Quarterly Portfolio Commentary

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Morningstar Investment Management South Africa

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Global Market Commentary
March 2022

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Important Perspective

From the opening days of 2022, investors were taken on a wild ride during a first quarter that featured wide swings in stock, bond and commodity markets around the world. Stocks took a dive as the market reassessed the potential of the Federal Reserve setting out a more aggressive path for interest-rate hikes to help curb inflation that hit a 40-year high. Bond prices slid, sending yields higher. In a knock-on effect of rising yields, some of the stock market's strongest performers in recent years saw share prices fall sharply.

Rising inflation and the invasion of Ukraine were the primary drivers of the pullbacks. For consumers, inflation is increasing faster than wages and is putting pressure on spending plans. Many businesses are facing higher costs for materials, and the war in Ukraine put additional pressure on supply chains that had only just started to untangle in the wake of the COVID crisis. Higher energy prices ranked among the most visible threats. The price for oil rose above $100 per barrel of West Texas Intermediate crude, up around 70% from a year ago. The Consumer Price Index, a key measure of inflation, jumped in the developed world, with U.S. CPI hitting 7.9% in the 12-month period ending February 2022. In response, central banks announced what it anticipates will be several interest-rate hikes to come this year.

Stocks fell heavily, but made a late recovery to mitigate the pain, marking the first quarterly loss since the COVID-pandemic shook up markets in early 2020. Volatility showed itself in the number of big up or down days, where the quarter was over twice as volatile as the median quarter over the past three years.

Communications services, consumer discretionary, and technology were the worst-performing sectors, while energy surged. Weak stock markets in Germany and Italy held back Europe, while commodity producers helped markets in Australia and the United Kingdom post gains.

Value-oriented stocks posted their best quarter of relative performance compared to their growth equivalents since the depths of the dot-com bubble in 2002. In the U.S., the Morningstar Value Index was up 2.3%, while Growth fell 12.0%. Having more energy exposure and less consumer discretionary helped Value outperform, but a broad shift from value to growth within sectors accounted for most of the difference, with the most notable gaps coming in healthcare, consumer staples, and financials.

Emerging markets had a difficult quarter. Russian stocks, which were 3.5% of the index to start the year, became untradeable after the invasion of Ukraine. Chinese stocks sold off for a combination of reasons, including worries about a COVID spike, an economic slowdown, and a broader reassessment of geopolitical risk. Emerging market debt also fell for similar reasons.

Looking Ahead

For all the attention on stocks, bond performance is perhaps the bigger story. The asset class saw its worst quarter in over 20 years. As stubbornly high inflation had central banks embarking on a path of more aggressive rate increases than was expected at the start of the year, bond investors are facing some of their worst losses in years. Hardest hit were longer-term bonds, which have the greatest sensitivity to interest-rate changes.

Higher yields are good for bond investors buying new bonds, but they hurt the price of bonds that had been trading at lower yields. Another aspect of the bond market's first-quarter selloff was a shrinking gap between long- and short-term government bond yields. The difference between the two began to level out in a trend known as a "flattening yield curve." On the final day of the quarter, the yield on the U.S. Treasury two-year note closed in the on the 10-year, on its way to moving over the 10-year in what is known as an "inverted yield curve." Historically, inverted yield curves have preceded recessions. Another cause for concern.

However, as we look ahead, it is important to remember that the future holds a wide range of possible outcomes and is typified by unyielding complexity that continually defeats those who seek to make confident forecasts. Fortunately, our role as investors is not to forecast the future, but rather to construct portfolios that empower people to reach their goals whatever the economic and market conditions. In every situation, the right approach is to view the future probabilistically and think long term.

As advocates of great investing, we must collectively resist impulsive actions and understand that the road won't be straight. Accepting some volatility is a pre-requisite for good returns in any market, but today's market arguably requires greater care than usual. In our view, this necessitates us to target the best assets for wealth creation and preservation, with careful sizing and smart diversification.

Morningstar Global Cautious Portfolio Update
March 2022

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Performance was negative in the first quarter of 2022 as Russia's invasion of Ukraine in late February caused a global shock. The grave human implications and the potential need for a faster pace of interest rate hikes to combat higher inflation weighed on both equities and bonds. The Portfolio returned –5.7% for the quarter and has generated a return of -2.5% over the past year.

Asset Allocation

Within equity markets, our allocation is balanced across the different regions. We continue to see the US market as being the least attractive from a relative perspective. We favour markets that offer better value and offer interesting diversification benefits, such as Japan, the UK, or Emerging Markets.

Our underweight exposure to North American stocks benefited portfolio returns as US stocks detracted from performance. Our overweight position to Emerging Markets equities acted as a detractor from performance.

The portfolio holds significant exposure to global bonds, with a preference for US bonds. The fixed income allocation is broadly diversified with significant exposure to more defensive assets such as governments bonds combined with exposures to both investment grade and Emerging Markets debt.

Our preference for government bonds rather than corporate bonds benefited returns as investment grade bonds performed poorly as interest rate expectations rose, and credit spreads widened.

With the markets trading at close to all-time highs, we emphasize the importance of diversification within the portfolios and place greater importance on running risk analytics and testing the robustness of the portfolios in different market scenarios. When positioning the portfolios, we remain focused on looking at the fundamental valuations for different markets and holding areas that are attractively priced and positioned to perform better than expected

Fund Selection

Turning to the underlying investments, the contribution from fund selection was negative over the quarter.

From an equity perspective, funds with exposure to cyclical stocks delivered decent returns, while funds exposed to technology struggled. The performance of Ninety One UK Alpha has been disappointing. The fund allocation to Technology (GB Group and AVEVA Group) and Consumer Defensive (Fevertree Drinks and Unilever) dominated performance and caused the fund to underperform the market.

Fidelity Emerging market underperformed the benchmark over the quarter. The fund's overweight position in Russia had a significant impact on performance. The effects were further exacerbated by a global rotation into value stocks. The fund had no exposure to Brazil (Vale and Petrobras) which was one of the better performing countries in the region.

From a fixed income perspective, US Treasuries held up better than global government bonds and investment grade credit. iShares Global Government Bond Index and Ninety One Investment Grade Corporate Bonds were notable detractors in this regard.

We remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with our expectations.

Recent changes

There were no changes made to the Fund in the first quarter.

Summary

As we look ahead, it is important to remember that the future holds a wide range of possible outcomes and is typified by unyielding complexity that continually defeats those who seek to make confident forecasts. Fortunately, our role as investors is not to forecast the future, but rather to construct portfolios that empower people to reach their goals regardless of the economic and market conditions. In every situation, the right approach is to view the future probabilistically and think long-term.

As advocates of great investing, we must collectively resist impulsive actions and understand that the road won't be straight. Accepting some volatility is a prerequisite for good returns in any market, but today's market arguably requires greater care than usual. In our view, this necessitates us to target the best assets for wealth creation and preservation, with careful sizing and smart diversification.

Morningstar Global Balanced Portfolio Update
March 2022

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Performance was negative in the first quarter of 2022 as Russia's invasion of Ukraine in late February caused a global shock. The grave human implications and the potential need for a faster pace of interest rate hikes to combat higher inflation weighed on both equities and bonds. The Portfolio returned –6.1% for the quarter and has generated a return of -1.0% over the past year.

Asset Allocation

Within equity markets, our allocation is balanced across the different regions. We continue to see the US market as being the least attractive from a relative perspective. We favour markets that offer better value and offer interesting diversification benefits, such as Japan, the UK, or Emerging Markets.

Our underweight exposure to North American stocks benefited portfolio returns, as US stocks detracted from performance. Our overweight position in Emerging Markets equities was a detractor from performance.

The portfolio holds significant exposure to global bonds, with a preference for US bonds. The fixed income allocation is broadly diversified with significant exposure to more defensive assets such as governments bonds combined with exposures to both investment grade and Emerging Markets debt.

Our preference for government bonds rather than corporate bonds benefited portfolio returns, as investment grade bonds performed poorly due to increased interest rate expectations and widened credit spreads.

With the markets trading at close to all-time highs, we emphasize the importance of diversification within the portfolios and place greater importance on running risk analytics and testing the robustness of the portfolios in different market scenarios. When positioning the portfolios, we remain focused on looking at the fundamental valuations for different markets and holding areas that are attractively priced and positioned to perform better than expected.

Fund Selection

Turning to the underlying investments, the contribution from fund selection was negative over the quarter.

From an equity perspective, funds with exposure to cyclical stocks delivered decent returns, while funds exposed to technology struggled. Dodge & Cox Worldwide US Stock were positive contributors in this regard, while Franklin US Opportunity detracted from performance.

The performance of Ninety One UK Alpha has been disappointing. The fund allocation to Technology (GB Group and AVEVA Group) and Consumer Defensive (Fevertree Drinks and Unilever) dominated performance and caused the fund to underperform the market.

Fidelity Emerging market underperformed the benchmark over the quarter. The fund's overweight position in Russia had a significant impact on performance. The effects were further exacerbated by a global rotation into value stocks. The fund had no exposure to Brazil (Vale and Petrobras) which was one of the better performing countries in the region.

From a fixed income perspective, US Treasuries held up better than global government bonds and investment grade credit. iShares Global Government Bond Index and Ninety One Investment Grade Corporate Bonds were notable detractors in this regard.

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Morningstar Global Growth Portfolio Update
March 2022

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Performance was negative in the first quarter of 2022 as Russia's invasion of Ukraine in late February caused a global shock. The grave human implications and the potential need for a faster pace of interest rate hikes to combat higher inflation weighed on both equities and bonds. The Portfolio returned -7.1% for the quarter and has generated a return of 1.0% over the past year.

Asset Allocation

Within equity markets, our allocation is balanced across the different regions. We continue to see the US market as being the least attractive from a relative perspective. We favour markets that offer better value and offer interesting diversification benefits, such as Japan, the UK, or Emerging Markets.

Our overweight exposure to UK equities benefited portfolio returns as FTSE 100 large-cap equities rose over the quarter. This was driven by the oil, mining, healthcare, and banking sectors; the strength in the banks reflected rising interest rate expectations. Our underweight exposure to North American stocks benefited portfolio returns as US stocks detracted from performance. Lastly, our overweight position in Emerging Markets was a detractor from performance.

With the markets trading at close to all-time highs, we emphasize the importance of diversification within the portfolios and place greater importance on running risk analytics and testing the robustness of the portfolios in different market scenarios. When positioning the portfolios, we remain focused on looking at the fundamental valuations for different markets and holding areas that are attractively priced and positioned to perform better than expected.

Fund Selection

Turning to the underlying investments, the contribution from fund selection was negative over the quarter.

From an equity perspective, funds with exposure to cyclical stocks delivered decent returns, while funds exposed to technology struggled. Dodge & Cox Worldwide US Stock were positive contributors in this regard, while Franklin US Opportunity detracted from performance.

The performance of Ninety One UK Alpha has been disappointing. The fund allocation to Technology (GB Group and AVEVA Group) and Consumer Defensive (Fevertree Drinks and Unilever) dominated performance and caused the fund to underperform the market.

Fidelity Emerging market underperformed the benchmark over the quarter. The fund's overweight position in Russia had a significant impact on performance. The effects were further exacerbated by a global rotation into value stocks. The fund had no exposure to Brazil (Vale and Petrobras) which was one of the better performing countries in the region.

We remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with our expectations.

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