Fund Commentary

Sanlam Investment Management Balanced Fund

September 2018

Portfolio Manager Quarterly Comment

Market overview

What a strange world we live in! Can US equities, which are by most observers perceived to be quite expensive by historical standards, be the safest haven around? The way asset prices have been behaving, one could be excused for wondering… Despite global manufacturing indicators such as purchasing managers' indices and manufacturing confidence remaining positive (albeit at levels below where it started the year), emerging market (EM) currencies and assets have been under relentless pressure, while in the developed world, equities continued to outperform everything else and within that universe the US remained the star. In the last 10 years, post the global financial crisis, US equities outperformed the MSCI World ex USA Index by more than 6% p.a. In the last year that outperformance increased to almost 15% and in the last quarter it accelerated to almost 30% (on an annualised basis). Although the US technology sector greatly contributed to this outperformance, it was not the exclusive driver. Even the S&P 500 ex Technology Index outperformed the MSCI World ex USA Index by roughly 5%, 10% and 23% annualised over 10 years, one year and 3 months respectively.

In our previous two quarterly reports we highlighted that emerging markets did not do themselves any favours, with a couple of self-inflicted crises that sowed doubt about EMs. However, EMs generally are in much better shape than historically when broader EM crises developed and we believe that market movements against EMs have been overdone. However, our exposure to emerging market equities continued to disappoint, with continued underperformance of EMs during the quarter accentuated by underperformance from our chosen solution.

We also previously made the case for global equities to continue outperforming global fixed-interest assets, on the back of interest rates rising slowly (given high debt levels) and earnings support. And in this context the US has been the poster child, with earnings rising strongly to support equity price performance. However, the accelerating nature of US outperformance and the level of earnings growth that would be required to support valuations are starting to concern us. Does that mean US equities are due for a correction as many commentators claim? It might be, but it is not certain – such an event is near impossible to predict. As long as earnings show positive growth, a US equity correction might remain a rainless dark cloud, but in our opinion it is a cloud that at least warrants carrying an umbrella or a raincoat. Consequently, in the last quarter we started adding some protective structures to the foreign equity portion of the portfolio and will continue to do so into any continued equity market strength.

In US Dollar terms only equities gave a positive performance for the quarter (with the MSCI World Index up 5%), while property, bonds and cash all delivered marginally negative returns. But the continued broader EM currency weakness saw the Rand weaken about 3% in US Dollar terms, lifting the performance of all foreign assets into positive territory and also above the best of what was available locally. After six months of continued weakness, the Rand reached levels above what fundamental drivers would suggest it should be at and when near R15/$ we started bringing some money back to SA to redeploy in attractively priced local assets. For this we had to trim back our foreign equity position a bit. We do find it very difficult to be very aggressive on the repatriation trade, however, since when things really went wrong for emerging markets in the past the Rand had sometimes blown out to levels in excess of R20/$ when expressed in current value terms. So, we'll rather bring back more aggressively during times of more substantial currency weakness.

We continued to avoid global fixed-interest assets. It is difficult to find a scenario where these provide any form of real return in the foreseeable future, given that developed market bonds are offering low or negative prospective real yields and, in addition, their yields are more likely to rise than fall due to the quantitative easing policies of central banks coming to an end.

We reduced the previously held exposure to a basket of developed market real estate investment trusts (REITs) and added the proceeds to a diversified portfolio of attractively priced real assets (property, renewable energy, infrastructure, utilities) where long-term contracts are in place for income to rise with inflation. These assets should over time exhibit lower correlation to equity markets, while providing attractive real returns that should rival that of equities.

On the local front, all assets but cash experienced another quarter of lacklustre returns. Fixed-interest assets delivered marginally positive returns of less than 1%, whereas growth assets lost some ground with property down by 1% and equity down 3.3% (FTSE/JSE Shareholder Weighted Index). It has now been almost four years during which all local assets gyrated around a trend return defined by cash and where no compensation was awarded for incurring volatility in the other asset classes. During that time the other asset classes all got cheaper and in our opinion they are all priced for returns in excess of their respective expected long-term returns.

Towards the end of the quarter bond yields started approaching levels last seen prior to the ANC elective conference, with prospective returns from bonds rising to around 4% in real terms. The risk of further downgrades to our credit rating has indeed increased again and hence the rise in yields could be justified, with the ever-present risk of another spike upwards in bond yields being a constant threat to local bond investments. However, at levels where bonds offer real returns of 4% and more, we deem the returns adequate compensation for the increased risk. Property, on the other hand, is offering a very competitive yield and a material slowdown in the sector's distribution growth will be required for the asset class not to outperform local fixed-interest assets. And after a prolonged period of low returns, combined with recent weakness, local equities have become the most attractively priced it has been in a few years.

Consequently, we continued to add to our position in local bonds, maintained our moderately high exposure to local property and added to our local equity exposure. That does give us above average exposure to growth assets and should the period of cash outperformance continue, our chosen position will put pressure on performance. However, we don't claim to have superior skill in timing the market and as valuation-anchored investors we believe in channelling money to assets that offer value, since over time these should deliver superior returns.