Investment Update

BRIDGE FUND MANAGERS

March 2019

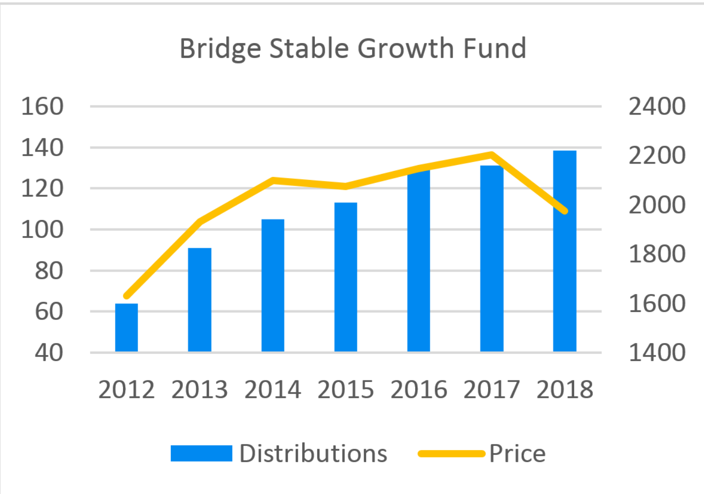
Since the end of March last year, the South African economy and financial markets have faced growing headwinds. These have included parliament's decision to amend the constitution to allow for land expropriation without compensation and revelations about the breadth and depth of corruption within government disclosed at the Judicial Commission of Inquiry into Allegations of State Capture. Eskom's financial and operational failings have led to the reintroduction of rolling blackouts, including stage 4 load shedding where 4,000 MW of the national electricity load are shed. At the same time, the global backdrop for emerging markets deteriorated as US President Donald Trump initiated a trade war with China, the US Federal Reserve continued to raise official US interest rates throughout 2018 and the emergence of populist leaders that have unnerved global investors.

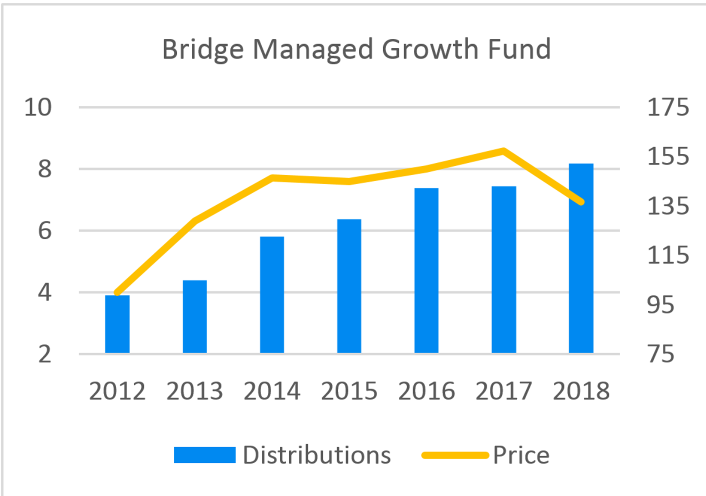
It is therefore not surprising that South Africa's financial markets have delivered poor returns over the past 12 months and foreign investors have been selling South African equities at a record rate in 2019. Since the beginning of the year, South Africa's equity market has been pushed higher by the dual-listed rand hedges, the Resources sector and Naspers. There is very little exposure to the Resources sector within the Bridge Fund Managers model equity portfolio because of the erratic dividend track records of businesses that are price takers (i.e. the price they receive for selling their products is set by the market). There is no exposure whatsoever to Naspers because the dividend yield is less than 0.5% and well below the 2% threshold we seek before including a company in our model portfolios. Income (in the form of dividends) and income growth are the cornerstones of our investment philosophy and processes and they have served investors extremely well in the past and will continue to do so into the future, notwithstanding this short period of relative underperformance.

The domestically focussed companies engaged in financial services (including real estate), retailing, food production and mobile telecommunications have been sold by foreign investors who have grown increasingly more apprehensive following the reintroduction of rolling blackouts by Eskom towards the end of last year. The General Retailers sector is down 9.4% since the start of the year, while the Mobile Telecommunications sector is down 8.3%, the Food Producers are down 5.4% and the Food and Drug Retailers are down 1.0%. But this selling appears to be overdone.

According to an article published by Bloomberg recently, "South African stocks are the cheapest on record relative to their emerging market peers" but this has not stopped offshore investors from selling a net R24.5 billion since the start of the year, the largest outflow for this period since Bloomberg began tracking this data 20 years ago. This offshore selling, together with a wait and see attitude amongst South Africans as the country heads to the polls in May, has created a situation where, on every metric, South Africa's equity and listed property markets look extremely attractive.

The best way to demonstrate this value is through a graphical depiction of the disconnect that has emerged between asset prices and the cash flows (either dividends or earnings) that they generate. The charts overleaf show the annual distributions (in cents per unit) of the Bridge Stable Growth and Managed Growth Funds and compares the trend in those distributions with the movements in market prices (also in cents per unit).





Source: Bridge Fund Managers

The charts clearly show that although distributions (i.e. the dividends, property distributions and interest income earned by the portfolio) continued to grow in 2018, the unit prices were declining. This disconnect between what is happening to cash flows (rising) and the prices paid for those cash flows (falling) is creating the value in South Africa's financial markets that Bloomberg referred to in their article. These disconnects between the fundamentals and prices can and do occur over short, discrete periods of time, but in the long-term, prices follow the cash flows/ earnings/dividends.

If those cash flows are growing now, the share prices will eventually move in the same direction and by the same magnitude. This means that South Africa's equity and listed property markets are poised for significant capital appreciation if, as expected, these cash flows continue to grow and the prices paid for those cash flows play catch up.

It is also worth noting that these short, discrete periods, where market prices move down while cash flows are moving up, do not derail or impact on longer-term financial plans. While they are often painful for investors to endure, they are part and parcel of the volatility in capital prices associated with any long-term savings plan, whether before or after you retire. Plans built using Monte Carlo simulations, like Bridge Fund Managers' Scenario Simulation Tool, which incorporate the impact of uncertainty in predicting and forecasting financial market returns, have already accounted for this short-term price volatility. This means the plan has already made an assumption that periodically, multi-year returns will be a lot lower than the long-term average but that the mix of assets and the level of income provided by those assets is sufficient to withstand this short-term volatility in the long-term.

Despite the poor relative performance of the last 12 months, most of the Bridge portfolios remain top quartile performers over the last 5 years, which has been an extremely difficult period for investors. According to performance data drawn from MoneyMate, the Bridge Equity Income Growth Fund was ranked 12th out of 104 funds in the South African – Equity – General category of collective investment schemes over the past 5 years to the end of February, while the Bridge Managed Growth Fund was ranked 23rd out of 101 funds in the South African – Multi Asset – High Equity category and the Bridge Stable Growth Fund was ranked 28th out of 81 funds in the South African – Multi Asset – Low Equity category. A large portion of the return generated by these portfolios over that period was the income produced by holding positions in the Payers & Growers® equity and listed property securities that form the backbone of our investment thesis (see table).

TABLE: CAPITAL VS INCOME OVER THE PAST 5 YEARS

		Income Return (p.a.)	Capital Return (p.a.)	Total Return (p.a.)
Bridge Stable Growth Fund	A Class	6.15%	0.55%	6.70%
	C Class	6.45%	0.55%	7.00%
Bridge Managed Growth Fund	A Class	5.06%	1.39%	6.45%
	C Class	5.36%	1.39%	6.75%
Bridge Equity Income Growth Fund	A Class	3.81%	3.16%	6.97%
	C Class	4.11%	3.16%	7.27%

Source: Bridge Fund Managers

The income streams, delivered reliably, predictably and growing consistently are not only used as a barometer for the health of the underlying investments in the portfolios but also serve to keep financial plans on track, despite the volatility in prices. For investors in retirement, who require regular cash flows from their savings to fund their lifestyles, the high and growing incomes from the Bridge Fund Managers range of funds can satisfy these regular drawdowns without requiring the retiree to dip into their capital, particularly when prices have been falling like they are now. This means that when market prices do recover, the investors capital base is intact to enjoy the full benefit of that recovery.

The Bridge Team