Momentum Flexible Factor Portfolio Range quarterly commentary to end June 2019

Assessing investment returns in an outcome-based investment context

The Momentum Flexible Factor Portfolio Range is managed in terms of Momentum Investments’ outcome-based investing philosophy, where the portfolios are designed to maximise the probability of achieving the inflation-plus return target of each portfolio over the relevant time period, while continuing to meet the portfolios’ risk targets. To achieve this, the company’s 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.

The Momentum Flexible Factor Portfolio Range differs slightly from the other Factor Series portfolio ranges in that investment managers that have flexible mandates are used, which allows them to adjust their asset allocations in response to changing market conditions. By comparison, specialist building blocks are usually used in the rest of the ranges and the asset allocation is controlled.

Given this outcome-based investing framework, when assessing the returns of the Momentum Flexible Factor Portfolio Range, it is important to start by looking at the returns of the portfolios against their inflation-related targets. This allows Momentum Investments to answer the question: did the company achieve its target over the most recent relevant time period? These returns are then assessed 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 will focus on the economic environment and the returns generated by the asset classes (beta) in the most recent quarter, measured against Momentum Investments’ average real return expectations for each asset class. The returns from the building blocks and the underlying investment managers are then reviewed against their strategic investment benchmarks.
Momentum Flexible Factor Portfolio Range returns

The lower factors, factor 3 and 4, have managed to outperform their strategic benchmarks over three and four years respectively. The respective inflation objectives of all the portfolios however, have been difficult to attain, given the low return from growth asset classes for the last five years.

Economic overview

Renewed growth risks and tepid inflation have caused most developed market central banks to walk away from their mantra of policy normalisation. However, global central bank balance sheets are close to historic highs and interest rates in a number of economies remain close to record lows, which limits the scope and magnitude of monetary policy measures to resuscitate growth. Moreover, high levels of public debt will constrain support from fiscal stimulus. By front-loading its interest rate response to subdued inflation and rising growth risks, the US Federal Reserve is likely to sustain the current economic expansion and prevent a sharp dip in growth. Other major central banks have joined the dovish chorus and could ease monetary policy further in the coming quarters.

With the pace of reform likely to be gradual in the near term only, the outlook for growth in South Africa is expected to remain sluggish at around 0.5% in 2019 and will likely struggle to achieve a rate higher than 1.5% in 2020. In Momentum Investments’ view, there is a significant risk that Moody’s will change its outlook on the country’s sovereign rating from stable to negative in 2019. This will be to flag the inability of government to stabilise debt and achieve speedier fiscal consolidation in an environment of low growth and hampered by political constraints. Should interest rates drop in the near term in response to subdued inflation, we anticipate the cutting cycle to be shallow, given the structural nature of South Africa’s low-growth quandary.

Asset class returns

The returns for the asset class benchmarks for the second quarter of 2019 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 (4.48%) for the year. The final column in the table contains the returns above inflation Momentum Investments expects to get (on average) for these asset classes for a full market cycle.

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Q2 2019 returns</th>
<th>Nominal returns for the 12 months</th>
<th>Real returns for 12 months*</th>
<th>Expected real return (p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local equity (Capped Swix)</td>
<td>2.90%</td>
<td>1.11%</td>
<td>-3.37%</td>
<td>5.80%</td>
</tr>
<tr>
<td>Local bonds (Albi)</td>
<td>3.70%</td>
<td>11.50%</td>
<td>7.02%</td>
<td>3.30%</td>
</tr>
<tr>
<td>Local property (Sapy)</td>
<td>4.52%</td>
<td>0.79%</td>
<td>-3.69%</td>
<td>7.00%</td>
</tr>
<tr>
<td>Local ILBs (IGOV)</td>
<td>2.80%</td>
<td>4.06%</td>
<td>-0.42%</td>
<td>2.80%</td>
</tr>
<tr>
<td>Local cash (SteFI)</td>
<td>1.84%</td>
<td>7.33%</td>
<td>2.85%</td>
<td>1.30%</td>
</tr>
<tr>
<td>Global equity (MSCI World)</td>
<td>1.74%</td>
<td>9.31%</td>
<td>4.83%</td>
<td>6.50%</td>
</tr>
<tr>
<td>Global bonds (WGBI)</td>
<td>0.84%</td>
<td>8.93%</td>
<td>4.45%</td>
<td>-0.30%</td>
</tr>
<tr>
<td>US dollar/rand**</td>
<td>-2.24%</td>
<td>2.89%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SA CPI</td>
<td></td>
<td></td>
<td></td>
<td>4.48%</td>
</tr>
</tbody>
</table>

* 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 growth asset classes have experienced in the last year. The best-performing asset class for the period was global equities and global bonds, while local property was the worst-performing asset class.

**Building block return assessment**

As explained above, Momentum Investments’ outcome-based investment philosophy starts at the asset class level and then goes down to an investment strategy (if appropriate) and investment mandate level within each asset class. The company thus constructs building blocks that reflect its 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 multiple balanced building block**

The local multiple balanced building block consists of five underlying investment managers, namely Foord, Investec, Coronation, Prescient and Abax. The investment managers were selected to provide an optimal combination of growth and capital protection.

The building block returned 1.75% for the quarter, which was below the benchmark return of 3.11%. Being underweight property and inflation-linked bonds were the largest detractors from returns.

The building block returned 7.29% for the first half of the year compared to the benchmark return of 6.46%. Abax was the best-performing investment manager for this period, with a return of 8.45%, outperforming the benchmark by 2%. Abax, Coronation, Investec and Prescient also managed to contribute positively to returns, returning 8.45%, 8.0%, 7.69% and 6.88% respectively.

**Local property building block**

Expectations of loose monetary policy saw global equity markets gaining in June, assisting the recovery of SA equities in the period. The SA 10-year bond yield rallied by 50bps during the quarter, with the rand strengthening by 2.8% against the dollar. On the back of this, the SA listed property sector, benchmarked by the Sapy, delivered a total return of 4.52% in the second quarter of the year, with returns largely driven by income growth of 3.2% and capital returns of 1.3%. The sector outperformed cash, nominal bonds and the local equities, which were up 1.8%, 3.7% and 3.9% respectively. A recovery in Resilient (Res), Fortress A, B (FFA, FFB) and NEPI Rockcastle (NRP) share prices during the quarter were the key drivers of the outperformance by the sector, with the stable accounting for 78% of total returns for the period. Res, FFA, FFB and NRP recovered by 13.27%, 16.78%, 12.06% and 10.37% respectively.

The best-performing shares for the quarter were Delprop, Balwin, Investec Australia, Fortress-A and Globe Trade Centre. The worst-performing shares for the quarter were Rebosis, New Frontier, Capreg and Intuprop.

A number of property portfolios announced possible merger and acquisitions activity during the quarter, with the reverse takeover of Gemgrow by Arrowhead expected to be finalised by the end of the company’s financial year.
The property building block achieved a quarterly return of 3.89%, with all of the underlying investment managers underperforming the Sapy benchmark.

The Momentum Asset Management Fund delivered a return of 4.09% compared to the Sapy benchmark total return of 4.52%. The portfolio benefited from being overweight Nepi Rockcastle (NRP), which was the biggest contributor to total returns during the quarter and being underweight ATT and Sac helped cushion losses in the portfolio. The portfolio’s underperformance compared to the benchmark was largely due to being underweight FFA and IAP during the quarter, which rallied by 16.7% and 18.1% respectively. FFA closed the quarter trading at a yield of 6.7%.

Catalyst achieved a return of 3.63% for the quarter and underperformed the benchmark by 93 bps. Being overweight Nepi Rockcastle and Stor-age, which outperformed the benchmark as well as the being underweight Accelerate, Redefine and Attaco, which underperformed the benchmark, contributed positively to returns relative to benchmark. Being overweight Hyprop, Rebosis A and Hammerson, which underperformed the benchmark and being underweight Investec Property, Fortress A and Equites detracted from returns relative to benchmark.

Meago recorded a return of 4.29%. The largest positive contributors to returns were being overweight Resilient, Nepi Rockcastle and Stor-age and being underweight Redefine and Hyprop. The largest detractors to returns were being overweight Rebosis and a being underweight Fortress A.

**Local flexible income building block**

For the quarter, the flexible income building block yielded 2.4%, underperforming the benchmark by 0.2%. It also underperformed the benchmark (10.9%) for the year, as it returned 9.50%. It struggled against its benchmark because it had a very high exposure of 81.8% in shorter-dated instruments with a maturity less than one year (mainly floating-rate notes). Cash, as measured by the SteFl, delivered 7.3% and the Albi returned 11.5%. Inflation-linked bonds (4.1%) and listed property (0.8%) detracted from the return. The portfolio had a short duration of 0.9 years compared to the Albi (1 to 3 years) of 1.6 years.

**Local inflation-linked bond building block**

Inflation-linked bonds bounced back this quarter, despite a continued benign inflation environment. Returns were boosted by a decline in real yields which were lower by an average 15 basis points across the curve. Much of the move lower was in short-dated maturities as this area of the curve responded to the change in sentiment globally, as growth fears have increased and economic data softened.

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 a healthy 2.21% this quarter, with 1.46% from inflation uplift and around 0.74% from yield accrual. The second component of the return was determined by the move in real yields of the bonds. Real yields moved lower during the quarter, thereby generating capital gains to the tune of 0.60%. These components combined thus explain the index (lgov) total return of 2.80%.

After a prolonged period of underperformance, the momentum behind rising real yields seems to have dissipated as a more synchronised global slowdown sets in. In addition, there will be some moderate upward momentum in
inflation that will come through in the remainder of the year. This supports Inflation-linked bond valuations and makes them more competitive relative to nominal bonds and declining cash yields.

For the quarter, the building block yielded 3.0% against the benchmark Igov (2.8%). For the year, it yielded a return of 4.8% compared to the benchmark of 4.1%. The building block had a modified duration of 10.2 years, compared with the Igov of 10.0 years. The investment manager was slightly underweight the 3-to-7-years sector and overweight the 1-3-years sector, 7-to12-years and the 12-plus-years sectors.

**Local cash building block**
For the quarter ending 30 June 2019, the building block delivered a return of 2.1% compared to 1.8% for the benchmark. Credit spreads continued to run ahead of themselves, with compression being driven by lack of supply, as opposed to fundamentals. Investment managers were very selective on which credit exposure to include in the building block. More than 91% of the building block was exposed to high-grade credit, classified as F1 and better. The credit spreads earned assisted in the building block’s generation of returns.

For the year ending 30 June 2019, the building block delivered a return of 8.8% against the SteFI benchmark of 7.3%. 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.

**Local absolute strategies building block**
The second quarter of 2019 added to the gains experienced in the first quarter, as all asset classes added positively to returns for period. For the quarter, the absolute strategies building block delivered 2.3% compared to its internal strategic benchmark, which returned 2.9%. For the year to date and year, however, the building block outperformed the strategic benchmark, returning 6.3% and 5.9% relative to the benchmark returns of 5.6% and 5.2%, respectively. The inflation plus 4% target, however, was difficult to attain, as the building block returned 8.5% for the year.

For the year, Prudential, Sentio and Tantalum, which are high equity investment managers, detracted from active returns, while Prescient and Absa contributed positively. This can be attributable to the challenges growth asset classes experienced in that period.

Prudential delivered a return of 2.1% for the quarter and 7.3% for the year to date. The largest positive contributor to absolute returns for the first half of the year included the Prudential’s exposure to SA bonds. This was followed by SA inflation-linked bonds, SA equity and cash. Equity holdings including banking shares such as Absa, Standard Bank, Richemont and MTN, which contributed positively to returns. Listed property marginally detracted from returns for the quarter. However, being underweight Intu and Capital & Counties, as well as being overweight Resilient added value. Sasol was the largest equity detractor from absolute returns for the quarter, while Bat and Sappi also detracted. Being underweight Anglogold and Goldfields also detracted from returns, given the rise in the gold price and shares in the period.

Sentio performed well during the volatile quarter, returning 2.5% for the period and 6.3% for the year to date, with top positive contributions during the quarter coming from positions in Anglogold Ashanti, Absa, Standard Bank, MTN, Naspers, Sanlam, Anglo America, FirstRand and Libstar. Top detractors included positions in BTI, Sappi, Sasol, Life Healthcare, Huge Group and Premier Fishing.
The largest contributors to the Tantalum portfolio on a year-to-date basis were local equities and bonds. Listed property detracted from returns. The portfolio was flat for the quarter and returned 5.2% for the first half of the year. Top positive contributors for the year to date were Northam Platinum, the R209, Naspers and Anglogold. The largest detractors were Sappi, Massmart and Sasol.

Prescient returned 2.9% for the quarter, 8.5% for the year to date and 9.2% for the year. Contributors to returns for the quarter were local equity, property and preference shares. Protection used in the portfolio detracted from returns.

Absa returned 2.3% for the quarter, 4.6% for the year to date and 9.8% for the year. The portfolio was defensively positioned at the end of the quarter, with 85% in local fixed interest and cash, 11.4% in local equities and 3.6% in listed property.

On a look-through basis, the overall absolute strategies building block was underweight equities, cash and inflation-linked bonds, while being overweight bonds and marginally overweight property.

**Commodities building block**

The commodities building block returned negative 2.24% and negative 0.44% for the quarter and year respectively. These returns were below the Stefi for the corresponding periods. Recent rand strength coupled with declining platinum, oil and copper prices largely explain the quarterly return.

**Moderate hedge fund of funds building block**

The moderate fund of hedge fund building block returned 2.7% for the second quarter, bringing the return for the year ending June 2019 to 10.38% after the deduction of all fees. This compares to Stefi, which returned 1.8% for the quarter, and 7.3% for the year. All strategies contributed positively to returns for the quarter. Most notably, an extremely volatile month of May yielded a positive 0.23%. Equity and fixed income strategies were able to profit from overall rand weakness and, in the case of fixed income funds, the flattening of the FRA curve.

**Aggressive hedge fund of funds building block**

The aggressive hedge fund of funds building block, which consists of the ZAR Equity Hedge multi-managed hedge fund and the Alternative beta replication strategy returned 4.15% after the deduction of all fees for the year to June 2019, having returned 1.87% for the second quarter. This compares to the two-third upside participation objective of 0.72% for the year and 1.9% for the second quarter (objective stated as two thirds of FTSE/JSE Capped Swix TR). The active strategy (fund of hedge funds component) returned 6.81%, while the replication strategy returned negative 0.84% for the year. On the active strategy, the investment managers had increased exposure to the Resi sector late in 2018 and this aided returns later in the second quarter. Equity investment managers continued to be long rand hedge shares and negative SA incorporated, given the headwinds to the local economy.

**Portable alpha hedge fund of funds building block**

The portable alpha hedge fund of funds building block returned 6.3% for the quarter, bringing the year’s return to 1.8% after the deduction of all fees. The FTSE/JSE Capped Swix TR index returned 3.8% and negative 2.6% for the periods respectively. Equity long-short and fixed income arbitrage strategies contributed positively to returns.
Special opportunities building block
The return for the second quarter came in at 2.47%, resulting in an annualised return for the 35 months of history of 9.3%. Returns since inception were at inflation plus 4.7%. Work continues on uncovering specialist investment strategies that meet the building block’s return objective, despite the tough economic climate facing the country.

Global active building block
The global active building block is made of up three investment managers, namely Orbis, Foord and Investec. They actively manage the asset allocation and the investment selection decisions in their portfolios and are assessed against a multi-asset-class benchmark.

This building block returned negative 1.42% for the quarter compared to the benchmark return of 1.32%. Most of the underperformance can be attributed to Orbis, as the portfolio returned negative 2.5% for the quarter. Orbis is comfortable with its portfolio positioning despite the underperformance of value strategies for the last year.

Global fixed income building block
Global bonds returned 0.92% for the quarter and 8.77% for the year. The positive return for the quarter and the year could largely be explained by the weakening of the rand. The building block returned 0.76% for the quarter and 8.74% for the year, in line with its benchmark.

Global equity building block
Global equities posted positive returns for the quarter, despite a sell-off in May, due to concerns over the US-China trade war. Equity markets were supported by the increasingly accommodative stance of major central banks and hopes of easing trade tensions in June. For the quarter, developed market equities advanced 4.0% in US dollar terms, taking the year-to-date return to 17.0%.

The US equity market led the way, returning 7.0%, and reached new all-time highs. The announcement by President Trump early in June that tariffs on Mexican imports had been avoided and the decision to resume trade talks with China provided a more favourable backdrop for markets. European equities advanced 4.3% in euro terms, despite the sharp fall in May. An about turn by the European Central Bank, in favour of keeping policy looser for even longer, was another key driver for the market rebound in June. In the UK, equities provided a positive return, returning 3.3% in sterling terms. Local politics continued to dominate and drive investor uncertainty, as the Conservative Party leadership race began. Japanese equities lagged the other major equity markets, falling 2.4% for the quarter, primarily as a result of weakness in May. The yen strengthened against other major currencies, driven by the perceived safe-haven status at times of market risk.

Against this backdrop, the global equity building block marginally underperformed its MSCI AC World Index benchmark. The building block returned 1.4% for the quarter compared to the benchmark return of 1.5%

Global property building block
The global property building block was introduced to the portfolio range during the course of the fourth quarter of 2018. The building block is managed passively by Blackrock and is aimed at achieving capital growth by tracking closely the return of the FTSE EPRA/NAREIT Developed Index. The building block is invested in equity securities of
companies that form part of the benchmark index. The building block returned negative 2.18% for the quarter, which was below the benchmark return of negative 1.23%.

Conclusion

The portfolios within the Momentum Flexible Factor Portfolio Range are all delivering in the main, long-term returns within expectations of their inflation-plus return targets, while considering the difficult operating and market conditions. Portfolio enhancements and other initiatives are continually being considered, as Momentum Investments aims to provide clients with well-diversified, risk-managed and risk-controlled investment solutions that give them the best chance of achieving their targeted investment outcome.