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STAND POINT

**Keep your eggs
in a world of
baskets**

STANLIB

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From our StandPoint



A note from our Head of
Retail Distribution,
Alan Ehret

The global market roller coaster ride has continued into this year.

For those invested in the S&P 500 or Dow Jones equity indices, there have already been more downs than ups. While the Year of the Tiger has begun, Chinese stocks are yet to experience an exuberant roar. Some market commentators suggest a Chinese rebound is on the way, but the regulatory environment and impact of continued lockdowns pose challenges.

As COVID news stories appear to be fading, wildfires, flooding and dramatic weather changes across the world are making headlines. Along with these events, there is concern over Russia's invasion of neighbouring Ukraine.

It promises to be an eventful year.

South Africans remain on the edge of their seats in anticipation of the next political move that could unleash much-needed economic growth. Boosted by unexpected tax windfalls, our fiscal challenges have been reduced, but we are all too aware that infrastructure development remains the key to a more prosperous outlook.

Investing in a world of volatility and constant change is not plain sailing. In this edition of STANDPOINT we go back to the old adage, "don't place all your eggs in one basket", and remind investors of the power of diversification.

STANLIB's Economist, Ndivhuho Netshitenzhe, highlights the risks of a policy error in 2022. After giving unprecedented support to markets, central banks are now faced with the challenge of unwinding stimulus and using levers such as interest rate hikes to control persistent inflation. The impact on markets if they get this wrong is unpredictable, so managing one's investment risk through diversification is critical.

Last year we announced our strategic partnership with J.P. Morgan Asset Management (JPMAM). This year we are excited to take the next step by introducing two new global funds. They are designed to complement our current offshore range and will offer clients an opportunity to invest in new global investment solutions which will also give South African investors access to JPMAM's in-depth expertise. You can find out more about these funds on our website: stanlib.com/more.

In this edition, we offer you an interesting read from JPMAM's portfolio managers of the STANLIB Global Growth Fund as they unpack the concept of digitalisation and why this matters for corporate growth.

As we grapple with the question of where to find value for our investments in 2022, STANLIB's Deputy Head of Fixed Income, Sylvester Kobo, finds home ground advantage and shares insights on the value of South African bonds, expanding on the team's investment case for this asset class. Turning to domestic equity, Jessica Bates, STANLIB Equity Analyst, responds to some critical questions and explores the potential for quality local corporates to continue delivering growth in 2022.

Investing through times of a pandemic certainly requires courage and confidence. Our team of investment specialists continue to prove their strength at the start of 2022 by winning some well-deserved accolades. We are pleased that STANLIB's Multi-manager team was nominated for South African Fund Manager of the Year at the annual Raging Bull awards, where the STANLIB Global Balanced Feeder Fund and the STANLIB European Equity Fund were Raging Bull winners for strong performance winners. We have also been nominated for the Best Fund House: Larger Fund Range at the upcoming Morningstar South Africa Fund Awards.

While we are excited to be recognised for our investment performance, we remain humble and committed to delivering optimal financial outcomes to all our clients through our commitment to our investment philosophies and our ability to leverage knowledge across experienced teams. We are especially excited about the collaboration with investment teams in JPMAM and look forward to sharing more of the benefits of this partnership as the year plays out.

Wishing you all the best for 2022. While it promises more volatility, we can only hope that the worst of the pandemic is truly behind us. And don't forget to spread your eggs across many baskets.

Regards,

Alan Ehret

CHARTICLE:

Are all your eggs in more than one basket?

The power of diversification cannot be underestimated in uncertain times and during periods of significant market dislocation

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Global Property 37.98	Global Equity 57.23	Local Property 26.64	Global Property 34.06	Local Bonds 15.42	Local Equity 20.95	Global Cash 18.55	Global Equity 25.24	Global Equity 22.37	Local Property 36.94
Local Property 35.88	Global Property 28.07	Global Property 25.49	Global Cash 34.01	Local Property 10.20	Local Property 17.15	Global Bonds 14.80	Global Property 19.53	Global Bonds 14.70	Global Property 33.24
Local Equity 26.68	Global Cash 23.52	Global Equity 16.53	Global Equity 33.51	Local Cash 7.37	Global Equity 11.27	Global Property 8.02	Local Equity 12.05	Local Bonds 8.65	Global Equity 32.94
Global Equity 22.47	Local Equity 21.43	Global Bonds 11.10	Global Bonds 29.72	Inflation 6.60	Local Bonds 10.24	Local Bonds 7.69	Local Bonds 10.32	Local Equity 7.00	Local Equity 29.23
Local Bonds 15.95	Global Bonds 20.24	Local Equity 10.88	Local Property 7.99	Local Equity 2.63	Local Cash 7.56	Local Cash 7.25	Local Cash 7.29	Global Cash 5.45	Global Cash 8.71
Global Bonds 9.63	Local Property 8.39	Global Cash 10.49	Local Cash 6.47	Global Equity -7.06	Global Property 5.14	Global Equity 6.46	Global Bonds 3.86	Local Cash 5.39	Local Bonds 8.40
Inflation 5.67	Inflation 5.36	Local Bonds 10.15	Inflation 5.28	Global Property -7.40	Inflation 4.72	Inflation 5.18	Inflation 3.56	Inflation 3.17	Inflation 5.47
Local Cash 5.54	Local Cash 5.19	Local Cash 5.91	Local Equity 5.13	Global Bonds -9.41	Global Bonds -2.78	Local Equity -8.53	Local Property 1.92	Global Property -2.49	Local Cash 3.81
Global Cash 5.19	Local Bonds 0.64	Inflation 5.33	Local Bonds -3.93	Global Cash -11.45	Global Cash -8.59	Local Property -25.3	Global Cash -0.70	Local Property -34.49	Global Bonds 3.54

Source: Morningstar

- Performance of any single asset class can be random from one year to the next. The chart above shows year-on-year performance in percentage terms for the main asset class indices over the last 10 years and it indicates there is no clear pattern.
- Investing in one asset class is clearly risky. A diversified portfolio, which holds a number of different asset classes in each year, will be more resilient to single market downturns and can better withstand market volatility. It also provides the investor with more opportunity to seek out investment returns in specific assets or sectors which may be performing at any point in time.
- In a world where the future is uncertain and markets remain volatile, diversification helps to manage investment risks and protect against the impact of significant capital loss. It also broadens investment opportunities to enhance return and achieve desired financial outcomes.
- Diversifying a portfolio requires skill and experience in allocating effectively across asset classes through various market cycles. Blending asset classes to balance the risk and carefully selecting investments within those asset classes to enhance the return is critical to achieve an optimal investment outcome.

Is there value in the domestic bond market?

AT A GLANCE

Investors in 2022 are questioning the impact of global policy changes on risk assets such as South African bonds

The South African fiscus has benefited from unexpected revenue windfalls over the past year

However, as local growth slows and spending rises, the risks to fiscal consolidation are high

Despite increasing policy tightening and uncertainty about the future of the fiscus, domestic bond valuations continue to offer investors compelling returns



By Sylvester Kobo,
Deputy Head, STANLIB
Fixed Income Team

Financial markets will have to contend with more uncertainty and volatility this year, as major central banks take the lead in tightening global financial conditions to avoid falling behind the curve in their responses.

Inflation in major economies has risen and has proven to be more persistent than policymakers have been guiding and the markets have been discounting. As a result, developed market central banks have pivoted away from an accommodative stance, to fight rampant inflation. The most important questions for investors are how fast monetary policy will tighten this year and what impact it will have on growth and risk assets, like South African bonds.

STANLIB's Fixed Income team believes four broad themes will drive South African bond markets this year:

1. Global central banks reducing their accommodative stance
2. Domestic fiscal trends that were presented during the Budget speech
3. Increases in the repo rate, and
4. The huge premium in the valuation of South African bonds that has built up over the years, making them compelling compared with the debt of other emerging markets.

We still see value in South African bonds this year and expect they will deliver double-digit returns, although it will be a tough year, given the risks.

South African fiscal environment

The 2022 National Budget proved an opportunity for National Treasury (NT) to instil fiscal discipline in the face of numerous spending pressures.

Revenue collection continued to perform better than NT expected in the November Medium-term Budget Policy Statement (MTBPS) with an over-collection of more than R180 billion in the 2021/22 fiscal year. This will lead to better fiscal metrics for the year and, to an extent, for the next two fiscal years. It will improve the budget deficit, which will reduce borrowing requirements over the short- to medium-term. This presents an opportunity for NT to marginally reduce weekly issuance levels, but it is more likely to err on the side of caution by retaining current levels, given the spending risks in the medium-term. The aggressive flattening of the yield curve over the past few months and lack of reaction by the bond market are evidence that the market is pricing in this scenario.

We view the major spending risks for the fiscus going forward to be:

- social support
- the wage bill and
- support for state-owned entities (SOEs).

The pandemic has exacerbated SA's poverty and inequality levels, which were already high. Unemployment numbers are rising, especially among the youth, which can be fertile ground for instability. In our view, NT has extended the current social relief of distress (SRD) grant of R350 per person, per month, for another year until progress is made on the wider basic income grant. While the Budget demonstrated commendable fiscal prudence, which will please the ratings agencies, on its own it will not be sufficient to accelerate the country's growth rate to the levels needed to tackle persistent unemployment and inequality. That growth will depend on government's implementation of other key measures.

Electricity supply, which continues to be a drag on growth, and Eskom debt are still issues for the government to resolve. In general, SOEs and some municipalities may put pressure on government debt. Although these expenses can be accommodated in the current fiscal year due to the revenue windfall, this will not be the case in future years, given the expected growth slowdown and uncertainty whether commodity prices will continue to support South African mining company revenues.

Fiscal consolidation could therefore potentially be derailed, which implies the long end yields are expensive relative to "belly" bonds, given the recent aggressive flattening. We expect the yield curve will steepen during the year.

Global and local inflation and interest rates

Inflation in the US and other major economies has proven stickier than initially thought and is currently at decade

highs. In the US it appears that wage inflation pressures are also building up, raising fears that overall inflation might not ease off as quickly as previously expected and that the US Federal Reserve will need to hike interest rates more than five times this year to avoid falling behind the curve.

We expect US headline inflation will start edging lower around the middle of the year. In the longer term, US breakeven inflation is well-behaved and is not increasing in line with spot inflation, supporting the view that markets expect inflation in the longer term will return to target.

The US yield curve also remains flat, which to us means the bond market is pricing in a higher probability of a growth slowdown as US financial conditions tighten later in the year.

The European Central Bank was the last of the major central banks to turn hawkish in the face of increasing inflation, signalling that it will also be increasing interest rates later this year. These concerted efforts by major central banks risk slowing global economic growth later this year, which is negative for risk assets.

South African inflation is close to the top end of the South African Reserve Bank's (SARB's) target band, and we expect it will moderate as the year unfolds. Most of the increase in headline inflation can be attributed to energy and administered prices, on which monetary policy action has little impact. Demand in the system is better captured by core inflation, which is under control, sitting at the lower end of the SARB's target band. Inflation expectations are also muted, supporting a less aggressive response by the SARB in hiking the repo rate. Economic growth over the next three years is only expected to average around 2% and, with unemployment so high, the SARB will continue to gradually normalise interest rates. We expect it will hike rates three - four times this year. The Forward Rate Agreement (FRA) market has priced in seven more domestic rate hikes this year, which we think is excessive and presents value in the short end of the yield curve.

Valuations

The 10-year yield spread between SA and the US is still elevated, around 7%. It is almost 3% higher than in 2013 during the taper tantrum episodes. On a real yield or currency-hedged basis, SA still offers the best return prospects among its emerging market peers. This provides SA with some cushion against tighter global financial conditions and we think it contributed to the better performance of South African bonds this year compared with most of its peers. Our fair value for the 10-year bond yield is 9.25% and in total we expect bonds to return around 15% this year.

With inflation expected to average 5%, domestic bonds make a compelling investment case, especially in view of the headwinds facing other asset classes.

Portfolio diversification helps to protect against monetary policy missteps

AT A GLANCE

Sustained higher inflation in advanced and emerging economies has placed monetary authorities under pressure to hike interest rates and tighten policy

As global central banks actively try to stabilise economies, the potential for policy error creates risks for financial markets

Until monetary authorities provide clear guidance about future policy, volatility risks highlight the need for asset diversification in long-term investment portfolios



By Ndivhuho Netshitenzhe,
STANLIB economist

Rising inflation and interest rate hikes

In January 2022, the South African Reserve Bank's (SARB) Monetary Policy Committee (MPC) continued the interest rate hiking cycle, increasing the repo rate by another 25bps to 4%. Although the decision was not unanimous, with four members of the MPC preferring an increase in rates and one voting for rates to remain unchanged, it has become clear that the MPC intends to increase interest rates from historically low levels.

The MPC is responding both to upside risks to South African inflation and the increased risk of monetary policy tightening by central banks in developed markets. Importantly, the MPC did not discuss hiking rates by 50bps, showing that it is unlikely to be aggressive.

SA is not unique in experiencing rising inflation and the decision to hike interest rates. According to the International Monetary Fund (IMF), the average rate of consumer inflation in emerging markets was measured at 5.8% year-on-year in December 2021, up from a mere 4.4% a year ago. Equally, consumer inflation in developed markets rose to 3.5% year-on-year in December 2021, up from 0.5% a year ago.

This sharp increase in world inflation is partly related to ongoing global supply disruptions as well as a higher oil price, strong demand for goods, rising wages and elevated commodity prices.

In response, many central banks have increased interest rates since 2021. In fact, a total of 32 countries (mostly emerging markets) have increased interest rates since 2021. Of those countries, 22 have hiked rates in the first two months of 2022, including the UK, South Korea, Brazil, Argentina, Poland, Chile and SA.

Critically, despite the monetary policy adjustments under way globally, there is an increased potential for policy errors by central banks that would affect financial markets this year. In fact, in making its decision, the SARB indicated that “it is uncertain how far the international normalisation of monetary policy will go, as well as the exact timing. And this uncertainty continues to cause financial market turmoil and capital flow volatility”.

Emerging markets feel pressure of advanced economies' monetary policy decisions

Given this uncertainty, the SARB (and many other emerging market central banks) is keeping a close eye on actions by central banks in advanced economies, particularly the US Federal Reserve (Fed). An element in the SARB's decision to hike rates influenced by global rate hiking trends.

In its recent meeting, the US Federal Open Market Committee (FOMC) decided to leave the Federal Funds target interest rate unchanged at a range of 0% to 0.25%, and also decided to leave the pace of QE tapering unchanged. This means that the Fed's asset purchases will stop in early March 2022.

Importantly, the Fed indicated that “with inflation well above 2% and a strong labour market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate.” This could be interpreted as the Fed signalling that the first rate hike will occur at the FOMC meeting in March 2022.

Similar moves have been seen in Europe. In its latest meeting, the European Central Bank (ECB) decided to keep its key interest rates unchanged, despite record rises in inflation. Instead, the ECB recommitted to its decision that its €1.85 trillion Pandemic Emergency Purchase Programme would reduce net purchases and stop them in March 2022. In contrast, the Bank of England (BoE) has been relatively more aggressive, increasing its policy rate for two consecutive meetings, with more increases expected in 2022. In addition, the BoE's MPC voted not to reinvest any of the £875 billion of government bonds it has bought under quantitative easing programmes when they mature.

The evolution of monetary policy tightening by central banks in developed markets, including the Fed and the ECB, will certainly put pressure on emerging market currencies, including the rand. Growing expectations of tightening by the Fed has contributed to most emerging markets' central banks adopting hawkish tones this year, as they seek to maintain attractive interest rate differentials.

Current outlook for global monetary policy

Given the higher inflation trajectory, the bias in global interest rates is to the upside, even as central banks try to avoid any undue tightening of monetary policy. It now seems likely that the Fed will hike rates five times in 2022 by 25bps on each occasion. In terms of the start of quantitative tightening, the Fed indicated that reducing the size of its balance sheet will commence only after the process of increasing the target range for the Federal Funds rate has begun.

Critically, while the members of the FOMC agreed to start to hike rates in March 2022, Chairman Jerome Powell made it clear that the pace of unwinding accommodative monetary policy will be steady rather than aggressive.

It also now seems likely that the ECB will embark on its own rate hiking cycle in 2022, given recent higher-than-expected inflation data. However, ECB President Christine Lagarde emphasised that the ECB would stick to the “sequence” it had already announced of only raising rates after it stopped net bond purchases, adding that the council would follow a gradual approach to tightening.

For SA, the SARB is likely to continue to hike rates during 2022, and we now expect a further three rate hikes this year (of 25bps each), taking the repo rate up to at least 4.75% by year-end.

Risks facing financial markets given current monetary policy adjustments

Unfortunately, the monetary policy adjustments that are under way have introduced two equally concerning risks, particularly from a financial markets perspective.

Firstly, it has become evident that many central banks, including the Fed, have been hesitant to tighten monetary policy, arguing that the current acceleration in inflation is “transitory”. If this approach persists, there is a real risk that major central banks could increase interest rates far too slowly, allowing inflation to take hold more fully. This would undermine economic activity, causing the already-fragile global economic recovery to slow further.

Under these circumstances, with higher consumer inflation becoming more entrenched, central banks will eventually be forced to be more aggressive in their monetary policy tightening, which would place strain on a number of financial assets, including stocks and bonds.

Unfortunately, the opposite risk is also prevalent. In other words, it is possible that central banks could overreact to the current high rate of inflation and decide to tighten monetary policy very aggressively to prevent a more persistent increase in consumer prices. This would risk pushing economies back into a recession.

All things being equal, undue monetary policy tightening would trigger a real interest rate adjustment and lead to a higher discount rate, resulting in lower stock prices.

Added to this is the risk that a more aggressive tightening of monetary policy will lead to stronger capital flow reversals from riskier assets such as emerging market debt.

Given these risks, long-term investors should remember the principle of asset diversification to manage the risk to certain asset prices caused by a substantial policy error by the major central banks. This should remain front of mind at least until it becomes evident that central banks can adjust monetary policy at an appropriate pace.

Conclusion

Overall, while the major central banks are quickly trying to reshape their forward guidance for monetary policy to ensure that consumer inflation trends move back below target, the pace of tightening needs to be monitored closely to prevent any undue tightening that could derail the fragile economic recovery.

A rapid increase in real interest rates could potentially lead to a disruptive revaluation of global equity markets, resulting in sustained and significant weakness in bond and equity markets. At the same time, delaying the tightening process could lead to inflation taking hold more fully, undermining economic activity and eventually leading to aggressive monetary policy tightening in the future.

As financial vulnerabilities remain elevated in several sectors, monetary authorities should provide clear guidance about the future stance of policy to avoid unnecessary volatility. Until then, these risks highlight the need for asset diversification in the construction of investment portfolios.

Why digitalisation matters

AT A GLANCE

A significant divide remains between digital leaders and laggards in the corporate world, despite the intensified focus on digitalisation resulting from the COVID-19 pandemic

An in-depth analysis of a selection of companies shows that digital leaders are growing at almost five times the rate of the digital laggards

Comparing sport apparel companies Nike and Asics, shows that Nike's foresight in investing in digitalisation before its rival has delivered better revenue and profitability metrics

Given our focus on growth and quality, along with our digitalisation theme, we consider some of the best investment opportunities available to global investors today lie in investing in both traditional and new businesses that continue to embrace digitalisation



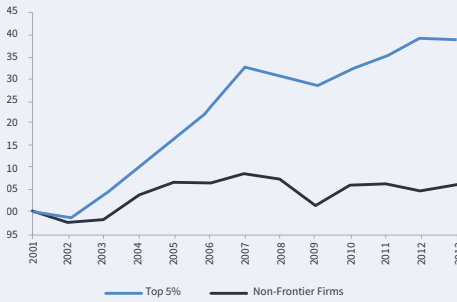
By Caroline Keen and Alex Stanic
Portfolio Managers J.P. Morgan Asset Management

Digitalisation has been a key topic for many years, if not decades. Its impact on a company's prospects is regarded with varying degrees of seriousness by corporates and investors. The COVID-19 pandemic intensified the focus on digitalisation as the world's interactions – social, transactional, professional, medical, financial, and educational – had to move online to survive. Still, we argue a huge divide persists between the digital leaders and the digital laggards in the corporate world and that understanding this is necessary both for investors' decisions and corporates' future growth and returns. Within our Digital Revolution theme, we look at the differences between these two groups of companies and draw some important conclusions about why digitalisation matters.

Digitisation: moving from analog to digital.
Digitalisation: embracing digital technologies.

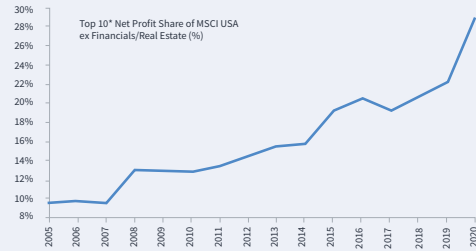
Firstly, taking a step back, we know that only a handful of exceptional companies have dominated stock market returns and corporate profitability for several years. These next two charts from Macquarie make this argument very clearly. They show the productivity of the top 5% of productivity generators compared with the rest and that the profit contribution of the top 10 companies in the MSCI USA index has risen from 10% in 2005 to 30% in 2020.

Productivity gap – top 5% vs the non frontier (frontier ex top 5% productivity generators)



Source:OECD; Macquarie Research, April 2021

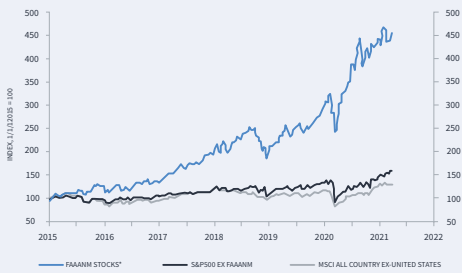
MXUS – Top 10 share of profits (%) – up from 10% in 2005 to 30% in 2020



*Top 10 AAPL, MSFT, GOOGL, FB, JNJ, INTC, VZ, AMZN, ABBV, PFE
Source:Factset;MSCI; Macquarie Research, April 2021

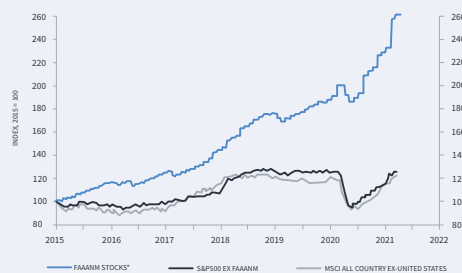
The charts below also show the dominance of a handful of companies on the S&P and MSCI ACWI ex US market value and forecast earnings. What all of these companies (Facebook, Apple, Alphabet, Amazon, Netflix & Microsoft) have in common is their digital prowess. Is this the reason for their success?

Market value, US\$, 2015=100



*Facebook, apple, alphabet, Amazon, Netflix and Microsoft

Forecast earnings, US\$, 2015=100



*Facebook, apple, alphabet, Amazon, Netflix and Microsoft

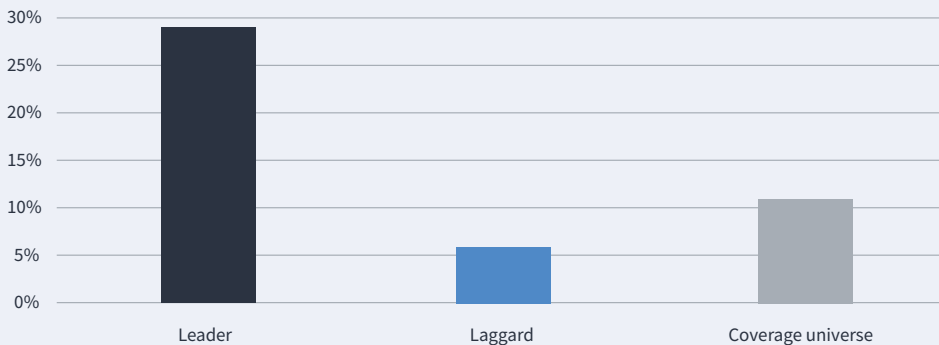
Inspired by a 2017 article in the Harvard Business Review entitled, “What the Companies on the Right Side of the Digital Business Divide Have in Common”, we decided to look a little closer to home to see whether we could find any similarities between digital leaders and digital laggards in our investment universe.

We asked our Global Sector Specialists (GSS) to identify the digital leaders and laggards within their sector(s) of expertise and identified 114 companies across seven sectors which formed

the basis of our analysis. We used internal forecasts which allowed us to access more relevant annual earnings per share (EPS) growth on a five-year basis – data which is not available using consensus estimates.

Perhaps unsurprisingly, our analysis shows that digital leaders are growing at almost five times the rate of digital laggards. This is important because the EPS growth component is the key driver of expected returns on our five-year valuation framework.

J.P. Morgan Asset Management five-year EPS forecast

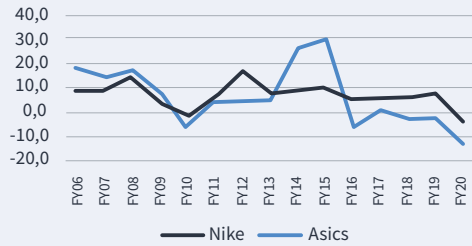


J.P. Morgan Asset Management, December 2021

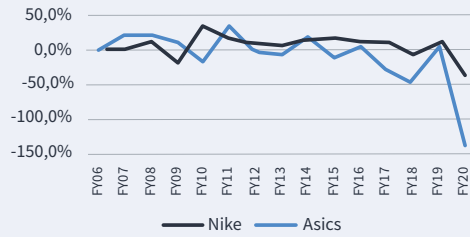
Why is this the case? Using history as a guide, we have taken a closer look at a leader and a laggard in the same industry, Nike and Asics. Both companies have a long history. Asics was founded in 1949 as Onitsuka and Nike 15 years later, in 1964. Nike has grown into a far larger company, with revenue multiples higher than those of Asics.

Looking at recent history, we can see the two companies really started to diverge in their sales growth, income growth and profitability in the last few years.

Revenue growth YOY (%)



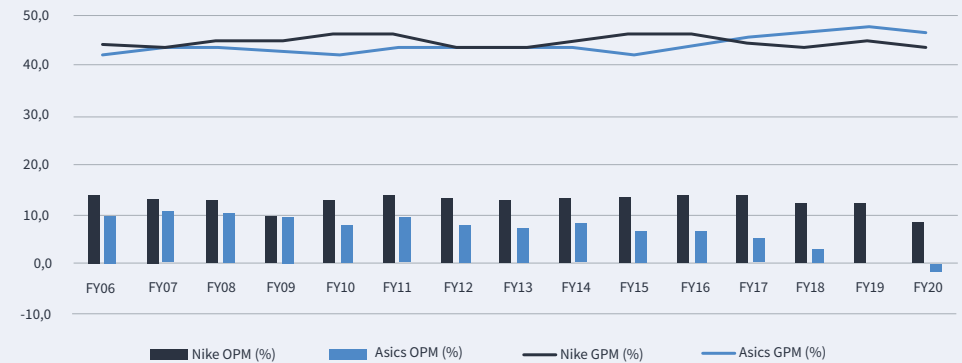
EBIT growth YOY (%)



Source: J.P. Morgan Asset Management, Nike Annual Reports, Asics Annual Reports. December 2021. EBIT is earnings-before-interest-and-taxes

Even more interesting to us as global investors, is that, while the gross profit margin of the two businesses has been remarkably similar, the profit at operating level has diverged meaningfully.

Gross profit margins (GPM) vs operating profit margins (OPM) (%)



Source: J.P. Morgan Asset Management, Nike Annual Reports, Asics Annual Reports. December 2021.

We suggest one key reason for Nike’s success is its foresight in investing in digitalisation – far earlier than its peers. Nike is explicit about this in its earnings’ calls, spelling out the positive flywheel of accelerating its digital transformation.

Nike’s breadth and depth gives it a huge scale advantage in employing its digital capabilities, making it viable to invest in initiatives such as the Nike training apps and the Nike run club, purely for directly better consumer engagement. This highly engaged traffic drives higher visitations to Nike’s commercial platforms, resulting in

higher repeat purchases from app members and increasing average basket size. Nike also has better data on its customers, giving it the ability to better segment its customer base and create superior products. This scale, and lead, makes it hard for any competitors to replicate it to the same extent. Already, 30% of Nike’s business is digital, and its ambition is 50%.

“At NIKE, innovation is a systemic approach and it’s how we extend our lead”.

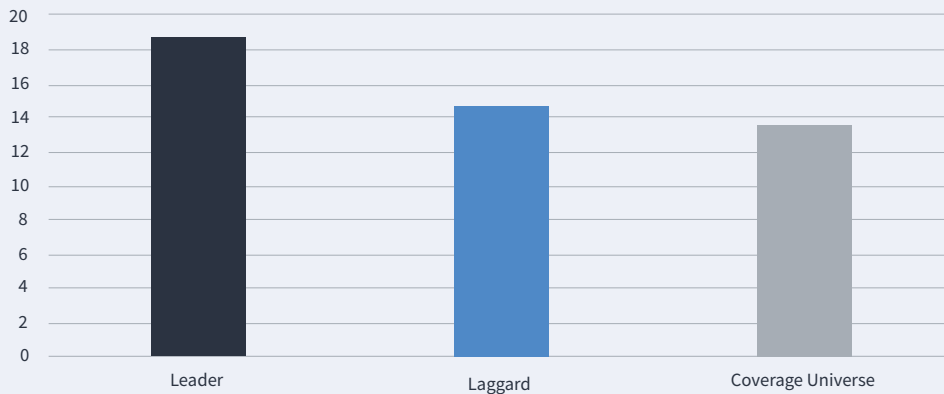
Return on equity (%)



Source: J.P. Morgan Asset Management, Nike Annual Reports, Asics Annual Reports. December 2021

While growth is important, any company which is growing without producing returns on that growth will run out of ammunition pretty fast. That is the case unless it can continually tap the market for more funds to invest in that growth, but not many companies can maintain that strategy on a sustainable basis. We analysed the return on equity³ for both the laggards and the leaders and found that the leaders were not only growing faster but they were also producing better returns.

Return on equity (RoE) % across our universe



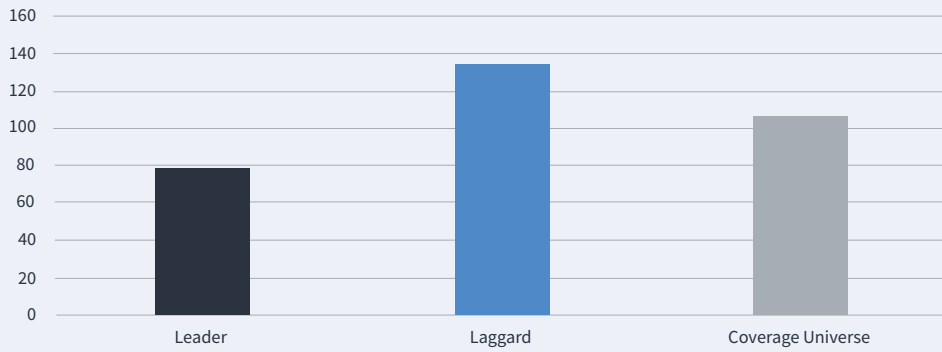
Source: J.P. Morgan Asset Management. December 2021

The difference was of a smaller magnitude than the growth rate, however the leaders exhibited a ROE of 19% compared with the laggards' 15%, and 14% for the coverage universe. ROE is boosted by leverage (one of the reasons we prefer the companies we invest in not to use it) and we could theorise that the laggards' ROE is flattered precisely because they have more debt. To test this thesis, we looked at the leverage statistics of the two groups and found that the laggards did indeed have higher leverage than the leaders.

Many investors assume that a fast-growing company is likely to be more risky and have more debt. This, however, is not what we have

experienced historically, and also not what we found in this analysis. The analysis below considers total debt to equity and shows that the leaders are far less leveraged at 0.78x than the laggards at 1.38x. The reason that leverage is not a strong feature of digital leaders is the availability of funding for newer, innovative companies. While banks typically shy away, the bond market is often also closed to newer companies with less of a track record. However, at the equity level of the capital structure, both private and public markets have more appetite for these newer, innovative companies. That allows them to finance with equity, not debt, and results in their holding cash on their balance sheets.

Leverage (debt/equity) across our universe



Source: J.P. Morgan Asset Management, December 2021

We should also note that not all the stocks picked as digital leaders are new companies. Many, such as PayPal, Assa Abloy, Tencent, Otis, HDFC Bank, Allegion, Accenture, Mastercard, Nike, L'Oréal, Microsoft and Starbucks have long corporate histories and have maintained leadership positions in their industry exactly because of their digital leadership. We hold many of these companies in the STANLIB Global Growth Fund, where our focus on growth and quality, along with our digitalisation theme make these, in our view, some of the best investment opportunities available to global investors today.

Can local corporate continue to deliver growth in 2022?

Q & A



By Jessica Bates,
Research analyst, STANLIB
Equity team

Q Why have equity markets performed well, despite the difficult economic conditions?

A South African listed equity delivered a lacklustre performance in the three years preceding the pandemic. That means the strong performance over the last 18 months has come off a relatively weak base.

South African corporates held relatively strong balance sheets going into the COVID pandemic. However, the focus of most equity analysts in early 2020 was to identify which companies would require additional funding, have to be recapitalised through rights issues, or, in the worst-case scenario, might not survive the gruelling operating environment that was to come.

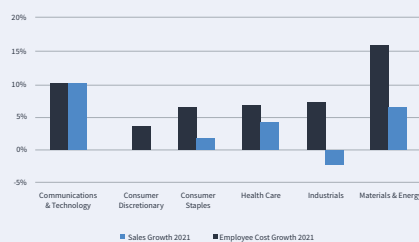
It was therefore remarkable to see how well most South African corporates withstood these events, delivering earnings, cash flow and balance sheet improvements that exceeded expectations. Incredibly, many have come out of the pandemic in better shape than before.

Q How did corporates achieve this resilience?

A Companies had numerous levers available to them, and pulled them, aggressively!

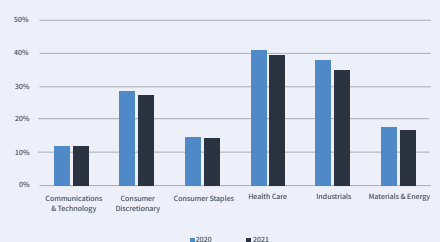
Employee costs on average accounted for 25% of operating costs in 2020, but were as high as 41% for Healthcare and 38% for Diversified Industrials. Companies managed to flex these costs more than they would have been able to under normal operating conditions. Our analysis suggests that headcount in 2021 was almost 5% below 2019 levels (excluding companies that made significant acquisitions or disposals). Retrenchments can be costly and take time to implement, hence the real benefit of staff cost initiatives came through in 2021 as growth in employee costs remained muted at 4% (on average) while sales growth accelerated to 8% (on average).

Sales growth vs employee costs



Source: Factset, STANLIB Equity

Employee costs as a % operating costs

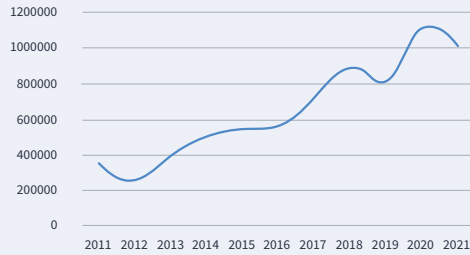


Source: Factset, STANLIB Equity

The rental reversion cycle that existed pre-COVID continued in this period, and corporates continued to take advantage of a market in which they could renew leases at lower rentals and lock in lower escalations, as well as benefit from rental relief

extended by landlords. Operating performance remains relatively resilient under the circumstances, with a strong recovery in operating margins and earnings in 2021 despite the ongoing pandemic and lockdowns.

Free cash flow RM



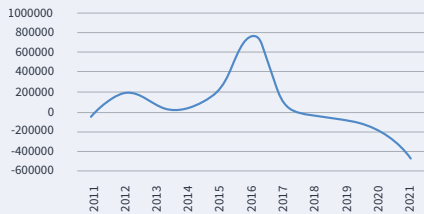
Source: Factset, STANLIB Equity

Various steps were also taken to protect cashflow. Capex was pulled back sharply, and corporates committed to spend the minimum in business capex.

Working capital was released due to cancelled orders for goods, resulting in flat or reduced inventory levels. At the same time, operating cash flow remained surprisingly robust, resulting in strong free cash flow generation.

The pre-emptive cancellation of or delay in distributing dividends meant this free cash flow could be used to reduce borrowings, strengthening balance sheets even further. It's remarkable that, during a period where corporates would have been expected to need additional capital, they actually paid down debt and bought back shares.

Funds from borrowing activities (Rm)



Source: Factset, STANLIB Equity

Capital raised (Rm)



Source: Factset, STANLIB Equity

These lower debt levels translated into another income statement tailwind, with lower interest costs further driving earnings delivery from below the bottom line. This should also benefit businesses in future, given that interest rate hikes are under way.

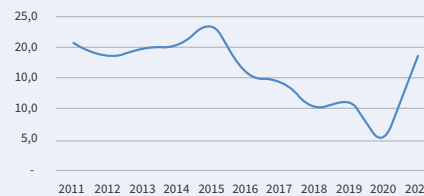
We expected that corporates would not waste a good crisis, and this was certainly the case for impairments and write downs. Management teams took the opportunity to clean up the asset base where assets were not generating sufficient returns, resulting in an extraordinary amount of impairments and write downs in this period.

Impairments/write downs (Rm)



Source: Factset, STANLIB Equity

ROE (%)



Source: Factset, STANLIB Equity

After these moves, unsurprisingly, 2021 ROEs of 19% (on average) are now above pre-pandemic levels of 11% and in line with levels last seen in 2015.

JSE-listed companies in aggregate now offer higher returns and stronger balance sheets, and should screen better going forward on our quality growth framework.

The balance sheet capacity to grow inorganically in an environment where long-term organic growth opportunities are stifled by poor macro-economic conditions could also be an additional lever for growth.

JSE Shareholder weighted All Share Index



Source: Factset (12m data)

Q Given the strong performance since the domestic equity market’s lows of March 2020, do you consider it to be expensive at current levels?

A We don’t think the equity market is overbought at these levels, because:

- We are expecting reasonable earnings growth over the next 12 months
- PE (Price/Earnings) ratios are at levels last seen in 2009 after the Global Financial Crisis, and we cannot see compelling reasons for valuation multiples to trend lower from here; and
- Companies have improved fundamentals, as described above.

While the counter-argument may be that companies should trade at discounted valuation multiples compared with history, given the outlook for growth, the market is acutely aware of the constrained growth environment and systemic risks SA faces, so this is already reflected in the valuation.

Q What are your expectations for earnings over the next 12 months and where do you see opportunities?

A We estimate that our investable universe within the JSE can deliver “low teen” percentage earnings growth over the next 12 months. Banks screen well on our quality growth framework and should deliver strong earnings growth as their “U-shape” recovery continues to play out. We also favour selected companies in sectors that have experienced delayed re-opening and recovery. These include companies in the Services and Leisure sectors (BidCorp) and Hospitals (Mediclinic and Netcare). We are defensively positioned within consumer segments, and favour sectors that have secular growth opportunities, like the Pharma-retail sector, where consolidation and corporatisation should drive decent earnings growth.

Performance at a Glance

Market Indicators

For the period ended January 2022

January 2022	1 Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)
SA markets	%	%	%	%
FTSE/JSE All Share SWIX	17,98	10,45	7,72	10,69
FTSE/JSE All Share	23,89	14,98	10,63	11,65
FTSE/JSE Resources 10	31,17	26,64	21,05	6,95
FTSE/JSE Financial 15	36,00	0,03	5,18	10,21
FTSE/JSE Industrials 25	12,55	15,31	8,84	14,55
FTSE/JSE SA Listed Property	37,44	-6,65	-5,21	5,12
STeFI Composite	3,85	-5,40	6,19	6,16
CPI (SA Headline Inflation)	5,9	4,3	4,4	5,0
Offshore markets (Base currency)				
MSCI World Index (ZAR)	20,3	23,3	17,0	20,1
Barclays Global Aggregate (ZAR)	-3,2	7,7	5,6	8,6
Global property**	25,0	12,4	9,6	15,2

**FTSE EPRA Nareit Developed Rental Index (ZAR)
Source: Morningstar, STANLIB Fund Research

Performance at a Glance

Core Fund Performance

For the period ended January 2022

Fund	1 Year		3 Years		5 Years		10 Years		Highest or lowest annual returns over the last 10 years (%)		
	Return (%)	Quartile	Return (%)	Quartile	Return (%)	Quartile	Return (%)	Quartile	Highest	Lowest	
<i>INCOME</i>	STANLIB Income Fund	4,54	2	6,41	2	7,34	2	7,11	1	9,63	4,41
	STANLIB Flexible Income Fund	7,01	2	7,71	1	7,32	2	7,30	2	11,86	1,84
<i>STABLE GROWTH</i>	STANLIB Balanced Cautious Fund	8,53	4	10,29	1	7,62	2	8,34	2	21,03	-1,31
	STANLIB Absolute Plus Fund	9,70	4	8,45	4	7,54	2	8,08	3	19,64	-3,86
<i>GROWTH</i>	STANLIB Balanced Fund	9,59	4	10,70	2	7,68	2	9,11	2	29,84	-7,46
	STANLIB Equity Fund	9,53	4	10,53	3	7,41	2	9,89	2	37,74	-12,78
	STANLIB Property Income Fund	31,77	4	-7,79	4	-7,09	4	4,21	3	61,04	-51,80
<i>OFFSHORE (ZAR)</i>	STANLIB Global Equity Fund	4,12	3	20,49	2	15,75	1	17,05	2	56,44	-12,62
	STANLIB Global Balanced Fund	4,12	2	15,98	1	12,20	1	13,89	1	37,05	-12,93
	STANLIB Global Property Fund	22,30	3	10,27	4	7,95	3	12,80	3	43,48	-19,27

Source: Morningstar

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