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Momentum Investments Target Factor Portfolio Range

quarterly commentary to end June 2020

Assessing investment returns in an outcome-based investment context

The Momentum Investments Target Factor Portfolio Range is managed in terms of our outcome-based investing philosophy, where we design the portfolios to maximise the probability of achieving the inflation-plus return target of each portfolio over the relevant period, while continuing to meet the portfolios' risk targets. To achieve this, our portfolio management approach conceptually starts at an (multi) asset class level, then progresses to the identification of specific investment strategies within each asset class (if appropriate) and finally ends up in the selection of (potentially more than one) investment mandates awarded to investment managers that will implement the desired investment strategies.

Given this outcome-based investing framework, when assessing the returns of the Momentum Investments Target Portfolio Range, it is important to start with looking at the returns from the portfolios against their inflation-related targets. This allows us to answer the question: did we achieve our target over the most recent relevant period? We then assess these returns relative to this target in terms of the following:

- The returns provided by the asset classes included in the portfolios
- The returns from the building blocks that provide the asset class exposure for the portfolio against their asset class (or strategic) benchmark. This in turn is explained by:
  - The returns from the investment strategies (or styles) used in the building block (if any)
  - The returns from the investment managers that were awarded the mandates used in each of the building blocks

This quarterly review thus starts with the assessment of the investment returns generated by the portfolios against their targeted investment outcomes over the most recent periods. The next section focuses on the economic environment and the returns generated by the asset classes (beta) for the most recent quarter, measured against our average real return expectations for each asset class. We review the returns from the building blocks and the underlying investment managers against their strategic investment benchmarks.

Momentum Investments Target Factor Portfolio Range Portfolio returns

The portfolios within the Momentum Investments Target Factor Portfolio Range outperformed their strategic benchmarks for the quarter and year to March 2020. The respective inflation objectives of the portfolios have, however, been difficult to attain, given the low return from growth asset classes for the last five years. However, the portfolios managed to outperform their respective benchmarks for all periods.

Economic overview

Despite the world thawing from containment measures, which froze economic activity, positive economic surprises are not a global trend as yet and sharp increases in the number of daily new cases in some countries have halted an easing in restrictions, causing positive data surprises to roll over in some geographies. Although a sizeable fiscal response was triggered in developed and emerging markets (EMs), EMs had fewer resources to deploy. As such, a number of economies may operate below their potential beyond 2021 and the divergence between richer and poorer nations is likely to grow. Monetary policy measures are likely to steady financial markets and spur inflation on asset prices, but the effects on the real economy are likely to be diluted.

The mood in global financial markets sweetened in the past quarter in reaction to a rapid and sizeable intervention by policymakers to counter the COVID-19 pandemic, but history has warned about a quick rebound in earnings. The current optimistic consensus could be in for a negative surprise given the disconnect between share prices and expected company profits against a backdrop of prevailing uncertainties. The bond market and the rand have nevertheless maintained a risk-off profile during this period, given concerns on the outlook for the economy.

The COVID-19 pandemic has aggravated South Africa's (SA) already severe socio-economic and political challenges. With the effectiveness of government's stimulus package being stymied by administrative challenges, the economy is still likely to contract by a sizeable 8.1% this year. We only see the economy recovering by 2% in 2021. We anticipate a further drop in headline inflation to around the 2% mark on pressured household incomes causing a drop in demand. Inflation is likely to average 3% in 2020 before rising to 3.6% in 2021, in our view. We see room for up to 50 basis points worth of easing in the repo rate in light of dismal growth and well-contained inflation.

We remain cautious of SA equities, as they are likely to take their lead from global equities during a risk-off drawdown period, but we are positive beyond that. We favour SA nominal bonds relative to inflation-linked bonds in the near term, given the expected slowdown in inflation. The relative rating of SA listed property to nominal bonds is still at historical extremes, suggesting a lot of bad news is already being discounted. We remain cautious in the interim, but we see the return profile as asymmetric to the upside beyond that.

Portfolio management

We continue to manage the portfolios with caution, given that we expect market volatility during the second half of this year and, therefore, still have protection strategies on local equity. During the quarter, we reduced our overweight exposures to global bonds and property, and we also reduced our global equity allocations slightly. We remain cautious on local property, as the full ramifications of the lockdown are still unknown and, therefore, have a material underweight position. We were, however, slightly overweight local equity and favour nominal bonds over inflation-linked bonds within fixed-income.
We maintained a slight overweight position to local cash, which was purely for capital protection purposes.

In summary, we are comfortable that the portfolios are positioned in a manner that will benefit from improved risk sentiment. However, elements of capital protection are embedded in case of another risk-off event.

We continue to monitor these exposures and developments daily, with a view to provide the optimal risk-adjusted outcome to you as well as the assurance that your investments are being actively managed in a prudent and responsible manner.

Asset class returns

The returns for the asset class benchmarks for the second quarter of 2020 are reported in the first column of the table below. The next column highlights the returns for these asset classes for the previous year. These one-year returns are then converted into real returns by deducting inflation (2.7%) for. The final column in the table contains the returns above inflation we expect to get (on average) for these asset classes for a full market cycle.

Asset class	Q2 2020 returns	Nominal returns for the 12 months	Real returns for 12 months*	Expected real return (p.a.)
Local equity (Capped Swix)	21.6%	-10.8%	-13.5%	5.8%
Local bonds (Albi)	9.9%	2.9%	0.2%	3.3%
Local property (Sapy)	20.4%	-40.0%	-42.7%	7.0%
Local ILBs (Igov)	4.8%	-3.3%	-6.0%	2.8%
Local cash (Stefi)	1.5%	6.9%	4.2%	1.3%
Global equity (MSCI World)	13.7%	26.3%	23.6%	6.5%
Global bonds (WGBI)	-1.2%	29.1%	26.4%	-0.3%
Global property	6.4%	3.2%	0.5%	4.0%
US dollar/rand**	-2.7%	23.1%		
SA CPI	**-0.8%**	**2.7%**		

* A positive/negative value here reflects the effects of a depreciation/appreciation of the rand against the US dollar on global asset class returns in rand terms.As the rand gets weaker/stronger, the returns of global investments get better/worse from a local investor's perspective.

Building block return assessment

As explained above, our outcome-based investing philosophy starts at the asset class level and then goes down to an investment strategy (if appropriate) and investment mandate choice level within each asset class. We thus construct building blocks that reflect our selected investment strategies and managers that were awarded the mandates to implement these to either improve on the returns of the asset class or manage its risk profile.

Local equity building block

Local equities had a strong quarter, with the Alsi advancing by 23.2%, recovering most of the year's prior losses and leaving it down a mere 3.2% for the year to date (YTD). The advance was led by Resource shares (up 41.3%) followed by Industrials (up 16.6%), with Financials lagging with a still respectable return of 12.4%. This divergence of returns was not unexpected, given the buoyancy of Resource prices and the underperformance of the local economy. Resource shares were in positive territory YTD, with a return of 5.7% and most Industrials exposed to global investments were also in positive territory, with Tobacco up 14.4% and the Technology sector advancing 39.3%. Locally, focused sectors like Financials and Retailers were down by 31.7% and 36.2% respectively YTD.

During the quarter, the building block achieved a return of 20.7%, which was marginally below the return of the Capped Swix.

The Momentum Systematic Strategies Portfolio outperformed the benchmark for the quarter, producing a return of 25.9%. Being overweight resources (platinum in particular) and underweight financials contributed to the outperformance. The holdings in Naspers and Prosus also contributed to absolute and relative returns. During the quarter, Harmony, Telkom, Resilient, Ninety One, Life Healthcare and Growthpoint were sold and FirstRand, Vodacom and Sanlam were included.

The Momentum Value Smart Beta Portfolio produced a return of 21.1%, which was marginally below the benchmark return. This strategy was overweight financials and underweight industrials. The portfolio was slightly overweight resources, specifically diversified miners. During the quarter, Resilient, Fortress B and Redefine were sold and AngloGold, Sibanye-Stillwater, Anglo American Platinum, FirstRand and MTN were included.

The Momentum Quality Strategy Portfolio produced a return of 16.2%, underperforming the benchmark by 5.4%. At quarter end, the portfolio was moderately underweight resources. Within the resource sector, the portfolio was underweight gold mining shares and overweight basic materials stocks. Within the industrial sector, it was overweight retail shares and food and beverage shares, while it was underweight personal and household goods. Within the financial sector, the portfolio was overweight insurance companies and underweight banks and property shares. During the quarter, Hyprop and Motus were sold while AngloGold, Ninety One and Netcare were introduced into the portfolio.

Local property building block

The Sapy and the FTSE/JSE All Property Index (Alpi) returned 20.4% and 18.7% respectively for the quarter ended June 2020, with the historic yield of the Sapy ending the quarter at 8.55%.

Property returns for the six months were materially affected by the imposed 'hard' lockdown during March 2020, which had a devastating effect on the SA economy, including commercial real estate. The Sapy returned negative 36.57% for March alone. Downgrades to the country's sovereign credit rating by Moody's to junk status further explained some of the weakness in property returns YTD . Although collection of rentals billed by landlords proved to be more resilient than most expected, it was nonetheless significantly lower than normal levels. The greatest pressure was felt in the retail sector, particularly large shopping centres, as most of the tenants could not trade, while convenience centres fared better, as they primarily sell non-discretionary items, which are essential for day-to-day living. On average, rental collections from Reits retail portfolios came in around 50%. Reits operating in the office sector saw their rental collections efforts around the 60% to 70% range, while industrial sector operators achieved reasonably high collection rates.

The building block returned 20.5%, which was in line with the benchmark.

The local bond building block

There was a sharp rebound in returns from the fixed income asset class for the second quarter of 2020 after the severe risk-off period experienced in the first quarter. Listed property (Sapy) returned 20.43%, nominal bonds (Albi) followed, delivering 9.94%, with ILBs (Igov) and cash (Stefi) returning 4.75% and 1.46% respectively.

Foreign activity in the SA bond market was muted since the sell-off in April/May. In June, the net foreign purchases were about R5 billion.

For the quarter, the building block yielded 9.3%, thus marginally underperforming the Albi benchmark (9.9%). The building block (1.7%) also underperformed the benchmark for the year (2.9%).

For the year, the building block benefited from being underweight the 12-plus-years sector for the first three quarters. Towards the end of the fourth quarter, the investment manager increased the exposure to the 12+-years sector).
The investment manager is of the view that, with the yield curve at historically steep levels, the long-dated bonds provided significant yield compensation for term or duration risk. In the short term, this was not the case though. This sector of the Albi was the weakest-performing area on the yield curve (negative 2.3% while the Albi returned 2.9%), thus illustrating the significant effect incorrect positioning on the yield curve could have on the building block's overall returns. The building block had a small exposure to ILBs (2.6%) and this detracted from the overall returns for this period. The building block had a modified duration slightly longer than the Albi (6.9 compared to 6.5).

Local cash building block

For the quarter, the building block delivered a return of 2.0% compared to 1.7% for the Stefi benchmark.

There were four interest rate cuts by the Sarb, totalling 275 basis points since beginning of the year. The building block return was expected to be slightly lower for the next number of months, as floating-rate notes reset at lower benchmark rates.
The local primary market remained frozen (no public auctions held), due to market uncertainty around COVID-19. Credit spreads in the secondary market were generally widened since the pandemic, effectively making credit cheaper and thus returns on the building block were lower than was previously the case. This was largely as a result of investors selling credit and moving into more liquid and less risky asset classes.

For the year, the building block delivered a return of 8.4% against the Stefi benchmark of 7.8%. The building block consistently met its objective of capital preservation, by maintaining positive returns on a one-year rolling basis. Both investment managers had a high exposure to floating-rate notes, which provided a fair degree of liquidity, while also providing excellent yields.
The investment managers have started to adopt a more conservative approach to credit, i.e. focusing on more defensive and higher quality companies and investing in shorter-dated instruments.

Local inflation-linked bond building block

Inflation-linked bonds have been among the more volatile and illiquid asset classes, but the investment backdrop they face is distinctly challenging. So, the view is that this quarter's rally was simply a pull back after the significant sell-off in the first quarter, and they still face a lack of inflation in the local economy and elevated issuance by government going forward.

The total return from inflation-linked bonds can be divided into two components – the monthly accrual and the mark-to-market of the capital value, due to the move in the real yields. The first component of return is the monthly accrual from the yield on the bonds and the inflation uplift. This component of the total return was a healthy 2.55% this quarter, with a 1.58% from inflation uplift and around 0.97% from yield accrual. The second component of the return is determined by the move in real yields of the bonds. Real yields moved lower during the quarter (22 bps), thereby generating capital gains to the tune of 2.2%.
These components combined thus explain the index (Igov) total return of 4.75%.

For the quarter, the building block yielded 4.8% against the benchmark Igov (4.8%). Credit spreads widened quite significantly (particularly on Landbank) and this has impaired returns for the quarter. The spread widening causes unrealised losses to come through in the building block total return but does offer attractive opportunities for investing new cash. However, investors should be very cautious deploying capital into ILB credit in the current environment.

For the year, the building block yielded a return of negative 2.6%, compared to the benchmark of negative 3.3%. It had a modified duration of 8.60 years, compared with the Igov of 8.68 years. The investment manager was slightly underweight the 3-to-7-years and the 7-to-12 years sectors and overweight the 1-to-3-years and 12-plus-years sectors.

Commodities building block

Commodities as an asset class responds differently to the very drivers that have rocked the global equity markets in 2020. However, the agricultural, energy and metals sectors respond differently to the same fundamental drivers. Similar to equities, the economically sensitive commodities had aggressive sell offs and vigorous bounces, while the traditional safe haven, gold, continued to perform its expected role, as a store of value in turbulent times.

Exposure to economically sensitive commodities (energy and base metals) was low for most of the first quarter in 2020. However, exposure has been methodically increased in diesel and copper late in the second quarter, as prices recovered in rand terms. A rising US dollar gold price was somewhat offset by a strengthening rand late in the quarter. This resulted in a minor correction and a moderate lightening of the gold holding.

The commodities building block returned 2.61% for the quarter.

Local real return building block

The real return building block returned 4.3% for the quarter, underperforming the internal strategic asset allocation benchmark, which returned 13%. For one and three years, the building block returned 1.5% and 6.2% per year respectively. The inflation plus 3% target was up 5.7% and 6.6% for one and three years. Absa returned 4.1% and Prescient 4.9% for the quarter. As these portfolios are defensively positioned, they did not participate fully in the strong rally experience by growth asset classes in the second quarter.

Prescient's portfolio's contributors to returns were the 5% exposure in listed property; 11% in preference shares and interest generated by income-bearing investments. Detractors were the longer-dated fixed interest exposure, such as 1% of the portfolio in ILBs, 12% in fixed-rate bonds. The portfolio maintained low equity exposure throughout the quarter and continues to do so. Given the significant real yield available, 9% for 10-year bonds, 9% for preference shares and 7.5% for ILBs, these remain the investment manager's preferred asset classes over equity.

Absa's defensive positioning also lagged the strong market recovery with consolidation of monetary and fiscal policies providing a significant boost to risky investments. The investment manager remains on high alert, with the expectation that the remainder of the year will remain volatile and thus remains cautiously positioned in this period with 10% in SA equities, 3% in listed property, 11.9% in cash and the remainder in bonds, floating-rate notes and ILBs.

On a look-through basis, the total building block was underweight equity, inflation-linked bonds and listed property and overweight in cash and bonds.

Global equity building block

The disconnect that occurs from time to time between returns from the stock market and economic reality could not have been more stark than in the second quarter of 2020. Induced by pandemic, the world entered its steepest and deepest recession for almost 100 years, yet stock markets moved relentlessly higher, with Wall Street leading the way with a return of 20% for the quarter, recovering much of the ground lost in the February and March sell off. Driving markets was the huge monetary stimulus, unleashed by the Federal Reserve on 23 March, with asset purchases on a scale never before seen, unlimited in size and duration, and including, for the first time, corporate bonds with sub-investment grade credit ratings. It was the critical moment in this crisis, and no coincidence that markets bottomed on that day. The Fed followed up in the second quarter with a commitment to continue asset purchases at the monthly rate of $120 billion and guiding that interest rates will be near zero through 2022. These actions averted a liquidity crisis, pushed interest rates on bonds to record lows, thereby supporting riskier and duration proxy investments, and ensured the smooth functioning of credit and money markets. Other major central banks have also taken drastic action, with extensions of stimulus programmes announced by the European Central Bank, Bank of Japan and Bank of England, and all effectively committing to near zero interest rates for years ahead.

Against this backdrop, the building block achieved a return of 13.5% compared to the MSCI AC World benchmark return of 13.2%.

Global property building block

The global property building block returned 6.3% for the quarter, in line with the benchmark return. The positive return was largely due to the gradual re-opening of many economies in Europe and the USA.

Global fixed income building block

Global aggregate bonds ended the quarter 3.3% higher in US dollar terms, after a flat first quarter, when credit spread widening offset treasury led gains. There was a marked improvement in sentiment to risky investments with little price deterioration from treasury bonds, which made for perfect conditions for the asset class. Spreads on the global index fell from 0.82% to 0.58% but remain wide of the 0.38%, where it started the year, leaving the prospect for some further upside from credit.

The best fixed income return for the month and quarter were recorded by the credit segment and by ‘peripheral’ country bonds. Overall, the ‘peripheral’ countries benefited from the EU's proposed recovery plan: the 10-year spreads on Spain and Portugal narrowed, ending the quarter at less than 0.9%, with Italy continuing to sit wider. Investment-grade corporate spreads tightened from 2.66% to 1.56% for the quarter.

The global bond building block returned negative 0.5% for the quarter, which was ahead of the benchmark return of negative 1.2%.

Conclusion

It’s only natural to be concerned when investment markets experience the volatility that 2020 has. The key during uncertain and volatile times like these is to remain invested and not to succumb to emotional reactions and to look beyond short-term fears. The portfolio managers are continually assessing how best to manage your well-diversified portfolio during this period.