IT'S BEEN A TOUGH YEAR FOR INVESTORS

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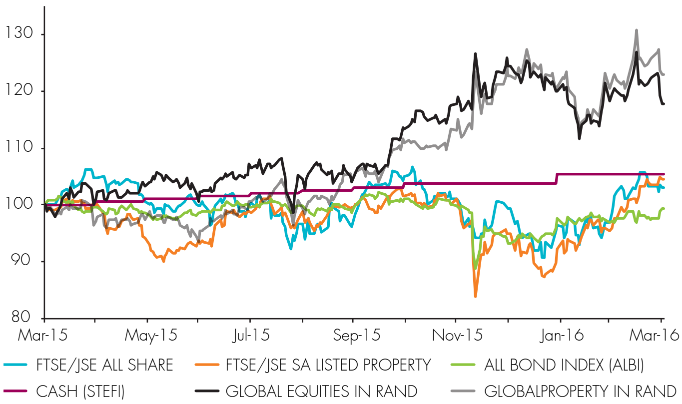
Markets have been on a roller coaster ride over the past year and as a result many investors are disappointed with their shorter-term fund returns. To understand why, consider the returns of the main asset classes South Africans typically invest in over the past year (summarised in Chart 1).

Equity markets have struggled while local bonds were punished

Local equity, which forms the bulk of most balanced funds (including ours), only returned 3.2% in the year to end March (including dividends). Local bonds, another cornerstone asset class particularly for more conservative, strategies returned -1%. Listed property, the standout asset class of the past few years only delivered 4.6%. Bonds, property, bank shares and other interest rate sensitive assets took a massive beating in December due to the shock axing of Finance Minister Nene. Based on these market returns, a typical SA only balanced fund would not have beaten inflation over the past year.

While the local market rallied from mid -February onwards, one-year returns are likely to remain under pressure for a while as the JSE All Share Index (ALSI) peaked at 55188 in April 2015.

Chart 1: **A year of diverging returns between asset classes**



Source: Datastream

Diversification benefits

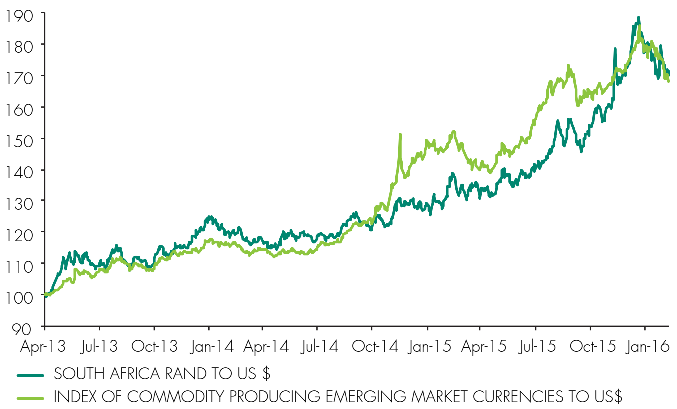
The importance of proper diversification was once again illustrated by the fact that it was foreign exposure that was the main source of returns over the year to end March for local investors. This was largely due to the weak rand since global equities were slightly negative over this period. Fortunately for local investors, most balanced funds including our Strategies were fully allocated to offshore throughout the past year.

However, one should avoid the temptation of chasing past winners. Heightened political uncertainty since December has resulted in many investors becoming extremely bearish on South Africa and the rand. However, the rand is primarily driven by global factors – commodity prices and investor sentiment towards emerging markets – and if these factors improve, the rand can strengthen again, as it did from mid-January onwards. Chart 2 shows an index of the currencies of other commodity-producing emerging markets (EM) against the US dollar – the rand tracks this index closely.

Divergence within asset classes too

While local equities were essentially flat over the past 12 months, there was a massive divergence between sectors. Consumer goods – dominated by rand hedges such as South African Breweries Miller (SABMiller) and British American Tobacco (BAT) – returned 25%, while resources lost 25%. If you were in the winning sectors, performance would obviously been better, but trends don't last forever on markets and the reversal of a trend can be quite vicious: Resources shares snapped back 18% in the first quarter of 2016.

Chart 2: **Rand driven by commodities and emerging market sentiment**



Source: Datastream

Higher inflation

The other factor weighing on investors is that inflation has risen sharply, with the latest reading at 7% (in February). This means the real return of local asset classes were negative over the past year. Inflation is expected to remain above the Reserve Bank's 3%-6% target range over the coming year, but should gradually return to target in 2017. Generating positive real returns will therefore be challenging over the shorter term, but should be achievable over the longer term given current valuations.

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HOW ARE WE MANAGING THE STRATEGY FUNDS IN THIS ENVIRONMENT?

Remaining true to our philosophy

We are sticking to our philosophy of valuation driven long-term investing, and continue to believe that diversifying across asset classes, geographies and fund managers is the best approach to manage risk and generate the targeted returns.

We continuously engage with our managers

The first step in our continuous engagement with our managers is to ensure that they remain true to their investment philosophy and are sticking to their process. We are confident that we have good managers in our Strategies. We just need to be patient – along with our investors – that they will deliver over the long term as they have in the past.

Apart from the tough markets, our managers have also underperformed benchmarks in equities and fixed income, the largest asset classes. (To use some finance jargon, beta was low and alpha was negative). Our equity managers are Coronation, Prudential and Visio, and our flexible fixed income managers Coronation and Prudential. The resulting underperformance relative to our peers over the past year is extremely disappointing to us, but we wish to remind investors that relative performance does not pay the bills at retirement – it is real returns over time that truly matter and our track record in this regard is still solid. Coronation is doing better as their higher resources exposure has started paying off.

Improved balance in our global equity exposure

Our overweight in emerging markets (EM) equities is based on historically attractive valuations. This detracted from performance over the past year as EM equities lagged developed markets by 9% over the past year, but there are encouraging signs of value being unlocked both in the asset class and the performance of our manager (Coronation). We have introduced new managers into our global equity building block which should improve the overall balance. Thanks to regulatory changes, there is now a far greater universe of global managers available to us and after extensive research we decided to add Baillie Gifford, Harris & Associates and Vontobel to our Strategy Funds. Global equity valuations are in line with long-term averages and should still be able to deliver real returns close to historic averages over time.

Positioning the Strategies to deliver real returns over time

The local ALSI is now trading at the highest price to earnings (PE) ratio since the index was created in 1995. This would ordinarily cause alarm bells to ring, but it is important to note how the JSE is now dominated by global consumers companies (the likes of SABMiller, Compagnie Finaniére Richemont, Naspers and BAT) who derive very little revenue from South Africa and who are highly prized by global investors for their defensive earnings. Excluding these global megacap shares, the PE ratio of the ALSI is in line with historic averages – i.e. there are still sectors that offer some value (such as banks) – but not cheap. The local economic environment is also difficult for those companies with substantial domestic exposure. We remain underweight on South African equities in the Strategy Funds and prefer global equities. We also remain overweight global property. However, global exposure is obviously capped at 25% in Regulation 28 compliant funds. While global bonds have performed well, we continue to avoid this asset class, given that some $7 trillion trade at negative rates and the rest do not offer a sufficiently positive yield to compensate for risks.

In contrast, local long bond yields are trading above 9%, well above average, and should generate decent real returns as inflation moderates. We remain overweight local fixed income and believe that the market already prices in a high probability of South Africa being downgraded.

STAY THE COURSE

It has been a tough ride for investors over the past year or so. We believe that global fundamentals are still fairly solid, but investor uncertainty over fundamentals is likely to persist, leading to volatility. On top of this we have seen a large divergence in returns not only between asset classes over the last year, but also within asset classes. The temptation to switch from underperforming to outperforming funds or to more conservative funds might be large. So too is the temptation to respond to a sharp fall in the rand by going boots-and-all offshore. So how should investors react? The answer remains the same: investment decisions should be made on a forward-looking basis and not by using the rear-view mirror. Our Strategies are appropriately diversified, and asset allocation is based on expectations of future returns. Investors therefore do not need to switch between more conservative and more aggressive funds because tactical asset allocation changes have already been implemented based on valuations.

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