Momentum Investments Target Factor Portfolio Range

quarterly commentary to end March 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

News of the emergence and worldwide spread of the COVID-19 virus has resulted in a very negative investment effect across global financial markets. The result of uncertainty regarding shorter-term economic growth and company profits intensified and subsequently resulted in developed market shares losing more than a fifth of their value in the first quarter of the year, with emerging market equities falling by a similar magnitude. The SA equity market followed suit, shedding 24.1% in the first quarter of the year, before experiencing some relief in April. The SA listed property index nearly halved in value since the end of 2019, as investors took a grim view on the sector as a whole. Traditionally, defensive asset classes provided some support relative to equities and property, but, in absolute terms, local government bonds fell 8.7% in the quarter, while inflation-linked bonds traded 6.9% weaker for the same period. Emerging market currencies also took a battering and the rand weakened more than 20% for the quarter.

The sharp sell off experienced across financial markets has been short in terms of trading days, yet severe in terms of magnitude, but the meaningful adjustments in asset prices in February and March 2020 suggest that some degree of a dire economic outcome is to some extent already discounted by numerous growth-orientated asset classes, including equity and property. These asset classes now look exceptionally cheap against their own histories.

As the spread and containment of the COVID-19 pandemic evolve across the globe, we should expect uncertainty to remain about the ultimate trajectory of the global economy, with volatility in financial markets likely to stay high in the near term. Once the virus effect has played out, global activity resumes to a degree of normality and isolation measures start to ease, there will be a rebound in economic growth and company profits on the back of the lagged effect of massive policy stimulus undertaken during the crisis. This economic rebound should renew risk appetite by global investors and will be discounted by rising risky asset prices ahead of the time. The recent market experience has similarities to when the tech bubble burst in 2001 and global financial crisis took hold of economies in 2008, albeit that the underlying cause and severity of those crashes were evidently not the same.

The barrage of fiscal and monetary policy measures enacted by global policy makers in reaction to COVID-19 should induce a strong lagged cyclical recovery in global growth in the aftermath of COVID-19. In our U-shaped recovery (base case), a sluggish upturn follows a more protracted slowdown. Disrupted global supply chains are only restored subsequent to the peak in COVID-19 fatalities in the third quarter of 2020, resulting in an economic recovery only taking hold from late 2020. While responses to public health in this scenario are sufficient, physical distancing and the control over the movement of citizens persist for additional months in an attempt to prevent a resurgence in infections.

Portfolio management

Diversification and risk management remains our best weapon in times like these and our portfolios have a healthy allocation to alternative asset classes and differentiated strategies, which helped absorb some of the market shock recently experienced. These include allocations to direct property, private equity and real assets, which are less affected by daily market moves and sentiment changes. Leading into 2020, we expressed our risk view by remaining underweight local property in favour of local equity and overweight cash in favour of local inflation-linked bonds and, where regulations allowed, we maintained an overweight exposure to global asset classes, which allowed the portfolios to benefit from rand weakness and added diversification benefits.

Given the extreme market returns, it is virtually impossible for anyone to reach their real growth targets and the severity of the market movements have resulted in our portfolios experiencing absolute drawdowns with the bulk of the decline concentrated in March. Depending on the risk profile and accompanying asset class mix, the shorter-term effect would have been dampened by as much as two thirds, so the more conservative portfolios provided members closer to retirement some level of protection.

In this environment, we continued managing the portfolios in terms of an outcome-based risk-mitigating process and looked for opportunities to protect portfolios, while still harnessing the available opportunity set towards our longer-term investment goals. In navigating our portfolios in this crisis environment where all asset classes start behaving in the same way, we implemented protection strategies to mitigate risk and we gave our investment managers appointed to our underlying mandates more flexibility to take advantage of any opportunities that may arise.

At the start of April, there was quite a rapid recovery in investment markets, with almost every asset class experiencing solid gains by staying the course, while managing the risks in our portfolios, they benefitted from this short-term recovery. We positioned prudently, with sufficient levels of protection and diversification to provide risk mitigation, while, at the same time, continue to benefit from changes in sentiment and the knock-on effects of globally synchronised stimulus packages in the medium to longer term. We continue to monitor these exposures and developments daily with a view to provide the optimal risk-adjusted outcome to clients as well as the assurance that their investments are being actively managed in a prudent and responsible manner.

Asset class returns

The returns for the asset class benchmarks for the first 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 (4.63%) 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	Q1 2020 returns	Nominal returns for the 12 months	Real returns for 12 months*	Expected real return (p.a.)
Local equity (Capped Swix)	-26.58%	-24.53%	-29.16%	5.75%
Local bonds (Albi)	-8.72%	-2.99%	-7.62%	3.25%
Local property (Sapy)	-48.15%	-47.91%	-52.54%	7.00%
Local ILBs (Ilbi)	-16.82%	-15.23%	-19.86%	2.75%
Local cash (Stefi)	1.69%	7.21%	2.58%	1.25%
Global equity (MSCI World)	0.42%	9.92%	5.29%	6.50%
Global bonds (WGBI)	27.94%	29.27%	24.64%	-0.25%
Global property	-8.50%	-5.38%	-10.01%	4.00%
US dollar/rand**	27.52%	23.18%		
SA CPI	**1.50%**	**4.63%**		

* 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.

The table above highlights the challenges local asset classes have experienced in the last year.

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

The first quarter of 2020 delivered the worst absolute quarterly returns in equity markets locally and globally, since the Global Financial Crisis of 2008/2009, as fears of COVID-19 spread across the globe. The Alsi declined 21.4% for the quarter, the Swix fell 23.3% and the Capped Swix declined by 26.6%. This is a large contrast to the previous quarter, when the Alsi delivered 4.6%, the Swix 4.8%, and the Capped Swix 5.3%. All three months of 2020 reflected negative returns, with March delivering the most significant decrease.

The negative return from the equity markets came from negative returns across SA industrials, resources and financials. The FTSE/JSE Financial Index was most negatively affected (negative 39.5%), dragged down by the returns from banks (negative 42.6%) and the property shares (negative 51.0%). The FTSE/JSE Resource Index returned negative 25.3%, weighed down by FTSE/JSE Industrial Metals (negative 29.6%), and FTSE/JSE Industrials fared the best with a negative return of 8.4%.

The worst-performing major equity sectors for the quarter were property, industrial engineering, mining, travel & leisure, general retailers, banks and insurers. While still recording negative returns, food producers, tobacco, food retailers and healthcare outperformed the broader market. While as volatile as most other shares within the period, index heavyweight Naspers outperformed the broader market and ended positively for the quarter.

The five-year return for the SA equity market is of course unsatisfactory for investors, with the ALSI delivering a negative 0.1% compound annual return, failing to outperform the cash and Albi return, which returned 7.2% and 5.2%, respectively

During the quarter, the building block achieved a return of negative 24.79%, taking the return for the past year to negative 21.57%, which was 2.95% ahead of the Capped Swix. The outperformance for the quarter and year was driven largely by the allocation to quality and momentum strategies.

The Momentum systematic strategies portfolio performed in line with the benchmark for the quarter, producing a return of negative 26.6%. The strategy was assertively positioned to have a material tilt towards shares that exhibit strong price-and-earnings momentum qualities. It achieved a return of negative 22.19%, outperforming the benchmark by 4.39%. It was overweight resources and underweight industrials and financials. Within resources, the portfolio was overweight platinum and general mining shares and, within industrials, it was overweight retail shares and underweight media and telecommunications shares. Within financials, it was underweight financial services shares. During the quarter, the investment manager sold out of MTN, Barloworld and FirstRand, while Harmony, Resilient, Life Healthcare, Investec and Ninety One were included in the portfolio.

The value smart beta strategy managed by Momentum Asset Management was assertively positioned to have a material tilt towards shares that exhibit strong value qualities, including price-to-book and price-to-sales ratios as well as earnings and dividend yields. It produced a return of negative 30.52%, underperforming the benchmark by 3.95% for the quarter. It was overweight the financial sector, underweight the industrial sector and marginally overweight the resources sector. Within the resources sector, it was overweight general mining companies and underweight gold and platinum mining shares. Within the industrial sector, it was underweight media, retail and healthcare companies. Within the financial sector, the fund was overweight banking and insurance companies. During the quarter, MTN and Sasol were sold and Resilient and Ninety One were included in the portfolio.

The quality strategy portfolio managed by Momentum Asset Management was assertively positioned to have a material tilt towards shares that exhibit strong quality qualities, including profitability and also stability and credibility of profits. It produced a return of negative 21.70%, outperforming the benchmark by 4.88%. At quarter end, the portfolio's equity exposure was 99.0%. It was moderately underweight resources, industrials and financials, which funded a 5.1% futures exposure. Within the resource sector, the fund 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 and industrial goods as well as services shares. Within the financial sector, the fund was overweight insurance companies and underweight banks and property stocks. During the quarter, Investec and Sasol were sold and Hyprop was introduced into the portfolio.

Local property building block

In line with global equity markets, the South African listed property sector, as measured by the Sapy benchmark, ended the first quarter of 2020 down with significant capital losses. The expected damaging effects of the COVID-19 pandemic on industries (including real estate markets) and on global economic growth drove equity markets lower during the quarter.

In South Africa, the United Kingdom and some parts of Central Eastern Europe, governments have imposed lockdowns and regulations limiting human interaction – some of which include barring large gatherings in work places and shopping centres. In addition, governments have prohibited trading in goods deemed as non-essential. In what was already a challenging operating environment in South Africa, COVID-19 has added to the uncertainty around the ultimate effect it will have on property fundamentals, valuations and the recovery period.

As such, the Sapy declined by 48.15% in the first quarter of 2020, with most of the sell off escalating significantly in March. The sector materially underperformed the Swix (negative 23.3%), inflation-linked bonds (negative 16.8%), the Albi (negative 8.7%) and cash (+1.7%) for this period.

The building block underperformed the benchmark for the quarter by 0.13% and 0.21% for the year ending 31 March 2020.

The local bond building block

The first quarter of 2020 was the worst on record for local fixed income asset classes, as event risks in the form of the COVID-19 pandemic and the Moody's rating downgrade to sub-investment grade caused massive increases in yields and corresponding negative total returns.

For the quarter, the building block yielded negative 8.9%, thus marginally underperforming the Albi benchmark (negative 8.7%). The building block (negative 3.2%) managed to marginally outperform the benchmark for the year (negative 3.0%).

It was another difficult quarter for local fixed income asset classes, as global and local uncertainty prevailed and event risk was elevated. Yields were up around 1.5% for March, liquidity evaporated and there was a complete dislocation in the market which prompted Sarb to announce a bond-buying programme to restore stability to the local market. This bought a relative calm and yields started to decline.

For the year, the building block benefited from being underweight the 12-plus-years sector for the period preceding this quarter. The building block had a small exposure to inflation-linked bonds (2.3%) and this detracted from the overall returns over this period. The building block had a modified duration slightly longer than the Albi (6.8 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.

The local credit market had performed well up to now; perhaps too well, as it was buffered by excess demand rather than fundamentally based investment rationale. But clearly the backdrop sketched above poses significant risk and uncertainty for the credit market and spreads began to widen meaningfully during March. The stability of the local credit market is thus being tested and the widening credit spreads added to investor woes. This degree of volatility comes as a complete shock to traditionally stable income building blocks. Investment managers are focused on capital preservation and, to this extent, the well-diversified building block does provide some level of comfort. However, the risks are much higher than they were three months ago.

For the year, the building block delivered a return of 8.6% against the Stefi benchmark of 7.2%. 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 high degree of liquidity, while also providing excellent yields, notably in 2019 pre the event risks mentioned above.

Local inflation-linked bond building block

Inflation-linked bonds were among the asset classes most affected by a lack of liquidity and panic selling by investors. They went into the quarter on the back foot as lack of inflation in the local economy and elevated issuance by the government continues to plague them. The risk events during the quarter were simply the last straw that broke the camel's back. Real yields rose an average 65 bps for the quarter, but at one stage were up a whopping 200 bps, to trade above 6% real, decoupling from any logical valuation anchor, in our view. At the end of the quarter, the long end yields were at 5% real.

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 on the low side at 1.40% this quarter, with 0.4% from inflation uplift and around 1.0% from yield accrual. The second component of the return is determined by the move in real yields of the bonds. Real yields moved substantially higher during the quarter, thereby generating capital losses of about 8.3%. These components combined thus explain the index (Igov) total return of negative 6.9%.

For the quarter, the building block yielded a negative 7.9% against the benchmark Igov (negative 6.9%). For the year, it yielded a return of negative 5.6%, compared to the benchmark of negative 5.1%. The building block had a modified duration of 8.2 years, compared with the Igov of 8.6 years. The investment manager was slightly overweight the 1-3-years, 3-to-7-years sectors and 7-to12-years sectors and underweight the 12-plus-years sector (39.8% compared to the Igov at 55.0%).

Commodities building block

During the first quarter of 2020, demand for commodities directly involved in economic growth, i.e. base metals (including PGMs) and energy, fell dramatically, as did their prices. One of the conventional safe havens in times of uncertainty, gold, performed well, despite shakeouts during the March liquidity crises.

The commodities building block returned 7.71% for the quarter on the back of a bullish gold market and significant rand weakness.

Local real return portfolio

The real return building block returned a negative 6% for the past three months, 8.8% higher than return of the internal strategic asset allocation benchmark, which was down 14.8%. For one and three years, the building block returned 0.1% and 6.2% per year respectively. The inflation plus 3% target was up 7.6% and 7.8% for one and three years.

Absa Investment Management ended the quarter defensively positioned following the stress the markets experienced in March. The investment manager's view is that bonds appear attractive relative to inflation and cash – with selection based on duration and yield curve level crucial, however. In Absa's view, property should best be seen within the lens of a paradigm shift and is therefore underweight the asset class. Equity will remain under pressure, as fundamentals come to bear and further earnings revisions are expected. The portfolio was down 3.3% for the quarter, which was 10.5% ahead of the internal strategic asset allocation benchmark.

Prescient reduced longer-dated optionality given increased volatility and a rise in the cost of protection. While interest-bearing asset classes contributed to returns, equity, property and preference shares detracted. The portfolio was down 9.2% for the quarter, which was 5.5% ahead of the internal strategic asset allocation benchmark.

On a look-through basis, the total portfolio was underweight all other asset classes (bonds, inflation-linked bonds, equity and listed property), funded by being overweight cash.

Global equity building block

During the first quarter of 2020, global stocks, as measured by the MSCI All Countries World Index and MSCI World Index returned negative 21.4% and negative 21.0% (in US dollar terms) respectively. At a regional level, US equities returned negative 19.6%, European equities returned negative 24.3%, Japanese equities returned negative 16.8% and emerging markets equities returned negative 23.6% for the period. Sector returns from the MSCI World Index was negative across all sectors and, most notably energy, financials and materials. The sectors that were the least negative for the quarter included healthcare, utilities and information technology.

The global equity building block returned 0.9% (in rand terms) for the quarter, which was below the benchmark return of 1.0%

Global property building block

The global property building block was affected by the general risk-off environment and in particular the closure of many retail centres as well as many industrial properties across the globe. The global property building block recorded a negative return of 8.2%, compared to the benchmark return of negative 8.6%.

Global fixed income building block

The quarter was dominated by developments in the COVID-19 outbreak, which spread outside of China, driving a risk-off market sentiment. In this environment, equities sold off drastically, with the S&P 500 Index experiencing its largest weekly fall since 2008. With equities selling off, developed market government bond yields rallied in a flight to quality. German bund yields fell considerably and the US 30-year traded below 1.5% for the month. Corporate bonds lagged government bonds, particularly high yield. US dollars and the Japanese yen were the best-performing currencies, as investors sought safe-haven asset classes.

The global bond building block returned 27.9% for the quarter, which was below the benchmark return of 31.5%.

Conclusion

It's only natural to be concerned when investment markets experience sharp drawdowns. 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.