

Portfolio Manager Quarterly Comment

Market overview

What a difficult quarter this was! The volatility in growth assets went into overdrive and caused a strong pullback in growth assets globally, with similar (but less severe) moves experienced locally. We've long expected continued growth asset volatility, fuelled predominantly by uncertainty about developed market interest rate normalisation, but believed that as long as interest rates normalised slowly (especially bond yields) and equity earnings did not come under pressure, the volatility should be tolerable and that by and large, growth assets should continue to slightly outperform fixed-interest assets. Despite the increased volatility in the last year and especially the last quarter and the initial strong pullback in growth asset values in October, by early December this view was still panning out and global equities, for example, were still outperforming global bonds on a year-to-date basis by about 3.5%. But a second sharp pullback in growth assets in December reversed that gain into a loss for the year, with global equities ending the year down by just more than 8%, while global bonds ended the year down by just over 1% following a mild rally of just over 1% in the last quarter. The signs of (gradual, but continued) slowdown in economic growth, combined with trade war fears and risk of policy error (albeit small), combined to cause investors to derate the equity market from a valuation level that was still high by historical standards and was (justifiably) built up over the period of quantitative easing.

A derating in equities often is associated with an increase in the outlook for interest rates (in theory, since the discount rate is rising; in practice, since alternative assets are offering better returns), or a reduction in the outlook for earnings growth (which of course could be associated with a rising interest rate at a level that might slow the economy, but does not have to be limited to interest rates as a driver). When equities derate while bonds rally (and hence bond yields decline), as we witnessed during the past quarter, it tends to suggest a 'flight to safety' and hence that growth concerns are rising, which would be negative for equity earnings outlook. This would be consistent with our current economic assessment, however, the severity of the reaction suggests a rapid escalation in that concern beyond the mild reduction in growth that we expect.

The equity market derating in the quarter was much more pronounced in developed markets than in emerging markets (EMs), since EMs were derated earlier in the year already when the trade war escalated. For the quarter, the MSCI EM Index delivered a total return of -7.4%, compared to the MSCI World Index total return of -13.3%. And in line with a concern we expressed in prior quarters, about the potential derating of the US market should earnings concerns rise, the US was the driving force of the quarter's equity derating – pulling back to levels where the protective structures we have in the portfolios were just about entering its band of protection.

We continue to expect positive earnings growth from equities and poor global bond returns given current (now reduced) yields and hence that trend returns from equities should be slightly better than that from bonds. We therefore continue to hold this slight bias towards growth assets, despite the fact that volatility is likely to persist. We offset some of the volatility risk that comes with growth assets through a more defensively positioned growth asset portfolio and we supplement this with some protective structures designed to reduce our effective equity exposure in the case of a very material equity derating – specifically in the US where equity ratings have been the highest and reasonably strong earnings growth is required to sustain the rating, and where interest rates have also been rising the fastest.

Our bias towards growth assets naturally resulted in a difficult quarter, since our asset allocation was incorrect for the quarter's asset class moves. However, given the portfolio construction, the loss was softened as the defensive composition of our growth assets came to our aid. Our portfolios benefited especially from the real asset portfolio that we included in 2018 and from the EM exposure that we continued to hold after getting hurt earlier in the year, but now was at value levels. These two components jointly outperformed global equities (as measured by the MSCI World Index) by roughly 10% for the quarter. In fact, all our equity components performed relatively well and for the quarter our foreign growth asset basket delivered performance well in excess of popular benchmark indices.

On the local front we did not escape the global pressure on growth assets and both equities and property declined by about 4% for the quarter, whereas bonds delivered almost 3% positive returns and cash just short of 2% positive. We had good exposure to local bonds and hence benefited from the positive bond returns, but our bias towards growth assets here too worked against us. Again, we had something to soften the blow though, since we had protective structures on roughly 15% of our local equity exposure, which was in its protective band when the market declined in October and which we exited near the equity market lows for the quarter to lock in profits gained via the protection.

Unlike the foreign positioning where both fixed-interest assets and growth assets are on the expensive side and likely to deliver medium-term returns that are below long-term expected returns from the respective asset classes, local assets are all priced for returns in excess of expected long-term returns. This is especially true for local property, where a lot of negativity is priced into the asset class. We therefore held positive growth asset exposure (both equities and property) on valuation grounds and we continue to hold that position. We did not replace the equity structures that we unwound with new ones, since we deem the equity market well priced and therefore the risk of incurring opportunity cost via protective structures have risen.

As far as the currency is concerned, it also exhibited quite a bit of volatility during the quarter, yet for the quarter as a whole it was not a significant contributor to returns after ending the quarter just over 1% weaker than where it started. The currency is not at a level where it warrants big foreign exposure bets irrespective of asset class valuation, and hence our current exposure is driven more by asset class valuations than by currency valuation. If anything, the fair level of the currency is a bit below the quarter-end spot level and the better value available in local assets would suggest a bias towards local exposure. But the momentum in global growth is moving against support for EMs, while SA-specific risks (to growth and potential downgrades) make it very difficult to justify a significant bet towards local exposure.