Portfolio Manager Quarterly Comment

Market review

We are very pleased to report that the Fund reached its 10-year track record during the second quarter of 2021. The Fund was launched during 2011 with an intent to meet and ideally exceed investor expectations. The performance track record and support received from clients throughout the period indeed suggest that we have been able to bring a valuable product to the table. We would also like to take the opportunity to thank clients for all their support over the years, which seem to have flown by, while we continue our endeavour to deliver on the investment objectives.

The performance of the Fund continues to stack up well, ranking favourably compared to the broader peer group and the benchmark, but in fact also compared to other traditionally available local asset classes. We believe the quite consistent track record is indicative of strategies employed in the Fund which aim to deliver sustainable and repeatable outperformance. Active management is a key aspect of the Fund's investment strategy, while yield enhancement is pursued by using a combination of both interest rate and credit or spread opportunities. The Fund's track record so far demonstrates that it is possible to outperform during both increasing and decreasing interest rate cycles, as well as favourable and even unfavourable credit or macroeconomic environments.

The first half of the year was a strong one for financial markets and we witnessed most global equity markets post good returns. European and North American equities posted some of the stronger gains while Asian and UK equities lagged a bit behind. In contrast, global developed market bonds pulled back and underperformed other asset classes so far this year. Yields on developed market government bonds have increased across the board so far this year. With yields across developed market bonds already at very low levels as a starting point, it leaves little breathing room for any weakness or upticks in yields. As such, the returns from global developed market bonds have been negative so far this year, and the weakness has spilled over into emerging market bond performances as well as high-yield markets in the US as well as Europe. The standout-performing asset class so far this year and also for the second quarter has been oil. This has resulted in some commodity indices also posting strong gains, such as the CRB Index, which has a high weighting in oil. However, we have seen mixed performances coming from the various commodities with gold and silver, for instance, trading much softer.

Local bonds had a strong second quarter and bounced back after ending the first quarter of the year on a weaker footing. The local All Bond Index (ALBI) returned 6.86% for the second quarter with longer-dated bonds being the best performers. The 7-12 year area of the local nominal bond curve returned 6.65% for the second quarter while the longer 12+ year sector returned 10.09%, thus significantly outperforming the shorter end of the curve with the 1-3 year area returning 1.40% and the 3-7 year area returning 2.01%. Inflation-linked bonds (ILBs) lagged behind nominal bonds for the quarter, but still delivered a decent return of 2.98% for the second quarter. For the year-to-date, ILBs are still well ahead of nominal bonds with ILBs up 7.68% for the first half of the year while nominal bonds are up 5% by comparison. Medium-dated bonds or the 'belly' of the real curve has been where the best performances have come from, with the 7-12 year area of the ILB curve up 9.99% for the year to date, while the 1-3, 3-7 and 12+ year areas were up 3.51%, 5.89% and 9.10% respectively.

The Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) kept the repo rate unchanged at 3.50% at their scheduled meeting in May. The vote was again unanimous, with all five committee members voting for rates to remain unchanged. The statement was a bit more hawkish with the SARB highlighting that the balance of risks around the inflation profile had increased, and that future decisions around the policy rate would take into consideration a balance of the risks. However, the inflation trajectory still appears to be muted and the SARB now expects inflation to peak at 4.7% this year and moderating to 4.3% in the upcoming months. The Quarterly Projection Model (QPM) still suggests two rate hikes during the course of this year, but the MPC continues to highlight that the QPM is only used as a guide and the committee applies a great degree of discretion when making policy rate decisions. Rate hikes do indeed seem quite unlikely for the foreseeable future given the weak economic backdrop and continued impact the pandemic is having in the country.

In contrast to short-term interest rates, longer-dated government bonds are still trading at elevated levels. Looking at our local yield curve levels towards the end of the second quarter, the 5-year area of the local yield curve increased over the quarter to 7.2% while the 10-year area decreased to 9.2%. Beyond 15 years the yield curve also rallied or 'flattened', but was hovering above 10% at the end of the first half of the year. The two main reasons for the big gap between the record-low repo rate and the rate on longer-dated bonds are the inflation risk and the counterparty risk on longer-term bonds. So, firstly, a part of the gap is to compensate investors for the uncertainty of not knowing whether their investment will keep up with inflation over the ensuing years, while as far as the second risk is concerned, the SA government has never defaulted on debt before but counterparty risk has indeed increased although it is impossible to say exactly how the situation will unfold. Indeed, the rates on longer-term bonds are attractive and although they remain elevated for good reason, we believe there is a large margin of safety and healthy real returns to earn from longer-dated fixed-interest yields.

Inflation is currently still anchored quite firmly towards the mid-point of the SARB's 3-6% target band. At the same time, nominal bonds are trading at around 9% in the 10-year area of the curve and hovering above 10% at the longer end. This suggests quite attractive real return prospects going forward. ILBs trading around 3% in the belly and 4% further out on the real curve are also still looking quite attractive – even after the strength already seen in the ILB market during the past year. But the yield and carry prospects still favour nominals in the medium to longer term. Going forward, fixed-interest asset class returns will be dependent on how the pandemic and vaccination programmes continue to unfold in South Africa, fiscal and monetary developments, as well as how and when the local economy can shift back to a more normal operating environment. Our local fixed-interest markets are strongly influenced by global factors, such as the global policy rate environment, inflation and capital flows. But at this point the local dynamics are outweighing the global influences from a valuation and pricing perspective, and as such the long-term investment outcomes will in all likelihood be determined by how the local situation unfolds.

It definitely continues to be worth bearing in mind that we are in a relatively soft inflation environment. Clients can take some comfort in the fact that the inflation-adjusted returns are still looking good in positive territory. Our positive yield environment locally is in contrast to the global environment where the vast majority of fixed-income markets are trading at negative real yields. Locally, yields have decreased to record low levels at the 'shorter end of the curve', i.e. the repo rate, and now makes products such as the SIM Enhanced Yield Fund even more important. For our investors in these Funds, we continue to place an emphasis on assets which offer good risk-adjusted return prospects and are appropriate for the current environment. The Fund's positioning is balanced by taking advantage of opportunities in interest rate markets should they be appropriate, while the Fund has very low exposure to credit investments or assets lower down on the quality spectrum.

The SIM Enhanced Yield Fund fits squarely on the lower end of the risk spectrum compared to most other investment products. During the last year – and number of years – the Fund served a valuable purpose to investors by delivering stable and positive returns in a particularly volatile and tough global as well as local investment environment. We believe the Fund continues to be a valuable investment proposition to clients given that South African fixed-interest assets are attractively priced both in absolute terms as well as compared to the relatively subdued inflation environment. These local assets are still trading at attractive levels, which is of course both a good starting point and supports the forward-looking return prospects of the Fund.