Portfolio Manager Quarterly Comment

Market overview

The SIM Active Income Fund posted a good return for 2018, in particular when considering the especially challenging investment environment locally as well as globally. By a number of measures, last year was one of the toughest on record with the vast majority of global asset classes ending the year in negative territory. These drawdowns were also associated with a fair share of volatility as global markets traded erratically all the way through to the end of the year: sell-offs were followed by sharp reversal rallies on a daily basis during even the last trading days at the end of the year.

Upward pressure on local interest rates resulted in our All Bond Index only marginally beating cash for the year. Inflation-linked bonds had a tough year as the upward trend in real yields resulted in the asset class posting only marginally positive returns for the year. Taking a closer look at the path of local interest rates and the bond market performance, it was quite a bumpy course during the year. The first quarter of the year delivered stellar returns from local fixed-interest assets on the back of Ramaphoria and positive local sentiment, with the trend subsequently turning around sharply in the second quarter as international factors took centre stage and weighed on local bond market performance. Foreigners were significant sellers of local bonds during the second and third quarter of last year and have now decreased their holdings of local South African bonds to the lowest level in almost two years.

The South African government's 2018 Medium Term Budget Policy Statement (MTBPS) was released during October. It showed clear links between medium-term expenditure and President Ramaphosa's proposed growth-enhancing reforms. National Treasury stuck quite closely to the expenditure ceiling despite the increased wage bill and additional payments to state-owned companies (SOEs). It also showed a clear intention to promote accountability and good governance, while spending available resources more wisely and efficiently. To back this up the MTBPS emphasised the need to bolster capital expenditure while curbing consumption. The minister provided a list of examples of targeted projects that support the growth-enhancing reforms. National Treasury also showed that it wants to stabilise the debt ratio and eventually reduce it but highlighted government's wage bill, which accounts for 35% of consolidated spending, as one of the major obstacles to achieving this. Another problem is the larger than expected revenue shortfall due to the repayment of overdue VAT receipts and disappointing growth in company tax receipts. A wider budget deficit is projected for the next three years and the primary budget balance (revenue less non-interest spending) remains negative over the next three years. At some point, in the absence of stronger real GDP growth or lower real interest rates, the primary deficit must switch to a meaningful surplus in order to stabilise the debt ratio. As it stands the government debt ratio climbs to 59.6% of GDP by 2024/25. Overall, years of fiscal revenue underperformance and excessive expenditure lingers in the fiscal numbers and the risks remain elevated. It is no easy task to stabilise the debt ratio in the absence of a decline in expenditure relative to GDP. But cutting spending is no easy matter considering South Africa's high unemployment rate. Also, there are latent risks in non-financial public enterprises and corporations. The state's balance sheet remains under strain and without a marked improvement in the primary budget balance, the fiscal maths is not adding up to a stable debt ratio, which implies the risk related to sovereign debt ratings is back on the cards.

The credit rating of South Africa will be an important consideration and potential risk factor going forward. Moody's is currently the only rating agency which still has an investment-grade rating for South Africa, although only one notch above investment grade while both S&P and Fitch have a sub-investment-grade rating of South Africa. In November, S&P announced they are keeping their rating unchanged at BB+ for the local currency and BB for the foreign currency, with a stable outlook. In December, Fitch also affirmed their rating of South Africa at BB+ on both the local and foreign currency debt, also with a stable outlook. It appears both rating agencies have given South Africa the benefit of the doubt, citing the usual key risk factors and challenges relating to economic growth, structural reform, fiscal consolidation and the ongoing concerns of SOEs. Moody's is key at this stage because it is the only rating agency which still has an investment-grade rating for South Africa. Should Moody's downgrade South Africa to sub-investment grade, it could lead to portfolio outflows and weakness in local fixed-interest markets. Moody's was due to give a review of their rating of South Africa during October 2018, but has since postponed their review into the new year. The National Budget released in February will be a key consideration for rating agencies and investors alike.

Local inflation increased at a measured pace towards the end of the year. The local consumer price index (CPI) increased by 5.2% year-on-year (y/y) in November, up from 5.1% in October. CPI goods increased to 5.3% y/y from 5.1% previously, while services held steady at 5.1% y/y. Core CPI – which is CPI excluding food, non-alcoholic beverages, petrol and energy – picked up slightly to 4.4% y/y in November from 4.2% in October. We expect inflation to remain contained within the 3-6% target band going into 2019 and 2020, with the main risk to forecasts the exchange rate and oil price volatility.

The asset allocation in the SIM Active Income Fund worked well during 2018, a year which was characterised by volatility and uncertainty and was generally quite a challenging investment environment. Overall, we are pleased with the performance outcome and positioning of the fund, especially given the circumstances and, furthermore, the negative returns seen on most asset classes worldwide. The Fund managed to deliver performance in a volatile market environment, which was driven by local as well as international factors. The Fund was able to participate in market strength but was also more insulated from market volatility than could otherwise have been the case, especially considering the events and market movements during the year. The Fund's investment objectives are always a key consideration when evaluating the overall positioning and underlying investments. This has continued to prove to work for the Fund as the performance has managed to keep pace with the local market during periods of strength, while, in addition, we have had scope available to take advantage of investment opportunities during market weakness and when interest rates traded higher.

The mandate of the SIM Active Income Fund is orientated towards higher-quality assets and it is also important to remember that the Fund does not utilise any offshore exposure. Offshore asset allocation brings the potential for associated currency diversification and an expanded investable universe. This expanded opportunity set would have been beneficial, especially during the last 18 months as we witnessed big moves in the local currency as well as reversals over shorter periods than is otherwise more generally the case. The Fund has performed well when considering the risk-adjusted returns delivered, as compared to both inflation and other available asset classes. When looking at the return of the SIM Active Income Fund compared to inflation, the Fund has performed as good as it can be expected to while, on the other hand, the conservative nature of the Fund has resulted in strong positive returns compared to returns in listed equities and property, which ended the year firmly in negative territory. Going forward, it should reasonably be expected that the performance will again normalise closer to historic norms.