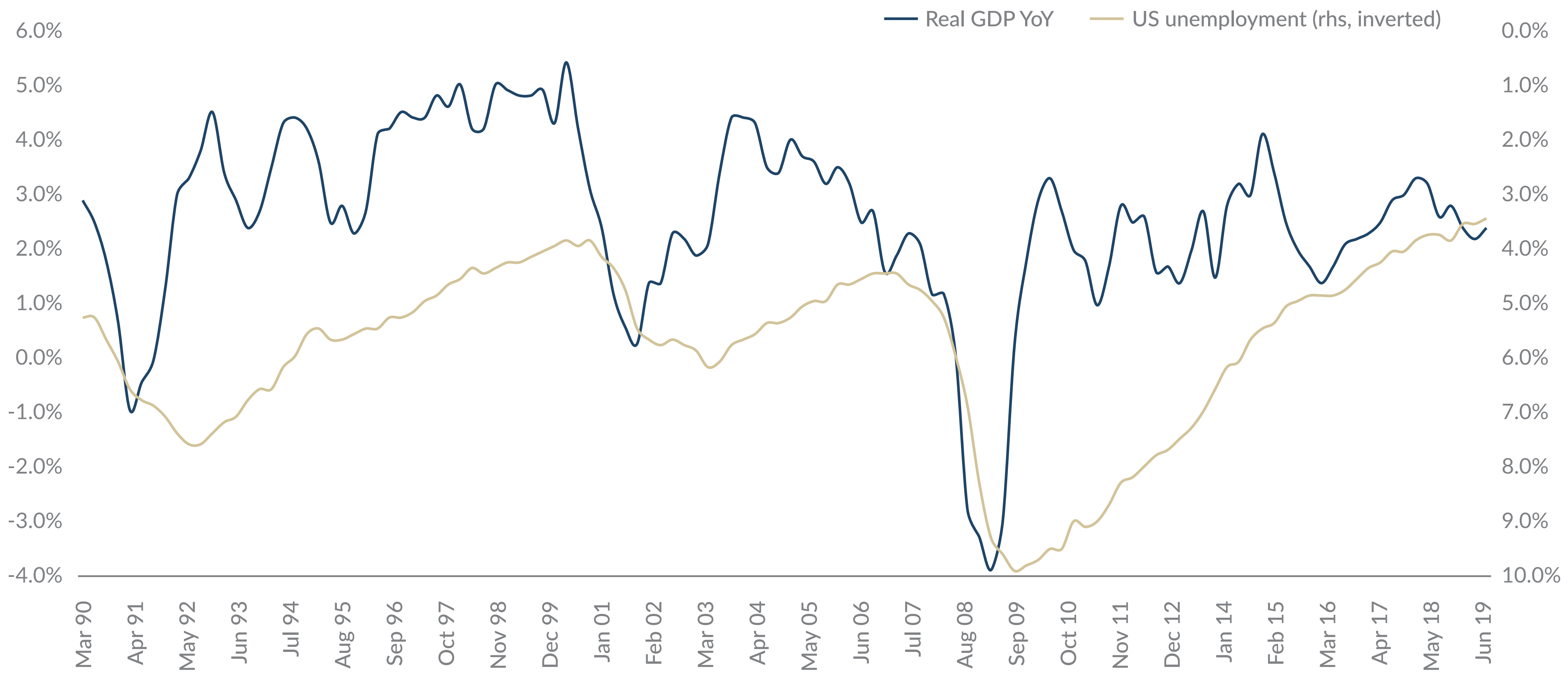
Governments and central banks are trying to furiously plug economic holes in an attempt to ensure that companies and individuals have access to grants or loans to tide them over until the situation normalises. The US has recently announced $2trn of fiscal stimulus (the equivalent of about 10% of annual US GDP), which should hopefully make up for much of the pull back in private consumption and investment. If the stimulus can keep companies from declaring bankruptcy, defaulting on debt and laying off workers, then the prospect of a much quicker resumption of normal economic growth remains reasonable. Governments and central banks are patently aware of the importance of confidence in greasing the wheels of the global economy.

Figure 7: US household consumption vs perceived employment prospects
Source: Anchor, Bloomberg



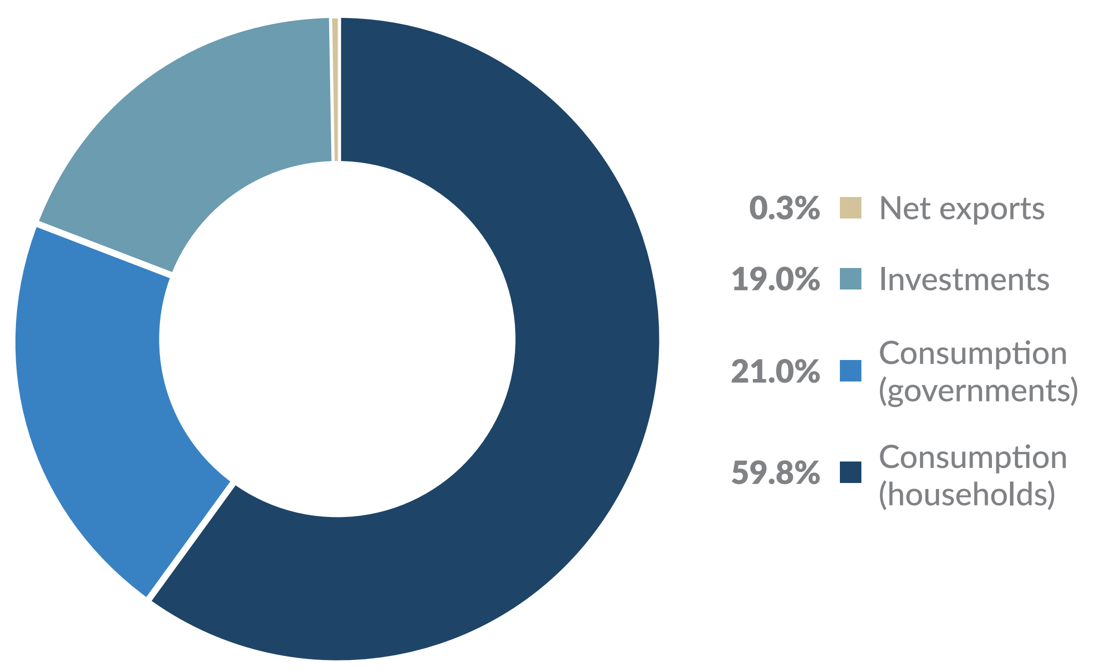
Once consumers start losing their jobs and savings, their propensity to spend less starts a downhill spiral which would require a shift in focus from the easing of movement restrictions (signalling a trough in economic declines), to the need for unemployment to come close to peaking before economic growth can trough (with the base effects allowing growth to bounce back much quicker than employment).

Figure 8: US unemployment vs US economic growth
Source: Anchor, Bloomberg



SA's economy, much like that of the US, is heavily reliant on consumers (60% of economic output vs 68% for the US), but it is slightly more reliant on government expenditure (21% vs 18% for the US). This is positive in the short term from a perspective of cushioning economic shocks, although it is less desirable in the long run.

Figure 9: SA GDP contributions
Source: Anchor, Bloomberg



The local economy is much more exposed to the impact of the rand exchange rate through net exports, which tend to have a much larger, and more volatile, impact on local economic growth than is the case for larger DMs. As a large mineral exporter, the impact of inventories also tends to add volatility to SA's path of economic growth. These two components, largely beyond our control, have had a significant impact (both positive and negative) over the course of the past three SA recessions:

Figure 10: 2019 – contributors to the average QoQ SA GDP fall (-0.5%)
Source: Anchor, Bloomberg

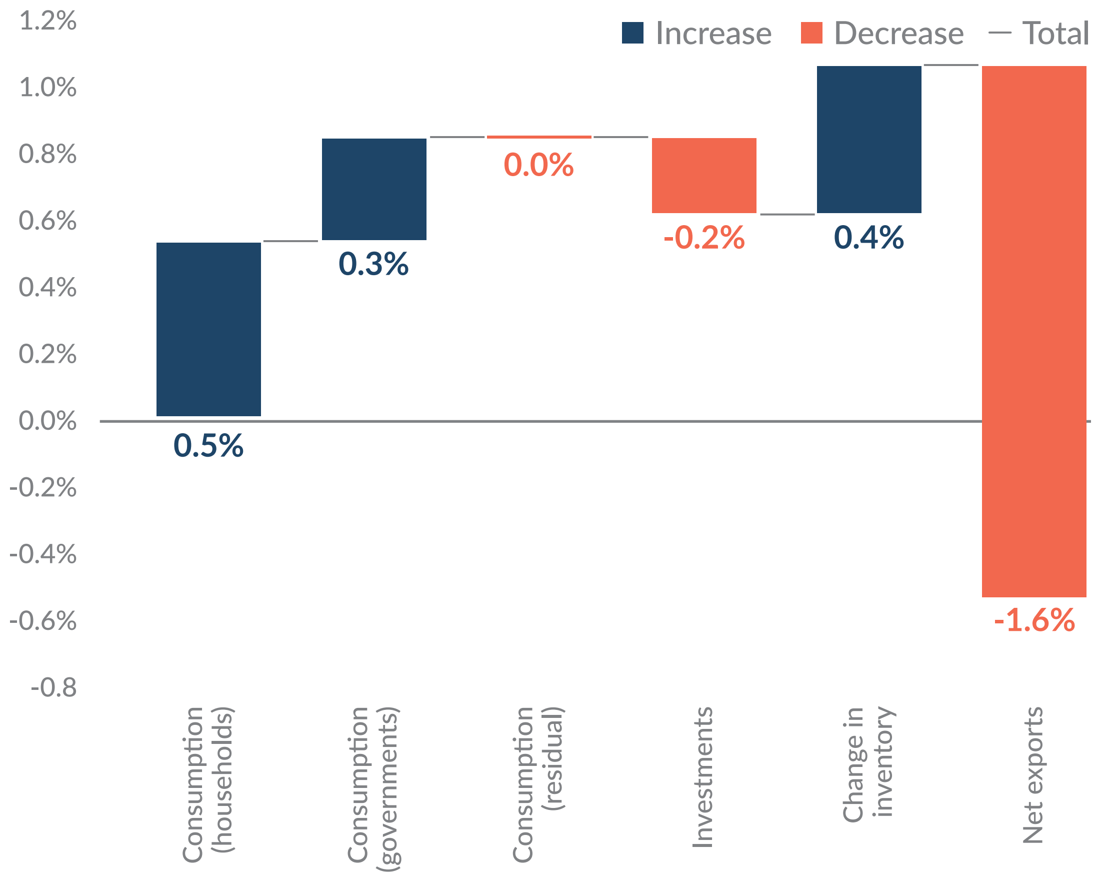


Figure 11: GFC – contributors to the average QoQ SA GDP fall (-2.2%)
Source: Anchor, Bloomberg

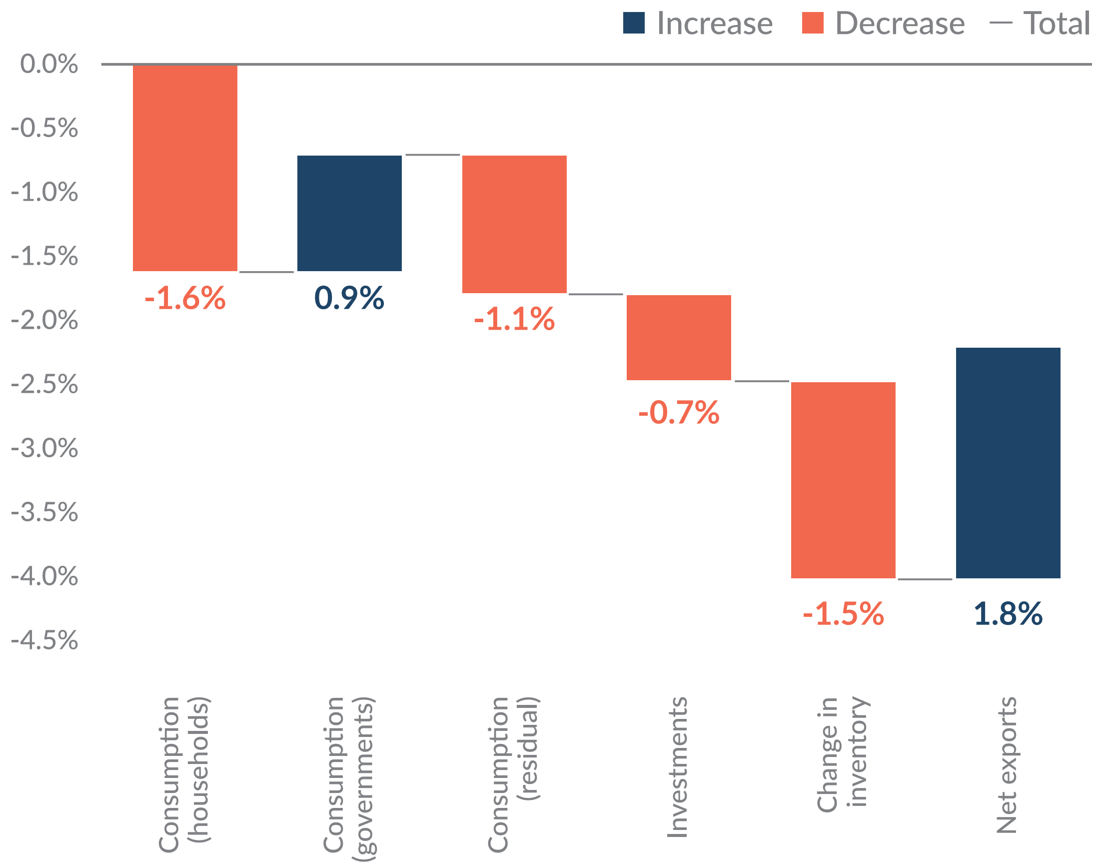
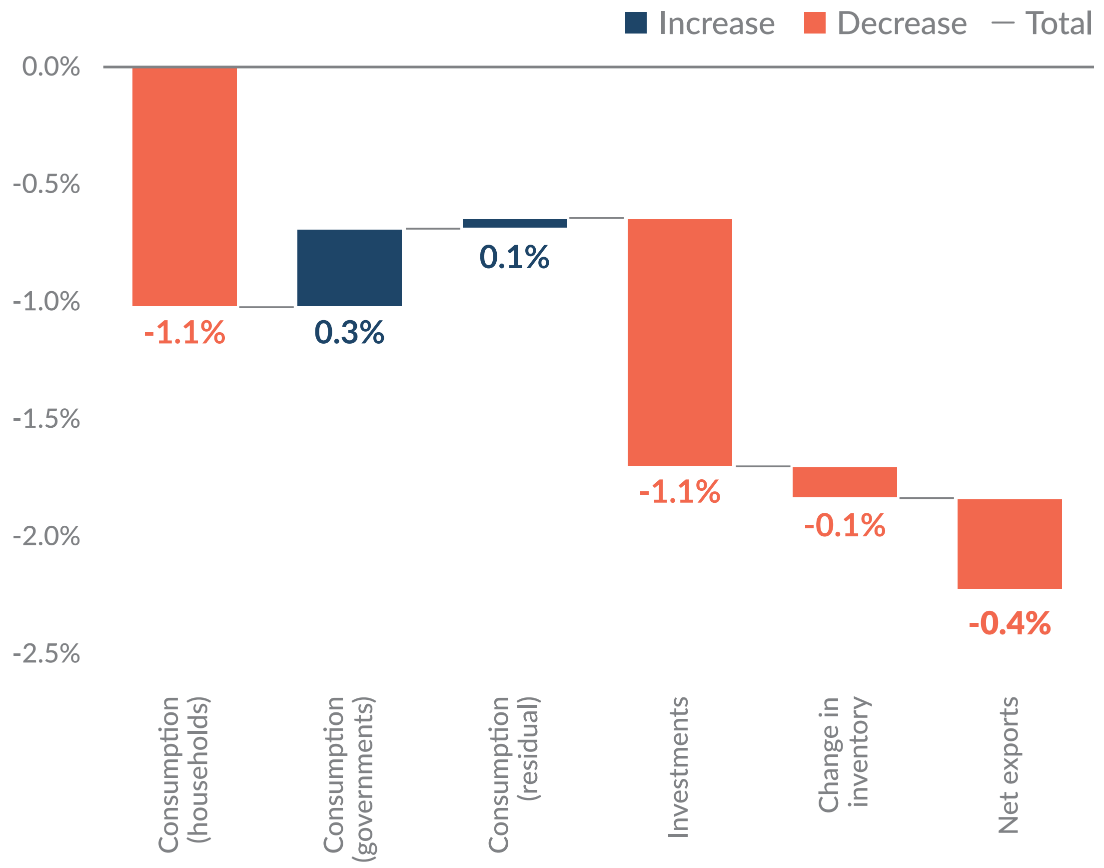


Figure 12: Early 1990s – contributors to the average QoQ SA GDP fall (-2.3%)
Source: Anchor, Bloomberg



Barring SA's most recent recession in 2019, drops in consumption and investment have had a similarly negative impact on local GDP growth (subtracting about 2%–3%, in aggregate, from growth during both the GFC and the recession in the early 1990s).

SA tends to have less granular data available for analysing GDP, but it's unlikely that discretionary categories of spending account for as much of household consumption as is the case in the US.

It's not inconceivable that the categories of spending that are most susceptible to restrictions of movement are in excess of 5% of economic output. Thus, we're likely to see a relatively large negative GDP print for the quarters hampered by lockdowns. A 5% drop in SA GDP is the equivalent of c. R65bn per quarter, with the government needing to plug at least that gap to avoid the kind of setback that would further exacerbate unemployment.

SA's economy, much like that of the US, is heavily reliant on consumers (60% of economic output vs 68% for the US), but it is slightly more reliant on government expenditure (21% vs 18% for the US).

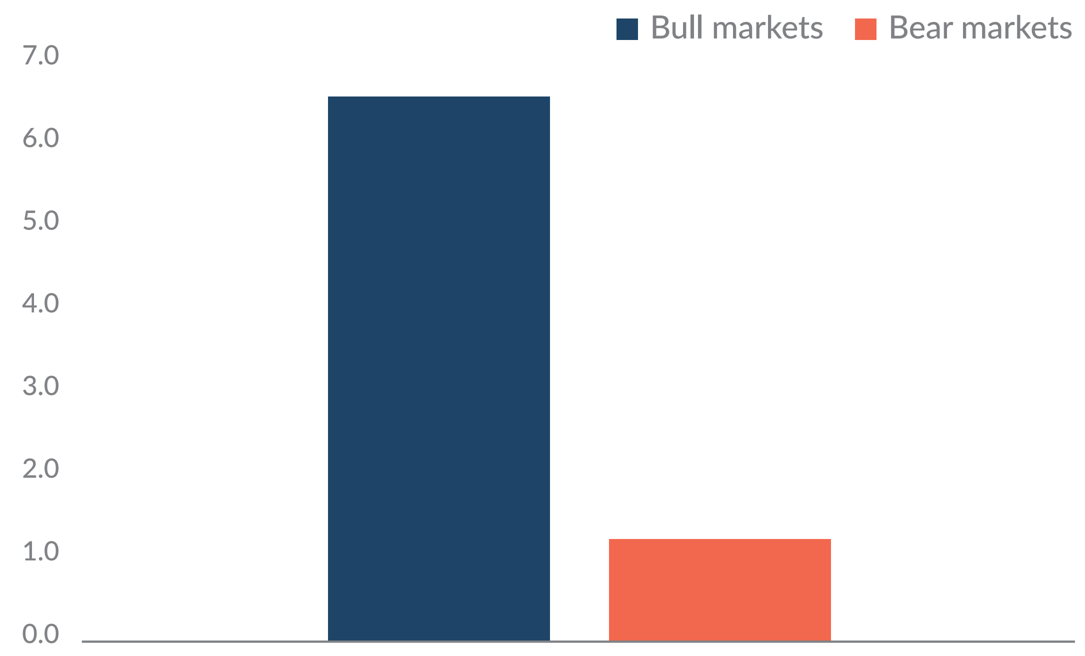
BEAR MARKETS

For investors, recessions not only have an impact on their income prospects but, since recessions typically coincide with bear markets, they also tend to have significant ramifications for the value of their investments. The US stock market started its most recent bear market (defined as a drop of >20% from the peak) on 20 February this year (after the longest bull market in history – almost 11 years!). Mark Twain is credited with the saying "History doesn't repeat itself, but it often rhymes." With that in mind, we thought it would be a useful exercise to study how bear markets typically behave, so that we're mentally prepared for the emotional rollercoaster and are best able to make rational investment decisions – forewarned is forearmed.

We analysed the past 40 years of US equity markets leading up to the most recent bear market, which includes five bull markets and five bear markets. The following three contrasts were stark:

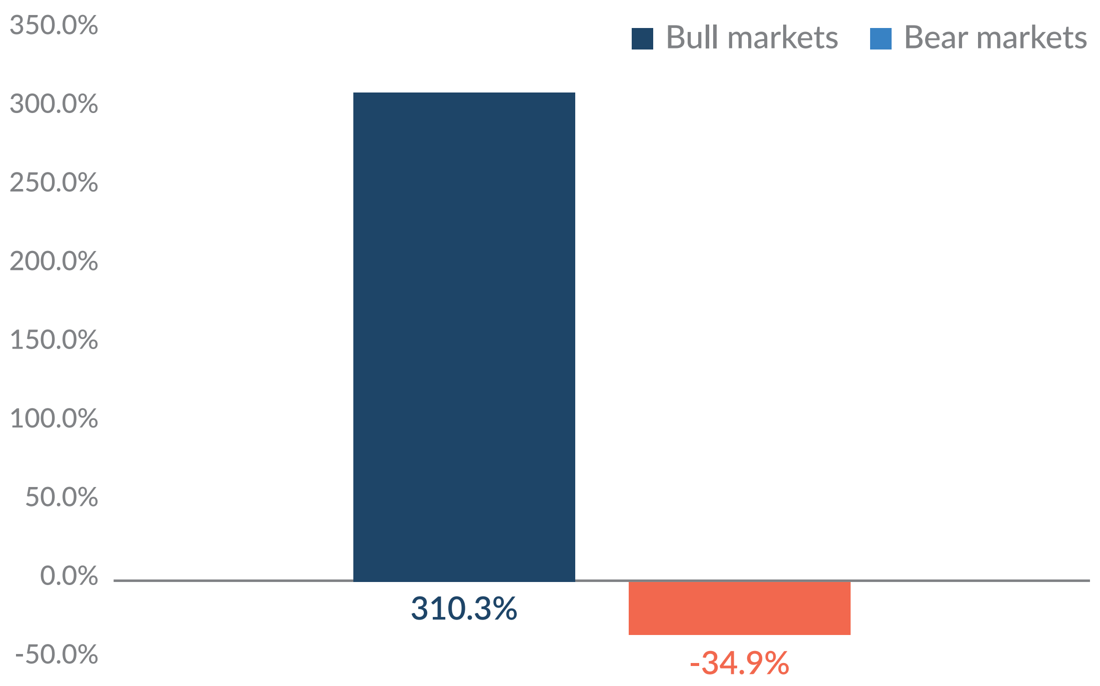
1. Bull markets tend to last about six times longer, with the average bear market lasting slightly more than a year (so we're about one-tenth of the way in, if the current bear market is equal to the average).

Figure 13: Duration of S&P 500 bull markets vs bear markets (# years)
Source: Anchor, Bloomberg



2. The direction of returns are obviously in the opposite directions for bull and bear markets, but the quantum of returns is a multiple of about nine times higher for bull markets, so investors can make around nine times more during bull markets than they would lose in bear markets (the power of compounding and of staying the course!). The S&P 500 is down c. 26% (up to the close on 3 April 2020) since it peaked on 20 February 2020, so we're about 70% of the way to an average bear market.

Figure 14: Quantum of S&P 500 returns in bull markets vs bear markets (Total return)
Source: Anchor, Bloomberg

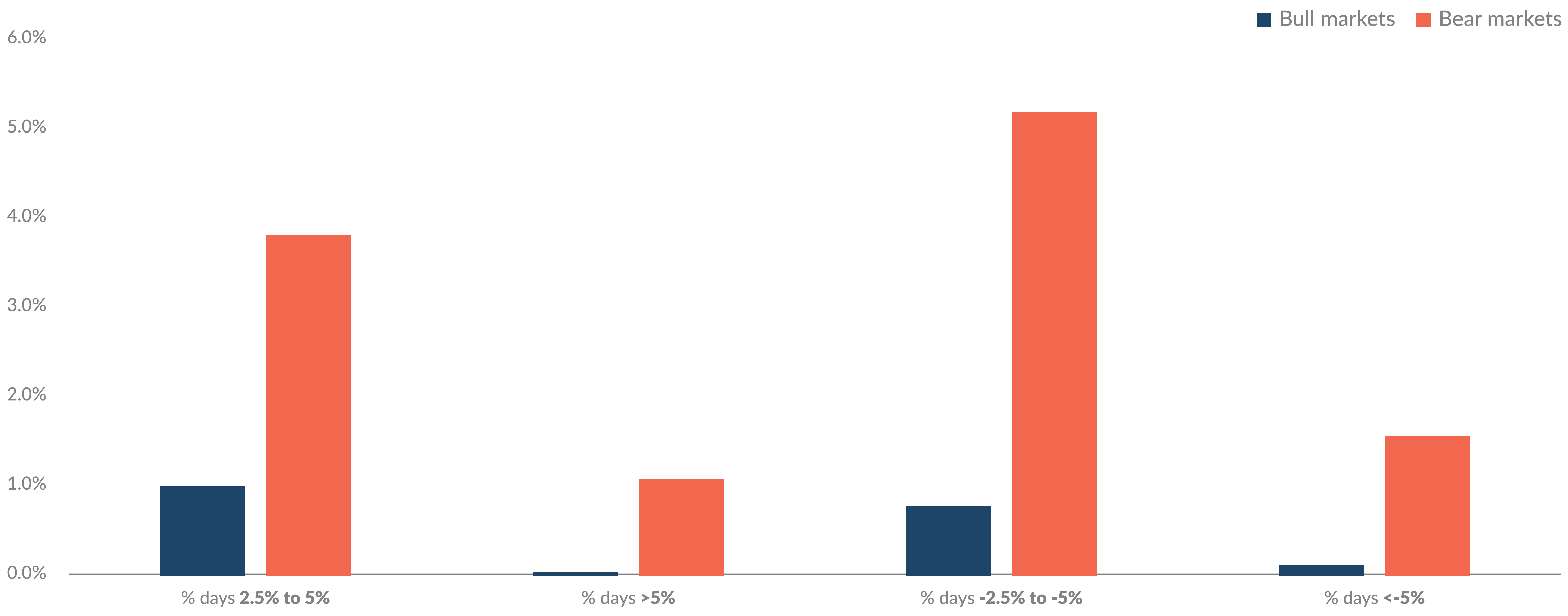


3. The frequency of extreme moves is significantly higher during bear markets, for both big up and down days on markets:

- Frequency of up days **> 2.5% are five times higher.**
- Frequency of down days **< -2.5% are eight times higher.**
- Frequency of up days **> 5% are thirty-four times higher.**
- Frequency of down days **< -5% are eighteen-times higher.**

For the first four weeks of the current S&P 500 bear market, less than 25% of the daily moves have been smaller than 2.5%, and more than 50% of daily moves have been >4% either way.

Figure 15: Proportion of extreme S&P 500 daily moves in bull markets vs bear markets
Source: Anchor, Bloomberg



There are also a couple of ways in which bull and bear markets don't differ particularly dramatically. These include:

1. Even in bull markets, only slightly more than 50% of daily moves are positive, for bear markets it's only slightly less than 50% (in the first four weeks of the current bear market, only 35% of trading days have been positive):

2. Though the adage suggests that markets go up the escalator and down the elevator, the last five bull/bear markets don't differ that much, with markets going up 24% p.a. on average and coming down by 29% p.a. on average.

Figure 16: Proportion of up days in S&P 500 bull markets vs bear markets (% positive days)
Source: Anchor, Bloomberg

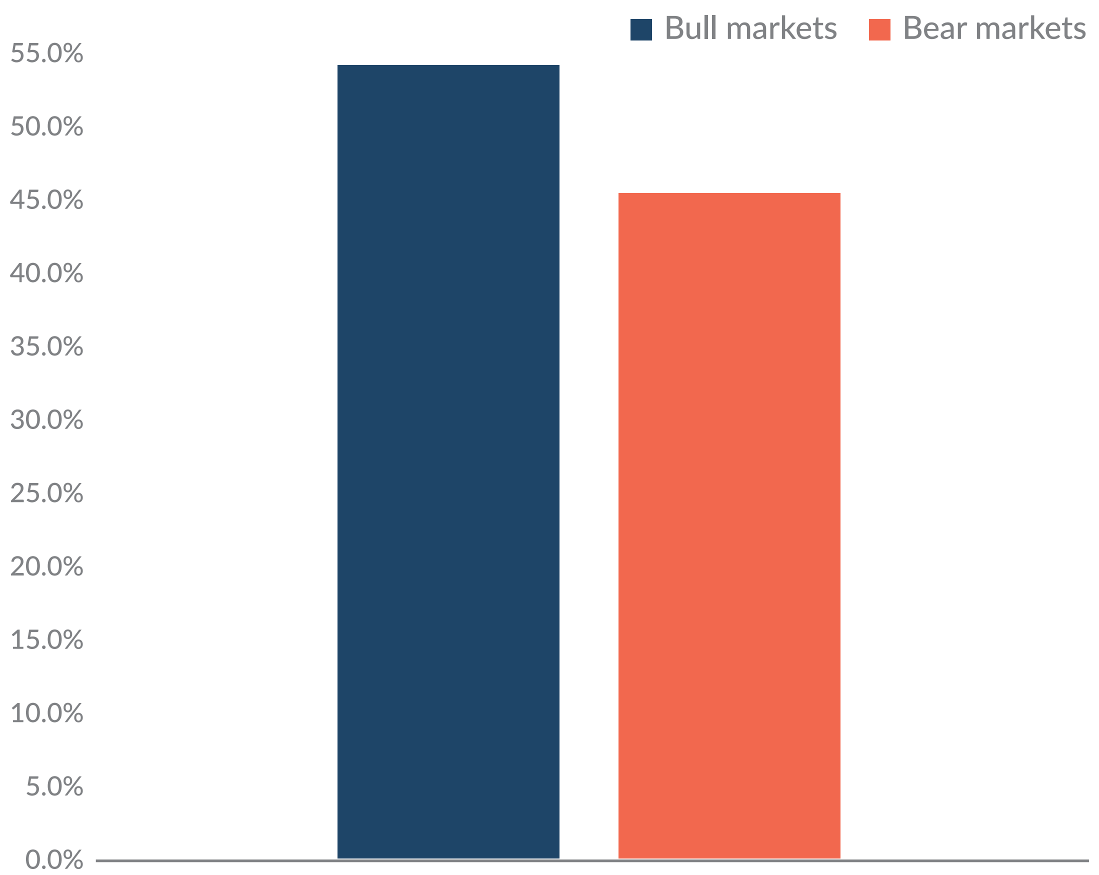
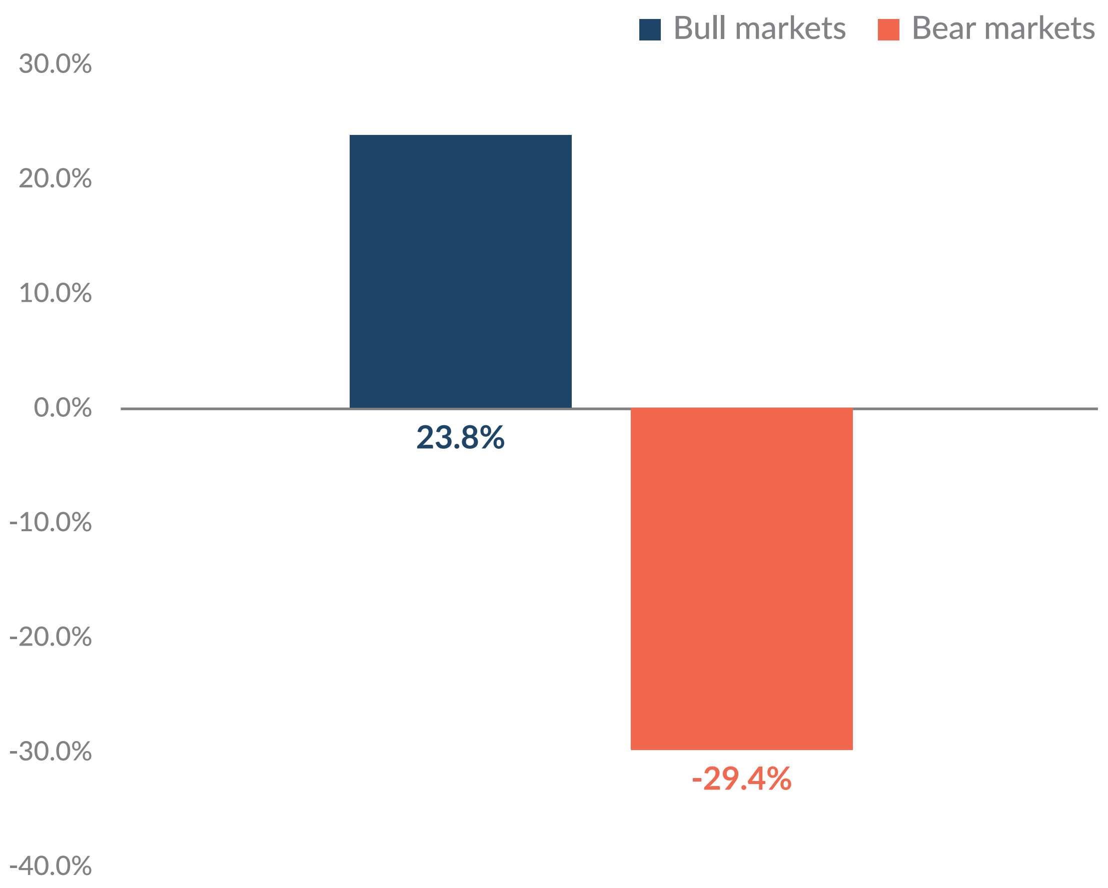


Figure 17: Annualised pace of S&P 500 returns during bull markets and bear markets (CAGR Rtns)
Source: Anchor, Bloomberg



We did a similar analysis for the FTSE/JSE All Share Index (ALSI), but data are only available going back 25 years, so we have used that time period for our analysis. The volatile nature of the benchmark means that we end up with eight bull markets and eight bear markets over the period (as many as the S&P 500 has had in 55 years). This includes the current bear market, which started over two years ago when the index peaked on 25 January 2018 (already about three times longer than the average bear market over the past 25 years).

1. ALSI bull/bear cycles are significantly shorter than those of S&P 500 markets, with ALSI bull markets lasting about 3.6 times longer than bear markets (vs six times longer for the S&P 500):

2. The FTSE/JSE All Share Index bull markets have half the relative potency of S&P 500 bull markets, delivering compound returns of about 4.6 times the quantum of bear markets (vs nine times for the S&P 500). The current ALSI bear market, at -25% (up to the close on 3 April 2020), is about 82% of the way to the average ALSI bear-market return over the past 25 years.

3. The frequency of large daily moves in ALSI bear markets relative to bull markets is not as pronounced as with the S&P 500, particularly when it is relevant to the upside:

   - Frequency of up days **> 2.5% are 1.1 times higher** (five times higher for the S&P 500).
   - Frequency of down days **< -2.5% are 3.8 times higher** (eight times higher for the S&P 500).
   - Frequency of up days **> 5% are 1.4x higher** (thirty-four times higher for the S&P 500).
   - Frequency of down days **< -5% are 4.5x higher** (eighteen times higher for the S&P 500).

Figure 18: Duration of ALSI bull markets vs bear markets
Source: Anchor, Bloomberg **(# years)**

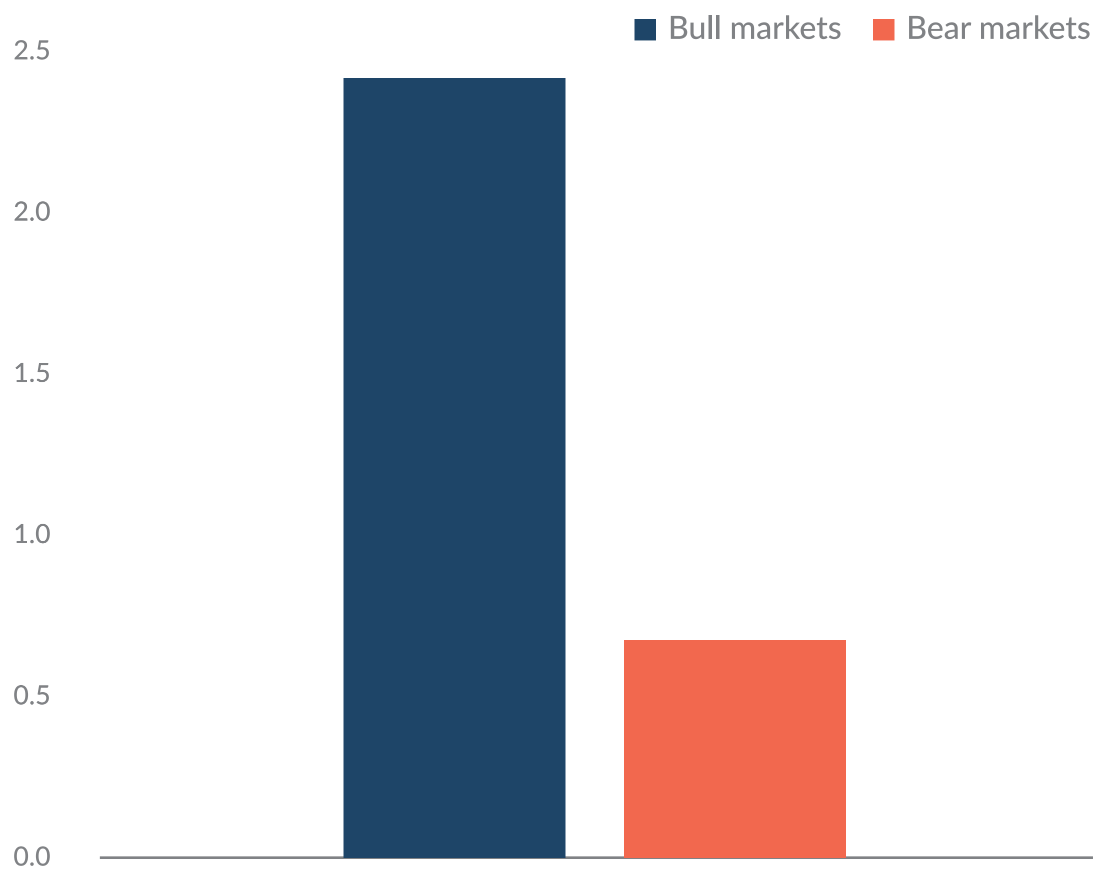


Figure 19: Quantum of ALSI returns in bull markets vs bear markets (Total return)
Source: Anchor, Bloomberg

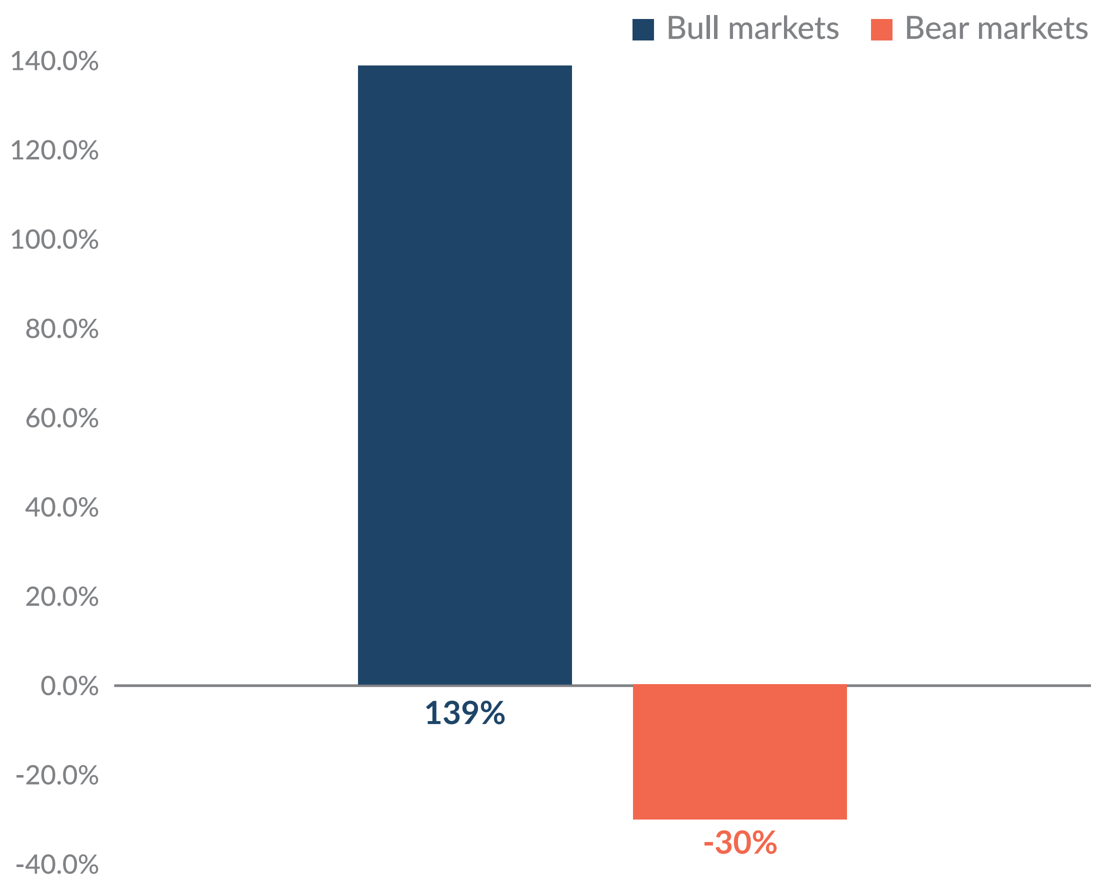
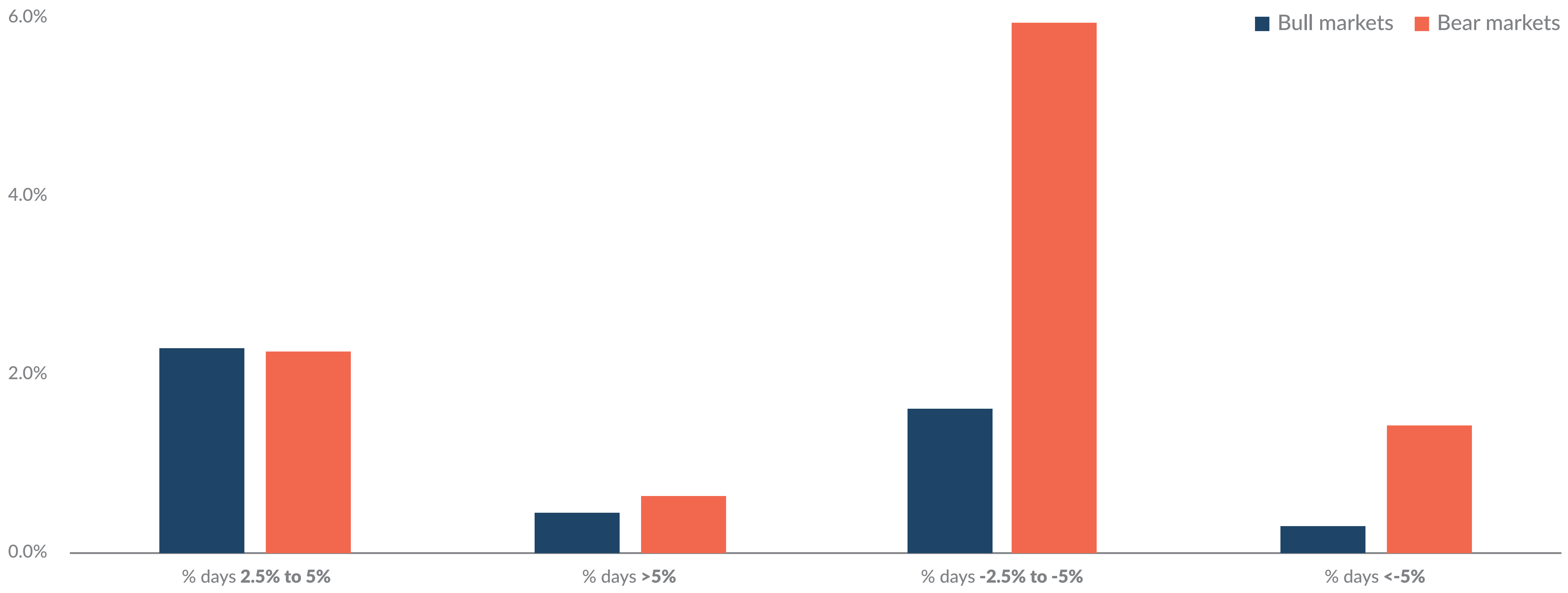
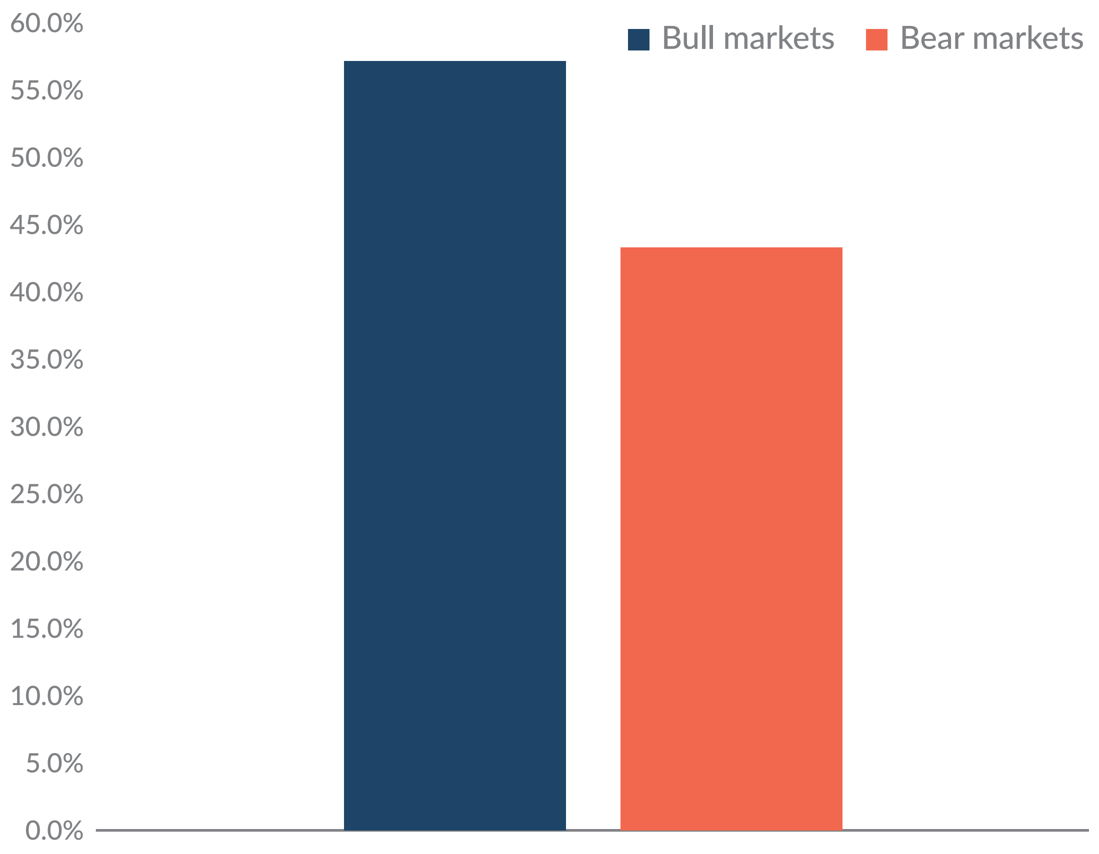


Figure 20: Proportion of extreme ALSI daily moves in bull markets vs bear markets
Source: Anchor, Bloomberg



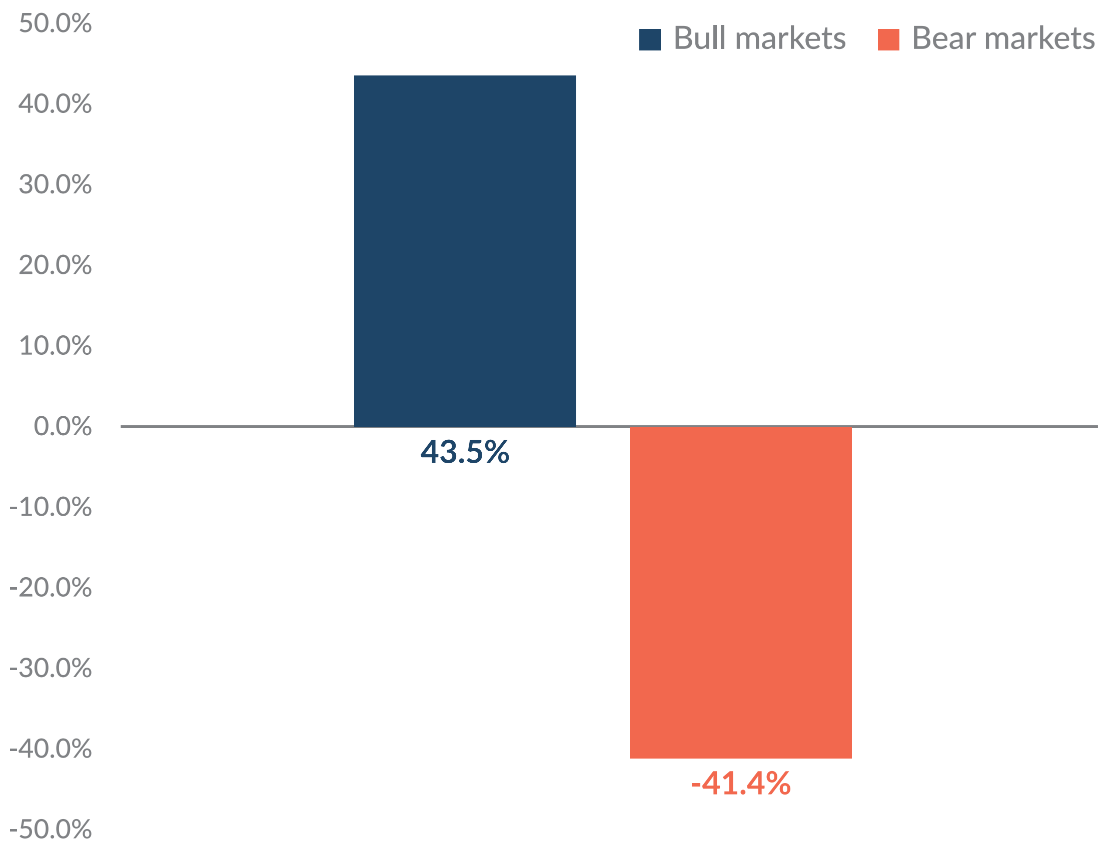
4. The number of positive days in ALSI bull vs bear markets is only marginally more pronounced vs the S&P 500 (56% of positive days in bull markets for the ALSI vs 54% for S&P 500 and 44% vs 46% in bear markets, respectively):

Figure 21: Proportion of up days in ALSI bull markets vs bear markets (% positive days)
Source: Anchor, Bloomberg



5. The adage about markets going up the escalator and down the elevator certainly doesn't ring true for the ALSI, which moves at a similar annualised pace of returns on the way up and on the way down (which is > 50% faster than the S&P 500 pace):

Figure 22: Annualised pace of ALSI returns during bull markets and bear markets (CAGR Rtns)
Source: Anchor, Bloomberg



CONCLUSION

There remains significant unpredictability about the duration of the current economic downturn at this point, especially given the uncertainty around the pace with which governments around the world can get the spread of the pandemic under control. There have been encouraging efforts by both governments and central banks to provide enough stimulus to ensure that, should the pandemic be under control in weeks rather than months (allowing for the removal of movement restrictions), then economies around the world have every chance of bouncing back as sharply as they're falling. However, if the pandemic and movement restrictions persist long enough that governments are unable to prevent meaningful bankruptcies, defaults and retrenchments, then we will likely have a few more quarters of an economic slowdown and a slightly slower recovery.

At this point, global markets have priced in about 70%–80% of a normal recession. So, in the event of a relatively quick V-shaped recovery, it seems likely that markets will recover a fair portion of their losses fairly quickly. Should this pandemic drag on longer than hoped, it's unlikely that we'll see a sharp recovery in asset prices for a couple of quarters although, with 70%–80% of a normal recession priced in, there's unlikely to be significantly more downside. For at least the next few weeks, while we await more clarity on the pace of the spread of the virus, it's likely that we'll see significant moves in asset prices on both the upside and on the downside. For now, the most appropriate course of action seems to be patience, but always bearing in mind that the next bull market is likely to last significantly longer than this current bear market, with compounding driving gains to multiples of the losses investors are experiencing in the short term.

You bought listed property for dividends – now what?

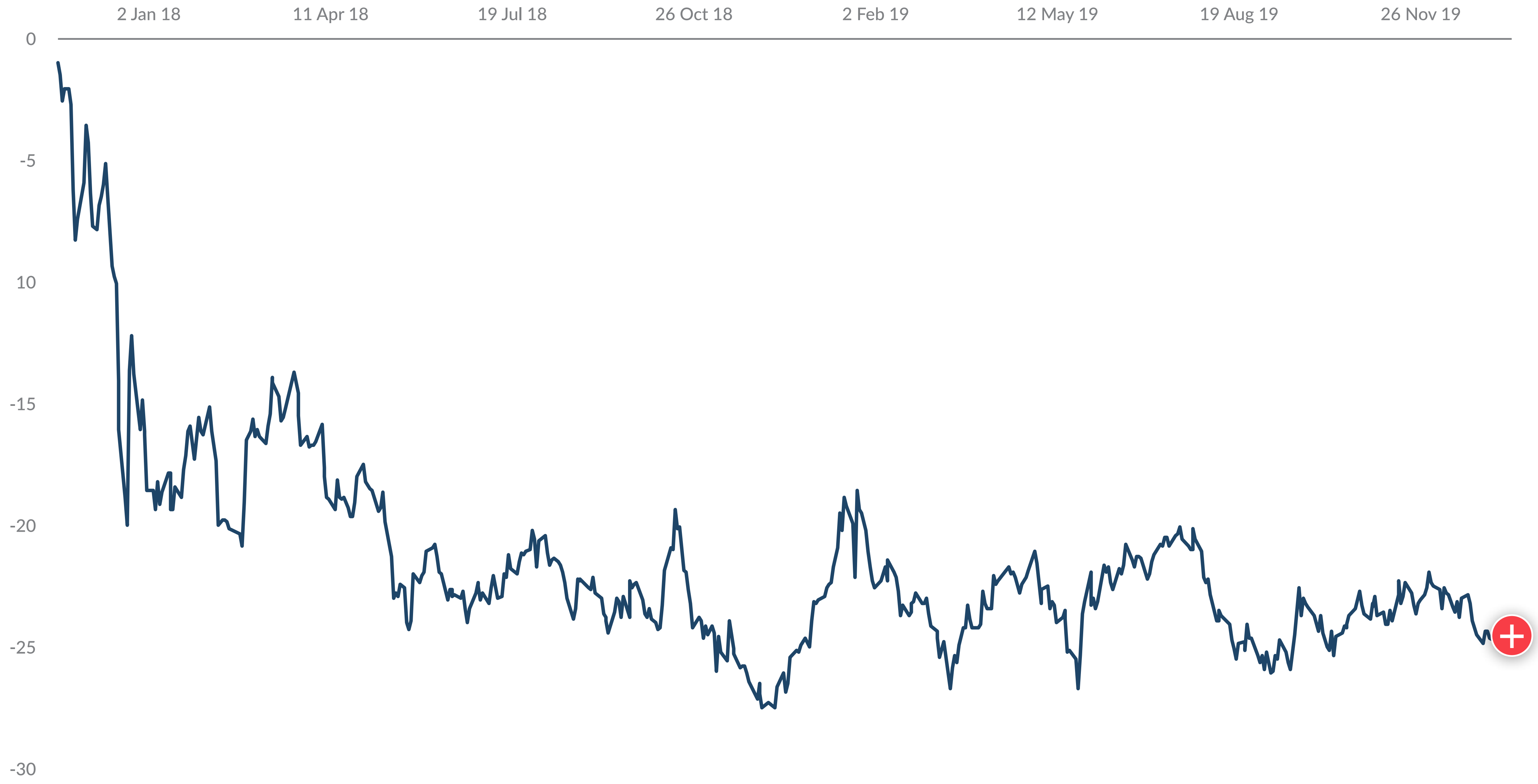
Written By:

GLEN BAKER
Fund Management

Glen has been working in financial markets since 1990. In that time he has headed up equity derivatives divisions at major local and international institutions and has both equity and fixed-income experience. On the sell-side he has advised fund managers on equity and index products specialising in derivatives and structured products. His direct investment experience includes managing Exchange Traded Funds (ETFs) at RMB before establishing the internal Hedge Funds, and managing the property and equity yield focused products at Anchor Capital. He is a member of the Anchor Asset Management team that constructs client and model portfolios.

SA listed property was a poor performing sector going into the COVID-19 pandemic. It lost its position on the podium at the end of 2017, when some of the corporate finance "magic" in the sector was exposed, and this was followed by further deterioration due to the steady and visible downturn in the SA economy. This resulted in the uninterrupted growth in distributions over the prior 10 years to falter in 2018/2019 and led to investors scrutinising all the fundamental reasons to own property shares. The bottom-line conclusion was that some did not like what they saw and headed for the exits.

Figure 1: FTSE/JSE SA Listed Property Index (JSAPY) total return (%), 2018-2019
Source: Anchor, Refinitiv



As 2020 started there was some optimism about the sector once again. This was based on what looked to be very attractive yields on offer, even with the understanding that leverage in the sector remained a concern and that some property companies were better placed than others. The tide, to the extent that it did rise, would not lift all ships, and investors knew that. But at least the tide should turn .... Unfortunately, COVID-19 has impacted all and sundry and, at the time of writing, its impacts are very difficult to try and forecast. This was followed by Moody's downgrading SA's only remaining investment grade rating to junk, some 24 hours after a countrywide lockdown, instituted by government because of the virus, started. As the Chair of the recently formed Property Industry Group (PIG) said in a conference call recently "... don't worry about storm, this is a perfect hurricane."

Figure 2: JSAPY total return (%), 1Q20
Source: Anchor, Refinitiv

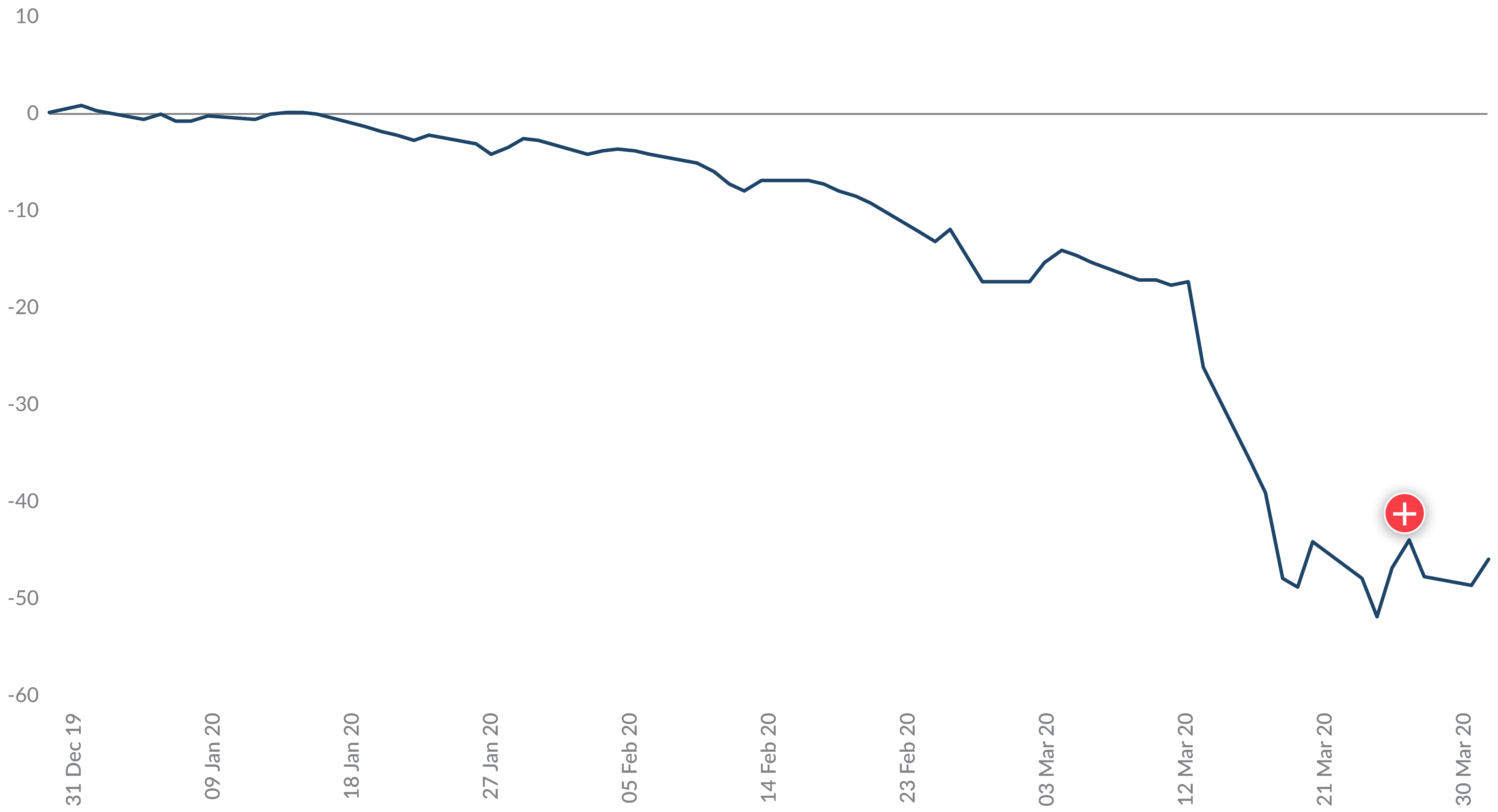
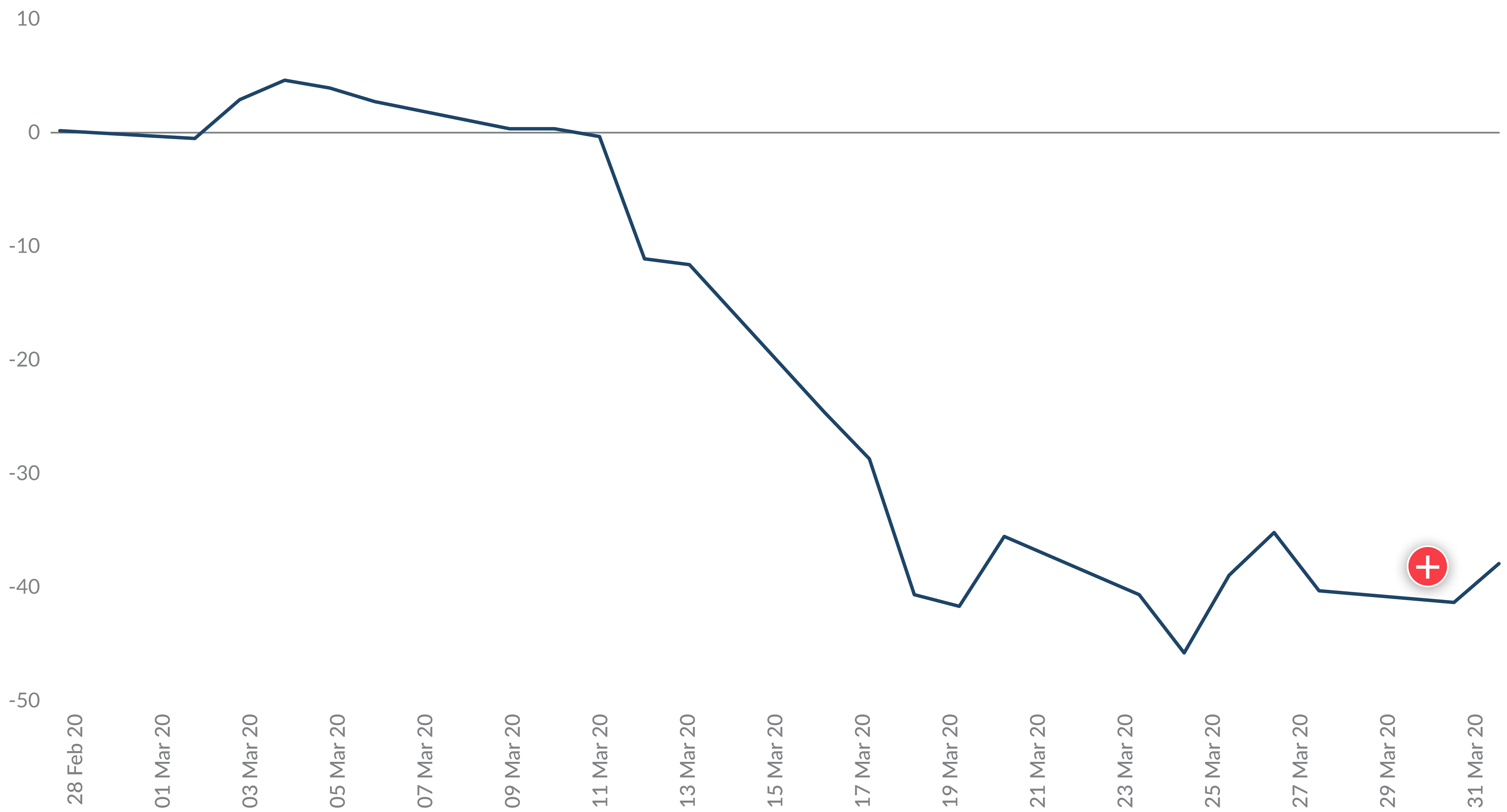
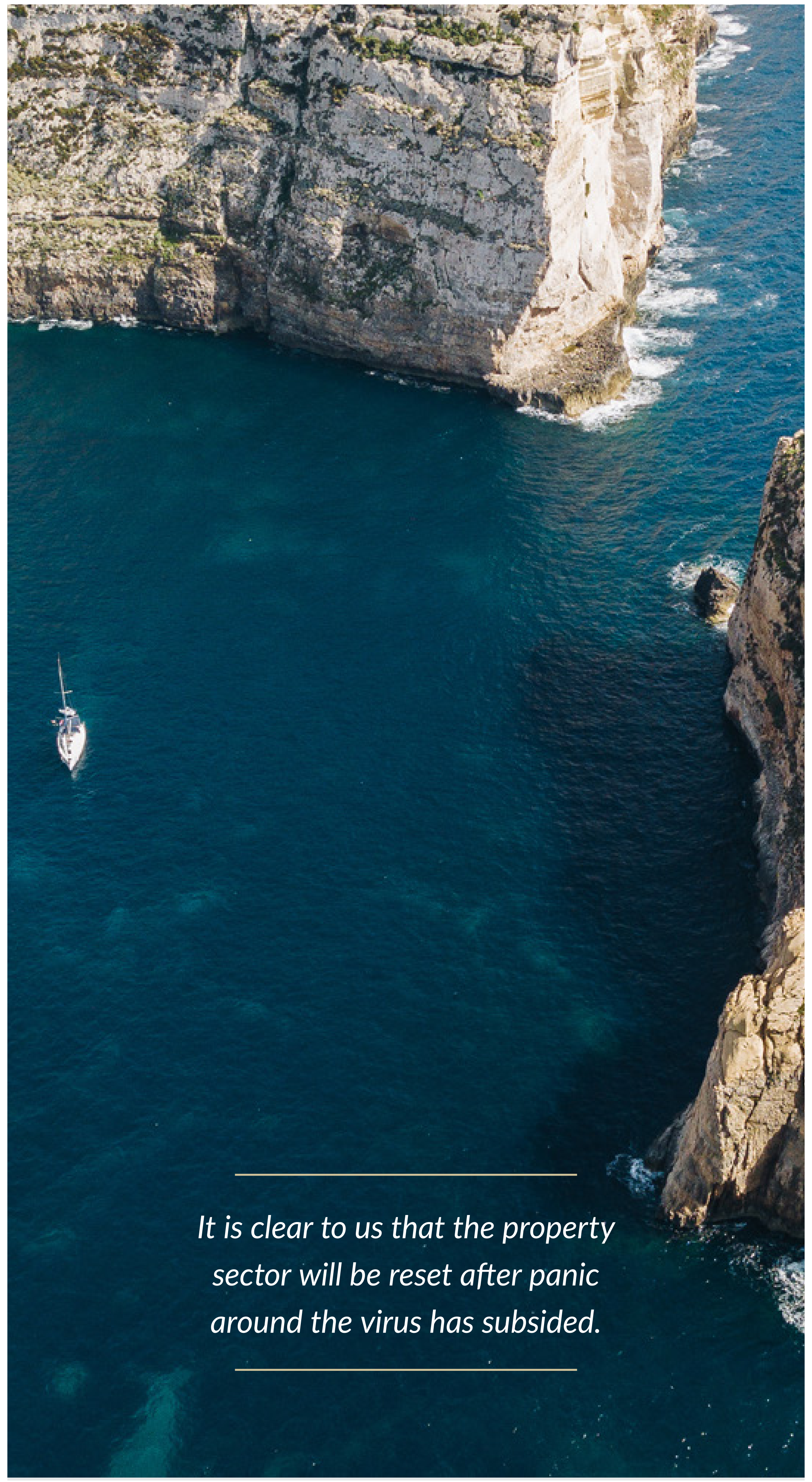


Figure 3: JSAPY total return (%), March 2020
Source: Anchor, Refinitiv



After falling over 36% in March and nearly 50% in 2020 YTD, the JSAPY Index, the primary benchmark for SA listed property shares, is now down 60% in 27 months!

So, what can we expect going forward? Because of the current environment, there are a lot of moving parts that make the short-term movement of property share prices difficult to guesstimate (and this is not only confined to the property sector). Therefore, we believe that the focus should be on any potential changes in trends and established practices within the industry. To the extent that these changes occur, they will shape investment indicators and dictate valuations. In addition, any analysis of a property company will now need to include influences that other players have in the industry rather than just focusing on standalone income statements and balance sheets. At the top of this list are valuers, funders and regulators.



VALUATIONS – INDEPENDENT VALUERS' ROLE

COVID-19 has caused (or forced) behaviour to change, the best example being the closure/lockdown of most stores servicing the economy. This has a direct impact on income streams for most rent-paying tenants and will lead to instances where landlords will lose rental income. This could result in a reduction in asset valuation of some kind but will more likely lead to property transactions drying up – a complete lack of liquidity in what was already an illiquid market to start with. Valuers will react by qualifying valuations with a "material uncertainty" stamp, effectively meaning that no reliance can be placed on the valuation. This means that, for a period, until normality returns, the best evidence of a physical property's value - what a buyer is willing to pay and what the seller is willing to receive - is not available.

Upon the return to normality, the result should be investor awareness of the valuer's role, based on transparency via documented methodologies of independent valuations of the property portfolio.

BANKS AND FUNDERS

Investor focus on dividend payments and dividend growth prospects, and the property companies' ability to provide these, meant that capital structure, particularly leverage, were not critical to the investment decision. If interest payments were covered adequately, loan-to-value (LTV) ratios were unlikely to be problematic. However, income statements have now come under pressure. This means that property values will fall and, in those markets where liquidity in the physical market has been affected and asset sales cannot happen, the LTV ratio will be difficult to correct. In the very short term, as we look to combat COVID-19, banks may provide some respite if LTV covenants occur. But, longer term, capital structure and leverage will be significant. Below, we highlight what we look for in a property company in this regard:

- The company should not be overleveraged but have a prudent LTV ratio with a debt profile that is not divorced from lease expiries as well as realistic cap rates.
- Debt being adequately serviced:
  - An interest coverage ratio (ICR), but even better NRI/interest; and
  - The net debt/NRI ratio should be the second check after the LTV ratio.

REGULATORS AND TAXATION

PIG will be meeting with regulators (the JSE and National Treasury), concerning the issues that the current environment is causing to the rules of companies retaining their real estate investment trust (REIT) status. In summary, these are:

- That 75% of income needs to be traditional rental income;
- That 75% of distributable income needs to be distributed to shareholders as dividends; and
- LTVs should not exceed 60%.

If these parameters are breached, a property company's REIT status can be withdrawn and the tax-free status that these companies have via the legislation is lost. What PIG will try and attain is a holiday/redemption from these parameters for a period of time or at least as long as the COVID-19 crisis lasts, including its "hangover" effects. Our best estimates are currently 12–24 months (with the caveat being that this is a moving target). This will mean that property companies will not have to pay dividends, and, for that period, these companies will not lose their REIT status.

We highlight that recent news reports have indicated that Estienne De Klerk, Chairman of the SA REIT Association and PIG, has applied to National Treasury to provisionally relax REIT tax rules and allow a two-year reprieve from paying out dividends.

For a period, until normality returns, the best evidence of a physical property's value - what a buyer is willing to pay and what the seller is willing to receive - is not available.

It is clear to us that the property sector will be reset after panic around the virus has subsided. The good news is that these big property companies generally have good management teams to navigate this change. SA banks, which will have a large influence on the sector over the next few months, have strong balance sheets and we believe that they will be co-operative in working with property companies to navigate the way through the current crisis. Focus will turn from LTVs to interest cover, cash flow and sustainability. It is not in the interests of the banks to "pull the plug" on some of their biggest clients and, if they did, the income statement impact for them would be damaging. Banks have a vested interest. Therefore, we expect property companies to work their way through this scenario together with the banks, with "reset" value emerging.

So, given what has happened, is the loss in value permanent? We conclude that in a base case scenario, the values are well-below current book values, but higher than the share prices. Among the quality counters, these companies are fundamentally worth 50%-100% more than their current share prices (unless Armageddon prevails!). But there remains a high risk of shareholders not getting paid dividends for one, or even two, years.

Our top share picks:

Finding opportunities in times of adversity

Written By:

STEPHÁN ENGELBRECHT
Fund Manager

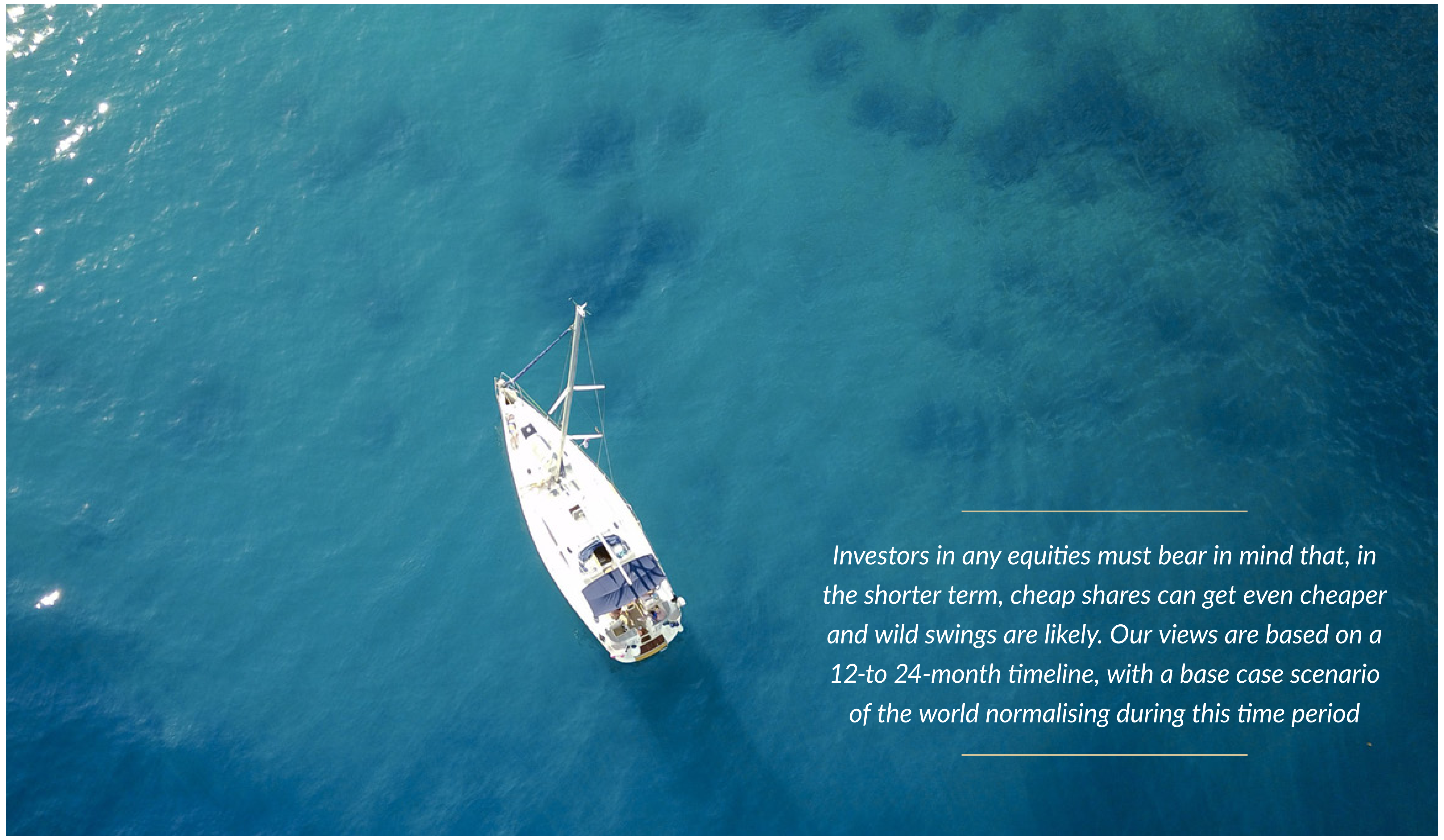
Stephán joined Anchor in 2019. Prior to that Stephán has been actively involved in the South African Equity Hedge Fund industry since joining Capricorn Fund Managers (Pty) Ltd in 2010. He holds an MBA (cum laude) and Bachelors in Financial Mathematics and Investment Management and he is a CFA Charterholder. Stephán is the lead portfolio manager of Anchor's South African focus suite of hedge funds and heads up the South African equity research process.

The world is entering an unprecedented time and there is no historical playbook for what happens next. While not our base case, calamity risk is increasing (mass infections across SA, with dire economic consequences), and nobody knows how to quantify this risk. We have many requests from clients asking for investment opportunities in this crash and we are happy to share our fundamental views. However, investors in any equities must bear in mind that, in the shorter term, cheap shares can get even cheaper and wild swings are likely. Our views are based on a 12- to 24-month timeline, with a base case scenario of the world normalising during this time period. So, risks have to be taken into account and any investment in equities should be considered in this context. Shares only become this cheap when risks are extremely high.

The past few weeks have seen global markets endure the most volatile period in history. The VIX, a US index tracking the stock market's expectations for volatility over the next 30 days and derived from price inputs of S&P 500 Index options, hit all-time highs recently, surpassing the records it set during the 2008 GFC. This volatility was due to the rapid worldwide spread of COVID-19 and the draconian, albeit very much justified, measures taken by global governments to fight the pandemic. Entire economies are being shut down with people forced to stay at home and to enact social distancing. The ramifications which these measures will have on the global economy will be severe, but (and this is what is causing the market volatility) almost impossible to quantify.

Having said that, it is important to keep a clear mind when looking at the extreme share price movements on the JSE. While we might agree that earnings for many companies will be decimated in the next few months, as it is very difficult to sell your products/services when everybody is staying at home, the human race is also extremely resilient. Looking at how Asian economies have reacted; it would appear to us that economic activity will return to normal after about two to three months.

With this as our base case, we have decided to look for the opportunities currently being created in the SA market. Our criteria are simple - we are looking for quality, high-growth and high return on equity (ROE) companies with strong balance sheets that can withstand a short-term cash drain. Many of these companies have in the past appeared too expensive for us to stomach and this sell-off may provide an opportunity for investors to accumulate these compounders at very attractive entry points.



NASPERS

Tencent, Naspers' most significant investment, reported very strong earnings during the week of 16 March (unfortunately, not the best week to report strong results). Revenue grew by 26% YoY and operating profit jumped by 35% YoY. But what was even more heartening was how well the company is progressing at diversifying its earnings base and setting itself up for more growth going forward. Advertising, financial services and international gaming (outside of China) continue to contribute a greater proportion of revenue and management are guiding that this is set to continue. Tencent also continued to generate significant cash flow and, ironically, although management was reluctant to elaborate on this on the company's investor conference call, the COVID-19 outbreak has resulted in a boost for its gaming segment and other online revenue.

Moving to Naspers, we note that holding company structures have come under pressure during this sell-off. Naspers is currently trading at a c. 50% discount to the value of its underlying investments or net asset value (NAV) and a 40% discount to the value of its investment in Tencent alone. This is the widest discount to NAV that we have ever witnessed for Naspers and the Group has, in its own right, established very attractive investment opportunities in the exciting spaces of online classifieds, food delivery and financial technology (fintech).

Naspers management have committed to try and close this discount and the company has sold some Prosus shares, which will potentially be used to buy back Naspers shares. At current levels, management are looking like geniuses, if they start buying now.

The wide discount to NAV, the attractive growth profiles of Tencent and the other investment companies and the additional optionality of management actively trying to close the discount, all combine to make this Naspers opportunity extremely attractive for investors.

BIDCORP

A very experienced industrial analyst once said that BidCorp's portfolio of assets is one of the most resilient and highest quality he has ever had the privilege to analyse, and he has covered many industrial companies globally. We tend to agree.

BidCorp has built a strong business network supplying food services to restaurants and hotels, community services (hospitals, prisons, etc.) and airlines. Over the years, the company has managed to acquire small independent food-services businesses and bring these under the BidCorp banner. This gave these entrepreneurs the stability of funding and infrastructure of a large corporate, but also provided them with the freedom to build and grow their businesses further. It was a formula that worked, and it helped BidCorp become a compounder of note, growing earnings every year by between 10% and 15%.

Unfortunately, the COVID-19 outbreak, and the subsequent clampdown, hit exactly those economies in which BidCorp operates and the market duly punished the share price. Nevertheless, we note that at our last engagement with management following the COVID-19 outbreak, they were surprisingly upbeat. According to them "… BidCorp is in the food business, people need to eat." BidCorp also services all food delivery and many food-retail companies that are doing very well in the current environment. BidCorp is also seeing significant opportunities in these trying times as many entrepreneurs are engaging with it to enter the BidCorp family of companies. In addition, its strong balance sheet will allow the Group to take advantage of these opportunities.

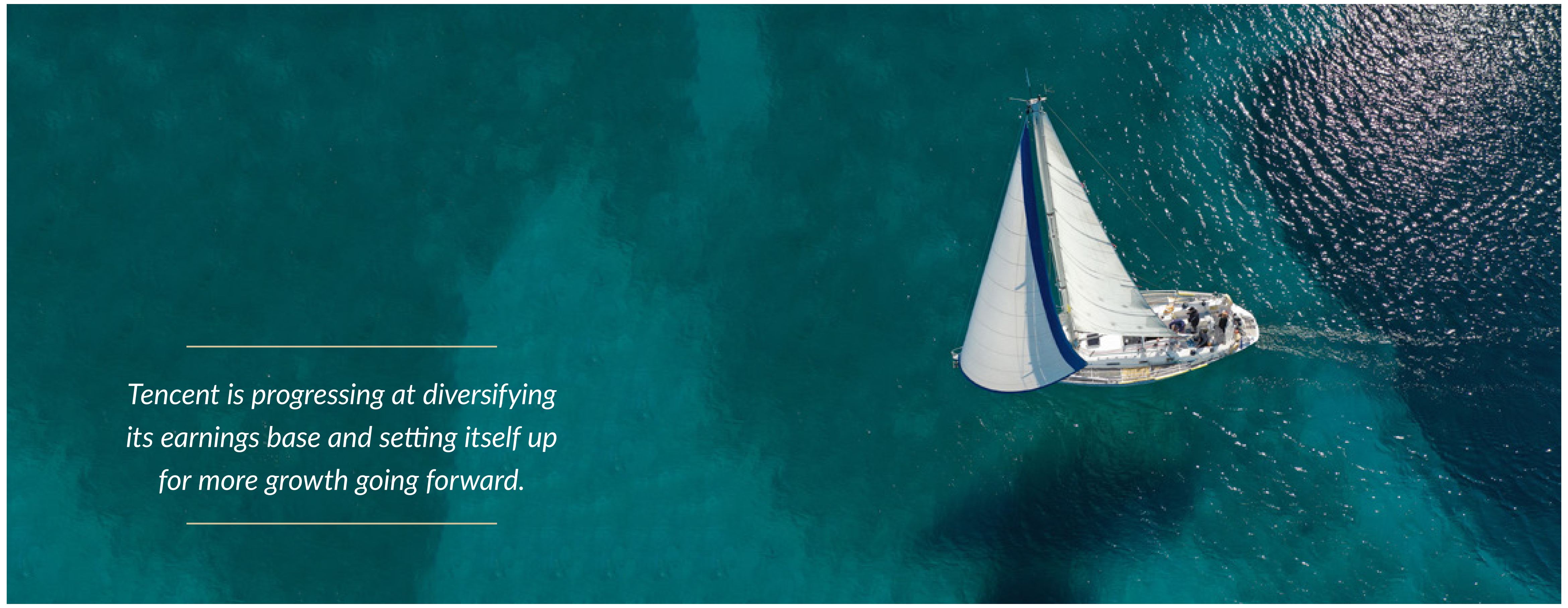
At a historic PE ratio of 12x, we believe that this is a great opportunity to buy into a high-quality company.

TRANSACTION CAPITAL

Transaction Capital has been a great compounder over the past few years, even in the face of some dire local economic growth. Its SA Taxi financing business, which provides financing and other ancillary services (including insurance and buying groups for tyres and fuel) to mini-bus taxi operators, has continued to perform well as the mini-bus taxi industry established itself as the most effective public transport system in SA. The COVID-19 outbreak may cause some of these operators to come under pressure due to a lack of commuters, but this should be somewhat negated by a reduction in local fuel prices. Over the past few years, SA Taxi has also built a strong and widening competitive moat through its vertical integration and data collection on taxi routes.

The collection services business may struggle somewhat in the current environment but, as management highlighted, Transaction Capital purchased these collection books at very attractive prices. Thus, it should be able to weather the economic impact that may arise from the COVID-19 clampdowns.

At our last engagement with management following the COVID-19 outbreak, they maintained their guidance of 15% to 17% CAGR in earnings for the next three years, with some downside risk to this financial year (FY20). With a very strong balance sheet and trading at a historic PE ratio of c. 10x, we believe that this potential downside is more than accounted for at its current, very attractive, entry point.



DISCOVERY

Discovery is one of the few SA companies with a truly global mindset. The company's concept of "shared values" (rewarding people who live healthier and who change their behaviour and using the data to price policies better and engage more effectively with customers) in insurance is truly a novel approach and it has a competitive advantage against its competitors, even on a global stage. One only has to look at how many competitors have tried (with limited success) to mimic the concept or how global giants such as Ping An, Apple, AIA, John Hancock, Generali and many more, have approached Discovery to collaborate with them, to see that its business model has value and significant opportunities to scale up.

Recently, Discovery has taken these same principles of "shared values" to short-term insurance and banking. The jury is still out as to whether it will be as successful in these market segments as it has been in life insurance, but the growth potential is huge. It is again interesting to note how competitors in both sectors immediately started to mimic this Discovery concept. These investments into new business segments in SA have, however, come at a cost. Despite this, we believe that over the next five years the cost of investment will start to decline and the operational leverage in these new ventures will cause a strong J-curve effect on the income statement.

Fears surrounding the negative impact of the COVID-19 on claims ratios and a weak balance sheet have caused the market to punish this share disproportionately over the past few months, in our view. Discovery is currently trading at prices last seen in 2014. We engaged with Discovery management during the past week and tested them on these two fears - we exited the meeting feeling even more confident that this is a great buying opportunity.

Management were adamant that Discovery's balance sheet is healthy and that even in an extreme stress scenario the company will not need additional capital. One key point management highlighted was that Discovery's greatest risk to requiring additional capital is if it exceeds its own growth expectations. Given the nature of a life insurer, and especially an early stage growth life insurer, the capital requirement is very severe upfront. If the value of new business was to reduce, the capital strain will actually decline and improve the firm's own cash generation.

Discovery was also very fortunate, through its joint venture with Chinese financial services group, Ping An, to have experienced first-hand the consequences of the COVID-19 outbreak on everyday life in China and the subsequent impact of the virus on life- and medical insurers in that country (surprisingly, we note that the outbreak had a positive impact on premiums for these businesses). In the greater context, the mortality experience due to the outbreak was minimal vs expectations. In fact, companies had positive claims experience vs expectations, as people started to prioritise only going to a hospital in severe situations. Nobody is going to go to hospital for a toothache, while the world is on high alert due to a pandemic. Thus, insurers recorded a strong uptick in sales, as people became acutely aware of their own mortality and started to buy life insurance and medical cover.

Of course, the real risk is what will happen if the world falls into a deep recession due to the outbreak. This will be negative for earnings but allowing your life insurance and medical cover to lapse is nevertheless likely to be low on the list for most people.

Overall, we see the balance sheet and claims ratio spike risks as being overblown and we believe that Discovery can become a truly global player in the insurance space. The current market sell-off provides a great opportunity for investors to jump on for the ride.

CAPITEC

Capitec has defied gravity for almost a decade, navigating through the African Bank crisis, weak economic growth and even an attack by short-seller, Viceroy Research, to compound its earnings by 27% p.a. for the past decade. Over the course of the decade, Capitec has also transformed from a pure unsecured credit provider to a far more diversified financial services Group. Net transactional fee income and funeral cover sales contribute 46% of its net income and covers 91% of operating expenses. The bank is also very conservatively capitalised, with ample liquidity coverage and a very low leverage ratio of only 5 times. The company targets a ROE of 25%, but it has achieved a ROE of 27% over the past few years.

The acquisition of Mercantile Bank has opened up exciting new growth avenues for Capitec. The small- to medium-sized enterprise market has been very underserviced by the big-four banks (ABSA, Standard Bank, Nedbank and FirstRand) and, in our view, Capitec's simplistic and affordable product offering will be extremely attractive to these entrepreneurs. Capitec's entry into business banking and the continued growth of its credit card book and funeral cover policies will allow Capitec to continue to grow at the high-teens to low-20% over the next three to five years.

Although we do believe that the next financial year (FY20) may be tough for Capitec, we also think that once the initial impact of the COVID-19 outbreak has passed, Capitec will resume on its high-growth path. We are mindful of the fact that Capitec is ensured by a third-party against defaults due to retrenchment and death on all of its products. The bank is also well-funded with its retail deposits exceeding its credit book.

We have always been reluctant to buy into Capitec, even considering the exciting growth prospects, because we believe that the market was pricing it for perfection at close to a 20x historic PE. However, at current valuation levels, the share provides a rare attractive entry point in a high-quality business.

MR PRICE

Discretionary spending may not be a space you want to invest in when people are not leaving their homes but, sometimes, an investor has to look through one year of bad earnings and buy a quality company for the decades to come. We believe that Mr Price falls squarely into this category.

Running through our modelling and based on what we have learned thus far from European and Asian apparel retailers, Mr Price will likely see a decline in earnings of between 30% to 40% YoY. It will, however, recover reasonably strongly after that, in our view.

Sitting on a cash balance equal to c. 12% of the current market cap and still generating free cash flow of 7.7% going forward, the management team are in the fortunate position to take advantage of this difficult environment. Management have already dismissed expansion into new markets, so they may be looking at buying back shares at the current depressed share price levels.

Mr Price is a high-quality business generating ROEs in excess of 30% (including the cash drain) and is trading on a very attractive valuation of 10x historic earnings.

FIRSTRAND

The global financial market has been in turmoil. Rumours of liquidity squeezes in the financial system have resulted in global banking counters being severely punished. Across the world, banking stocks are down by between 60% and 40%. And SA banks have not been spared!

Regulators globally have reacted by injecting liquidity into the system. We maintain that these measures should be enough, and we are not expecting (as things currently stand) to see any significant bank failures due to the COVID-19 outbreak.

As such, we believe that SA banking shares are providing some exceptional opportunities and we can probably have listed any of the big local banks here for a good opportunity to enter. However, in times of extreme dislocation the market provides the opportunity to buy an Audi at the price of a Fiat 500 and that is why we picked the gold standard of SA banking stocks - FirstRand.

Although we acknowledge that revenue growth will be lacklustre for the next few years and that bad debts may continue to tick up, FirstRand's dividend yield should be sustainable as this environment will have a limited demand for capital. The bank is also diverse enough to absorb the uptick in bad debt and the management team has been extremely conservative on the lending front over the past few years, which should protect the bank from an extreme blowout in bad debts.

Generating a ROE of between 18% and 22% going forward and offering a dividend yield of 9% at current prices, we believe that this is a great opportunity to buy.

BIDVEST

Bidvest's stable earnings growth profile and its diversified income streams have ensured that the company has evolved into one of the cornerstone stocks in many SA portfolios. With a presence in freight, office management, trading and distribution as well as automotive dealerships, Bidvest's presence in the domestic economy is indeed far and wide. Bidvest has also been one of the few local companies that has successfully expanded beyond our borders. It first started to venture into food services, building an attractive and scalable portfolio of assets, and later independently listed BidCorp. More recently, the firm ventured into office management and hygiene markets with the acquisition of Noonan in the UK and Ireland and PHS in England. These latest acquisitions are still in the bedding-down phase, but Bidvest's management team has a very good track record of successfully incorporating new businesses under the Bidvest umbrella.

Several of Bidvest's businesses are in the eye of the COVID-19 storm, which is both a positive and a negative for the company. Many of its aviation and travel-facing businesses will face tough times as the world goes into lockdown and global travel grinds to a halt. Management have guided that the company is working closely with its customers to ensure the viability of the industry going forward. Bidvest's freight division is very reliant on export volumes of chrome and manganese to China. These volumes were significantly down while China was in lockdown but should recover as China starts to re-open its industries. In Bidvest's automotive and trading divisions, the impact is still difficult to assess and also very fluid, but it will, in all likelihood, be a tough few month for those divisions. On the positive side, the heightened awareness of hygiene is proving to be a boon for the company's office management and hygiene divisions.

Overall, we believe that Bidvest's earnings will be under pressure in the short term, but then management are of the view that the Group's well-diversified earnings stream and strong balance sheet will be able to absorb the economic shock.

In our view, the current valuation of 11x historic earnings provides an attractive entry point into a solid SA industrial company with the optionality of a successful global expansion almost for free. Given the success that Bidvest has had in building BidCorp this is a bet we will very happily take.

CURRO HOLDINGS

Since listing on the JSE in 2011, Curro has established itself as the largest private-education player in SA. From 4,200 learners in 2011, Curro has grown its learner base by 35% p.a. to 62,700 in 2020. These expansions have, of course, come at a cost with Curro spending significantly on new schools or upgrading older school to accommodate these new learners. Curro spent R1.3bn in 2019 alone, with plans to spend another R1bn in 2020. To December 2019, Curro has spent a cumulative R10.2bn in capital!

During the initial stages, Curro used the equity market to fund its expansion plans and it has successfully completed a number of capital raises from 2011 to 2015, which helped the company reach scale. From 2016, however, Curro started tapping debt markets to fund its capital requirements. With very strong and defensive cash flow generation, banks were more than willing to extend credit to Curro at very attractive interest rates. But even at these attractive rates, Curro's interest expense started to increase aggressively, growing from R55mn in 2014 to R243mn in 2019 (by 35% p.a.). A lagging local economy resulted in Curro's EBITDA underperforming its growth in interest expense (which advanced by 29% p.a.), and this dynamic combined with a higher depreciation and amortisation charge culminated in Curro reporting a 15% YoY decline in earnings (to ZAc51/share).

The market took these results very negatively and sold the share down aggressively. But, as always, the market tends to overreact and share prices very quickly swung from overvalued to undervalued. We believe that Curro is now pricing in a doomsday scenario, and that the market is placing too great a focus on earnings and ignoring the structural momentum which the company continues to maintain.

The key stat that we focus on is learner growth. Curro has continued to grow this measure at a robust rate, albeit at a slightly slower pace than the company would have liked. Curro's pricing has remained strong and it has been able to maintain fee growth at a higher rate than inflation. We still expect turnover growth in excess of 15% YoY for 2020 and, in the current local economic environment, that is very strong. Earnings will continue to be depressed due to higher interest expense and depreciation charges, but we believe that Curro is past its peak in terms of capital expenditure requirements and it now just needs to fill excess capacity.

Education remains a defensive sector. People want to get the best education for their children and, even in a COVID-19 shock, people will continue to try and find a way to provide their children with high-quality education. The current poor economic conditions may place a brake on Curro's growth ambitions, but we still think that the market is completely overpricing the counter's downside risk. It is important to remember that Curro's debt profile is due to its expansion and the firm can choose to slow that down if it believes it to be prudent, which will change the profile significantly for the better.

Trading at an enterprise value less than 70% of its cumulative capital expenditure over the past 7 years, provides a fantastic opportunity to enter a high-quality company.

FOR THE MORE RISK-TOLERANT INVESTOR

In times of extreme market volatility (and corrections), it is often unnecessary for investors to look far down the quality curve to find attractive opportunities that will generate significant returns in future. This is oftentimes the correct strategy as those economic uncertainties causing market volatility can have far more dire consequences for lower-quality businesses. This can make a company look inexpensive on the surface, but the upside might be limited as the business first has to struggle through an earnings trough, or raise equity to shore up its balance sheet which will, in turn, dilute current shareholder returns.

However, sometimes it is worth taking the risk. During market corrections, fundamentals are often ignored, and some market participants will sell a share at any price. It is at these prices where, we believe, the risk-return profile is so attractive that these counters deserve a small allocation in a diversified portfolio. These calculated risks may just turn out to be some of the best performers in an investor's portfolio.

With that as background, we have scoured the SA market for some very exciting investment opportunities. We concede that these opportunities do come with some risks, whether it be debt, currency, regulation, liquidity or, in some cases, a combination of these factors, associated with them. Nevertheless, we believe that, at current valuation levels, the investor is more than compensated for such risks. So, put your hard hat on and prepare for some volatility although, at the end of the day, we are confident that a portfolio of these shares will reward investors handsomely.

MTN GROUP

If one were to draw up a list of countries where it is notoriously difficult to do business, and that also have extremely volatile regulatory and economic environments, the chances are that a large number of these nations will be among the 21 countries in which MTN operates. Initially, with major global mobile operators reluctant to enter these markets and regulations being fairly light, these countries held the appeal of attractive EM growth potential, with limited competition, for MTN.

While this worked well in the beginning, over recent years MTN has appeared to stumble from one exogenous shock to the next – wars, extreme currency volatility, sanctions, exorbitant regulatory penalties and various lawsuits – but the company has weathered all these setbacks. MTN's vulnerability to these exogenous events means that it is typically sold off, particularly aggressively during periods of risk aversion. This time around, the market sell-off was amplified by the collapse in the oil price, to which a number of MTN's markets are vulnerable (especially Nigeria). With MTN's share price falling to below the R40/share level in early March, the counter had at that stage declined >85% from its 2014 peak. It has since posted some gains but is still trading at levels last seen in 2005 and thus we see definite upside to the current share price.

In an industry where scale is critical, the significance of MTN being a top-two market share operator across all the markets in which it operates should not be underestimated. Where the telecommunications sector globally has largely been consigned by investors to the status of an ex-growth utility, MTN stands apart for several reasons. First, many of the Group's markets still have further opportunities to increase penetration of mobile telecommunications and the potential to migrate those users to smart devices and drive data adoption. Second, while most DM operators are confined to the provision of commoditised voice and data services, MTN is capitalising on opportunities to also add digital and mobile financial services.

Although MTN CEO, Rob Shuter has announced that he will be leaving the company at the end of his contract in one year's time, he assembled a very competent management team during his tenure. Shuter has set the Group on a self-correction course. This includes the disposal of non-core assets, with proceeds being used to pay down debt (R14bn in sales were raised in the first year, with guidance of a further R25bn to be realised over the next few years) and paying particular attention to turning around some of the Group's underperforming business units.

Since many of MTN's new revenue streams do not require significant capital investment and are delivered through over-the-top platforms already in place, it has enabled the company to provide guidance of low double-digit revenue growth, margin expansion and relatively flat capital expenditure over the next 3-5 years. With the strong double-digit growth in free cash generation that this guidance implies, MTN is targeting annual dividend growth of 10%-20%.

Even at the bottom of the dividend guidance range, the prospective dividend yield is 15%, while the price as a multiple of expected earnings in 12 months' time is 5x. No doubt, Brent Crude oil at below $30/bbl poses risk in the short term of foreign exchange availability and currency devaluation in Nigeria (MTN's largest profit generator in FY19, accounting for c. 40% of group EBITDA). However, we are mindful of the oil industry saying, "the best cure for low oil prices, is low oil prices" and it is unlikely that the current situation will be sustained long term. At current levels, we believe there is now enough of a margin of safety in MTN's share price to compensate for the risks it presents, with the potential for a strong recovery as current headwinds abate.

INVESTEC

Over the past four decades, Stephen Koseff and Bernard Kantor created an institution. Built on the foundation of entrepreneurship and being agile and nimble to service its customers, the distinctive zebra logo became one of the most widely recognised symbols in SA financial markets.

In the early 2000s, Investec started to expand offshore with the UK being a key target market. Unfortunately, the UK's highly competitive banking environment, ever more draconian and complex regulation and a GFC that hit just as Investec started to expand aggressively in the UK, made the experience far more lacklustre than the firm's local successes. However, the company stayed the course, and, over time, Investec has built a strong UK presence.

Nevertheless, the UK remains a considerable drag on the Group's profitability and ROE. Since the disastrous acquisition of Kensington in 2007 and the harsher regulatory environment post the 2008 GFC, Investec's UK division has struggled to achieve a ROE greater than its cost of capital. This has resulted in Investec rightfully trading at a discount to its book value for significant periods since the GFC.

This discount to book value reached extremely low levels during the current sell-off, trading at close to 0.3x book. In addition, it coincides with some real positive changes taking root at Investec. The old guard has moved on and the new management team have taken decisive steps to improve the profitability of the bank.

Management unbundled the asset management division to make the structure less complex, committed to improving the cost-to-income ratio in the UK and promised that there were no sacrosanct segments of the business that will not be cut in the event of underperformance. We are still at the initial stages of the new regime and it will be interesting to see whether management can indeed improve the UK division's ROE.

Although we acknowledge that Investec is not the highest-quality bank in the world and its earnings growth and ROE profile are far more volatile than its SA peers, we believe that the current share price provides an opportunity to enter at depressed multiples that more than sufficiently reflect the lower quality. And, the investor may yet benefit from an improvement in operating metrics as the new management team start their work.

NORTHAM PLATINUM

The platinum group metals (PGM) miners were the talking point of 2019. After being priced for bankruptcy in 2018, the price of the PGM basket recovered in 2019 resulting in the share prices of these miners rallying by 250% or more. The higher basket price helped these miners reduce their leverage with some of the mining companies going into a net cash position. It was a remarkable turnaround and highlighted just how cyclical the fortunes of these businesses are. Which begs the question, do you want to buy into such a cyclical industry in these uncertain times?

It is a fair question, and the answer very much depends on the risk tolerance of the investor. The reason why we are comfortable with a small position in Northam is due to the precarious demand-supply balance which the industry faced going into the COVID-19 crisis.

Prior to 2019, the threat of electric vehicles (EVs) caused the PGM basket price to remain below the breakeven price for mining companies and they battled to survive. Capital expenditure was cut across the board, with mining firms struggling to pay for maintenance capex, not to even mention expansionary capex.

Then, in 2019, the combination of a greater focus on carbon emission worldwide, the more enhanced testing after the VW scandal and the lack of R&D in combustion engines over the preceding few years forced vehicle manufacturers to just add more and more PGMs in their respective catalytic converters as emission standards became more onerous. With the costs of PGMs a small fraction of the total vehicle production cost, they had the luxury to do this. Demand for these metals surged and the miners were not in a position to increase supply. This caused PGM prices to rally, with rhodium and palladium hitting all-time highs.

In our view, this situation will not change in the short- to medium-term, despite the COVID-19 outbreak and the subsequent decline in global vehicle sales. We expect demand to remain strong due to higher emission standards. Importantly, the threat of EVs, which are expected to be close to 50% of global vehicle sales by 2030, will prevent PGM miners from investing in new mines, thus keeping a constraint on the supply response.

Northam is one of the few PGM miners that will see strong volume growth over the next few years. Due to some tough decisions taken by management during the lean years, the company was able to shore up its balance sheet and it continued to invest in operations. As a result, we expect Northam's annual production volumes to increase from c. 600k ounces this year to 1mn ounces over the next few years. Northam's mines are also of a very high quality, operating at very low operating costs due to mechanisation. Trading at very attractive valuations and offering significant earnings (at spot PGM prices) and production growth, Northam is a high-quality operator in a very cyclical industry.

ALVIVA HOLDINGS

alviva HOLDINGS

Alviva Holdings is not an exciting company! But it is one of the Africa's largest providers of information and communication technology (ICT) products and services. The Group has three business segments - ICT Distribution, which imports ICT hardware and software and sells it into sub-Saharan Africa via resellers, Services and Solutions, which provides system integration and ICT solution services, and Financial Services, which provides leasing finance to small-, medium- and micro-sized enterprises (SMMEs) for their ICT products.

The risks to this business are real. It is difficult to see Alviva continuing to operate in the same verticals and products as it is currently working, in five years' time. This is due to the ever-changing industry in which it operates. For example, cloud storage and processing will, likely, fundamentally change the role ICT service providers play in the lives of their customers. To survive, ICT service providers will have to adapt their business models quickly and also ensure that they have a balance sheet strong enough to absorb any shocks.

We believe that Alviva has both these traits. It has a very experienced and conservative management team, which have navigated through some very turbulent times in the past and we maintain that management should be able to continue to do so in future. In addition, management have also been conserving cash. Over the past few years, they have adopted a very conservative dividend policy, paying out only 10% of earnings in dividends.

At our last engagement with management, they conceded that the operating environment is very tough at the moment, adding that they were very disappointed in the company's performance but that it should improve in the second half. Management have guided that they will first look to retire around R400mn in preference shares, after which they will engage with shareholders regarding potential share buybacks. Admittedly, this was before the COVID-19 outbreak.

However, Alviva's valuation is ridiculous – it is currently trading at a historic PE ratio of c. 2x and a normalised free cash flow yield of 50% (and we believe that we are being conservative here), so the risk-reward profile for investors is very much skewed to the upside. Liquidity is a concern and we highlight that investors should be patient if investing in this counter.

SA LISTED PROPERTY

In recent years, many SA (and global) conservative investors squirrelled their savings away in property shares to earn an attractive, growing income. This bubble burst over the last few months and even the highest quality property companies have seen their value decimated.

As discussed in the previous section, we believe that, in a base-case scenario, the adjusted book value of the SA listed property companies will be well below current book values, but higher than the prevailing share prices. We calculate that many property companies are fundamentally worth 50% to 100% more than current share prices (unless Armageddon prevails!). But there is a high risk of shareholders not getting dividends for one, or even two, years. The share prices are factoring in a far worse scenario than our base case. Investors should, however, focus on the balance sheet and track closely the progress the various firms make in degearing.

There is a long road ahead but, in our view, in the end, we will look back at this as a great opportunity to buy property shares. For the more conservative investor Growthpoint, with its lower LTV and diversified portfolio, is the most appropriate entry into the sector and for the more risk-tolerant investor, we believe that Redefine is offering significant value, but it comes with some real risks that should not be ignored.

Navigating change and fostering your financial health

Written By:

CRAIG MICHEL
Wealth Management

Craig started his career as a Social Anthropologist, translated that interest in studying people and relationships into the financial sector. This background allows Craig to manage his client relationships across their entire financial portfolio (from health to wealth) with a strong amount of empathy and conviction, emphasising service as a core function. Craig has been in the financial services industry since 2009, after spending 6 years at Discovery as a Business Consultant, he joined Anchor in January 2016.

Last year, Anchor rolled out the slogan that would describe our business in only two words - Navigating Change. These words are especially pertinent at the moment as we deal with change on a heretofore unprecedented level. These major changes investors are experiencing at present are ones I deal with daily – health and wealth. I once worked for probably the best distribution manager SA has ever seen, who always used to say: “People spend their health creating their wealth, then spend their wealth maintaining their health.”

This paradox seems even more salient now, given the health crisis our country is facing as the COVID-19 pandemic sweeps across the globe. People are finally starting to fully understand that our relationship to our health should be proactive and not reactive. The same can be said about our financial health. It’s been cited in numerous case studies around the world that many families are one salary away from being bankrupt. For many, it is most often a function of current economic models that are not the inclusive panaceas we were led to believe, where money would ‘trickle down’ from the upper class to the workers. In fact, wealth inequality around the world has shown an alarming increase – Thomas Piketty’s brilliant work, *Capital in the Twenty-First Century*, makes this point quite forcefully. We are now seeing this disconnect even further with a virus that is literally destroying the poor and the vulnerable in front of our very eyes.

My job as a wealth manager/financial advisor is quite simple but can also be fairly complex at times. However, my main objective is to ensure that I help grow clients’ ‘pot’ of money which these clients will need when they retire. You can grow that ‘pot’ in various ways:

Save each month into a pension, provident fund, retirement annuity (RA), tax-free savings account, unit trust, endowment or share portfolio, to name but a few available investment vehicles.

You can inherit wealth through your family - either in your own name or through a trust.

You own a business that pays out the proceeds of profit in the form of dividends.

Those are just a couple of examples of how people navigate their way to this end goal of retiring comfortably. I don’t think anyone will be resentful of the fact that our fellow human beings should be entitled to at least this bare minimum - whether they are rich or poor. Below, I highlight two examples of two different individuals at both the beginning and at the end of this spectrum in order to illustrate the job of a financial advisor and how we are critical to clients’ outcomes for financial health.

My first example is a young 26-year old female who approached me around saving for her retirement. She has no assets other than a car and no investment savings. She earns around R23,000/month net and can afford c. R1,000/month into either an RA (if she wants to get the tax deduction for the contribution) or a tax-free savings account (if she wants liquidity with no constraints on how she invests at retirement).

My main objective is to ensure that I help grow clients’ ‘pot’ of money which these clients will need when they retire.

I calculated that, should she want to retire on 60% of her current salary (in present value terms or, simply put, in today’s money), she would need to save an additional R4,300/month. Clearly, she cannot afford this right now. In fact, she works as an occupational therapist and is completely reliant on seeing clients, which she cannot do when the country is on lockdown due to the COVID-19 virus. How is she going to save towards the R5.8mn pot of money she needs to retire comfortably?

My second example is far more sombre. I visited a gentleman in his early 70s at his retirement village in Benoni. His total assets were around R438,000 - this was his pot of money that was supposed to sustain him until he passed away. Below, is the email I sent him after our meeting:

- We worked out that your minimum monthly expenses are about R5,050/month.
- If we paid off your credit card debt of R7,000, reduced your credit card payments of R320/month and then cancelled DSTV, we could get your monthly income needs down to around R4,300/month.
- For the purposes of the calculation, I worked on a monthly income amount of R4,500, increasing by 3% p.a.
- If we get a return of between 6% to 8% on your investments, then we can help preserve capital until you are around 80-81 years of age.
- The crucial aspect is to keep costs as low as possible, draw the minimum monthly income that we need and thereby achieving the long-term growth targets for your funds.

I found out early this year that this gentleman had passed away. At the time of our meeting, sitting in his small, cold place in Benoni, he recalled his wife's passing and those of most of his neighbours. It was heart-wrenching that I had to take a surgical knife to his expenses, just so that he could survive.

The point of the above two stories shows the simple, yet complex, job that advisors deal with on a regular basis with their clients. We must advise clients on how to grow their pot of money and then, once they have grown it, how to preserve it so that it provides them with an income for life. Increasingly, we encounter situations like the two highlighted above that, alarmingly, are in serious jeopardy of not achieving financial health.

We must advise clients on how to grow their pot of money and then, once they have grown it, how to preserve it so that it provides them with an income for life.

When this is the case, there are a few ways in which we can assist clients, at least in terms of daily cash-flows issues, to bring down expenses and allocate more resources towards savings and the protection of their current lifestyle.

Make sure you keep a budget – I'm frankly amazed at how many people don't monitor their everyday spending. This is the easiest way to identify where and on what you are spending frivolously.

Reassess your medical aid plan. The most common query I get these days is whether a client should be downgrading their plan. The answer is most often a resounding 'Yes'.

Don't rack up debt on your credit card. This may sound like common sense advice, but I personally know people with over R200,000 of debt on their credit card, with no hope of ever paying this back. At interest rates of 16% to 22%, why would any reasonable person do this?

Financial advisors and wealth managers arguably play an even more important role in their clients' lives now as we navigate the 21-day shutdown, the likes of which we may never see again in our lifetimes. I personally know of businesses either shutting down or putting people on two days a week contracts, not to mention the thousands who have lost their jobs (the sad news of Edcon going bankrupt filtered through the news recently). Should we now be advocating that schools introduce a curriculum on financial literacy for our kids, so that they are aware of how to avoid the pitfalls of poor financial health?

It's not simply about whether we pick the right stocks or funds to help grow your retirement pot; it's also about helping you make smart financial decisions in your everyday lives. Our business has one of the most diverse and knowledgeable skill sets in SA. You may have an inter-vivos (living) trust that might be unnecessary and costly to run each year. Perhaps you have three life policies that could be consolidated into one policy, where we can save you thousands of rand each month. You are healthy and never claim for day-to-day medical expenses, so we assist you in downgrading your medical aid plan, once again realising significant savings each month. You've just sold your business and are looking to retire, so we can assist you in doing a cash-flow analysis and help you invest so that you never deplete your capital, thereby leaving a legacy for your family. Paying provisional tax and need assistance – we can refer you to our in-house tax practitioner.

Now, more than ever, clients need sound financial advice from trusted advisors who can cast their net far and wide over every facet of your financial life, so that we ensure your health and wealth for years to come. In so doing, we don't just assist your family and yourself but also broader society. With the world waking up to a new reality as the COVID-19 virus sweeps across the globe, a heightened sense of community will hopefully be borne out of this pandemic. At Anchor, we hope that we can be there to assist you in navigating these changing times.

For all official information and updates regarding COVID-19, visit the South African Department of Health's website at www.SAcoronavirus.co.za

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