Momentum Passive Lifestage Portfolio Range
quarterly commentary to end September 2019

Assessing investment returns in an outcome-based investment context

The portfolio range has a lifestage model, which allows a member of a retirement fund to switch from a more aggressive investment portfolio with longer terms to retirement to more conservative and, ultimately, defensive portfolios as a member approaches retirement. The lifestage model uses a combination of asset classes, managed by multiple investment managers with different investment strategies to achieve its objectives. The lifestage philosophy uses ‘term to retirement’ as a proxy for the risk a member is able to adopt. This means, for example, the asset classes in which members of a retirement fund would invest 10 years from retirement will have a different emphasis from those closer to retirement. It stands to reason that when a member of a retirement fund has a long-term investment horizon, the member should be invested in growth asset classes, which would include a significant allocation to higher yielding asset classes and strategies also characterised by a higher level of risk (such as local equities and property as well as global equities). Although these asset classes are volatile, they provide returns above inflation over the long term. However, as a member moves to a medium-term investment horizon, the exposure to volatile asset classes should be gradually reduced to protect members in a retirement fund from being exposed to unnecessary volatility.

Our purpose is to enhance the lifetime financial wellness of people, their communities and their businesses, building a reputation for innovation and trustworthiness. In this way, we aim to become the preferred lifetime financial wellness partners to our clients. In keeping with the financial wellness framework, we have developed an investment philosophy that maximises the probability of you achieving your unique investment goals. We call this investment approach outcome-based investing. In response to the ever-evolving investment landscape, we manage our portfolios in such a way that they set their sights beyond mere benchmarks and instead focus on the things that matter the most to you – ensuring we maximise the probability of you achieving your investment goals. This portfolio range is managed using our outcome-based investment philosophy.

When assessing the returns of the Momentum Passive Lifestage Portfolio Range, it is important to start with looking at the returns from the portfolios against their inflation-related targets. This allows us to answer the question: did we achieve our target over the most recent relevant period? We then assess these returns 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 focuses on the economic environment and the returns generated by the asset classes (beta) for the most recent quarter, measured against our average real return expectations for each asset class. We review the returns from the building blocks and the underlying investment managers against their strategic investment benchmarks.

**Momentum Passive Lifestage Portfolio Range returns**

The portfolios in this range have inception dates of April 2015. Factor 3 managed to outperform its strategic benchmark for three years, returning 5.6% compared to a benchmark return of 5.2%. Factor 4 was in line with the strategic benchmark for four years (5.7%). Factors 5 and 6 do not yet have five- and six-year histories. All the portfolios’ returns, however, lagged their respective inflation targets, as a result of the low returns from growth asset classes at this time.

**Economic overview**

Unfavourable demographics, rising debt levels and high global uncertainty will ensure lower potential growth in a majority of developed economies in the next five years. The pace of adoption of structural reforms has been too sporadic and too slow to promise a return to pre-crisis growth norms. Monetary policy is likely to adopt an increasingly unconventional role, as some central banks have already breached or are close to breaking below the zero lower bound in short-term interest rates. A combined policy mix, including higher levels of public infrastructure spend and structural reforms could limit financial distortions in the economy and enhance long-term growth and living standards. This could prove beneficial in reducing the growth effect of rising trade protectionism and potentially turbulent financial markets, amid protracted uncertainty.

The risk of a recession is rising, making a case for de-risking portfolios. Although sharp equity drawdowns are typical around recessions, global equities can still move higher in the interim. United States (US) equities tend to act as a defensive play in a slowdown and often outperform equity markets in non-US regions.

In South Africa (SA), some progress has been made on reforming the struggling economy, but big business is growing impatient with President Cyril Ramaphosa’s trickle-through approach to reform and government’s discernible inertia on critical reforms at state entities. The outlook for SA growth remains tepid and is expected to rise from 0.6% in 2019 to 1.5% by 2021, on a marginal positive adjustment in confidence as incremental reforms and more concrete restructuring plans are unveiled for energy utility Eskom. Absent demand-pull inflation and benign underlying price pressures should keep headline inflation below 5% for the next three years, creating space for the SA Reserve Bank (Sarb) to cut interest rates by at least 25 basis points more.

The vast majority of SA shares are trading considerably below their highs after underperforming in the last five years. However, historical returns underpin prospective SA equity returns from the current low five-year trailing return level. The global hunt for yield has become even more pertinent, as the global stock of negative-yielding debt continues to rise. SA’s real bond yields continue to look attractive relative to other emerging-market peers. Good returns are expected from the low base created in SA listed property in 2018, even at an unchanged relative rating to bonds and below-consensus real distribution growth of negative S
Asset class returns

The returns for the asset class benchmarks for the third 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 (4.3%) for the year. The final column in the table contains the returns above inflation we expect to get (on average) for these asset classes for a full market cycle.

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Q3 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>-5.1%</td>
<td>-2.4%</td>
<td>-6.8%</td>
<td>5.75%</td>
</tr>
<tr>
<td>Local bonds (Albi)</td>
<td>0.7%</td>
<td>11.4%</td>
<td>7.1%</td>
<td>3.25%</td>
</tr>
<tr>
<td>Local property (Sapy)</td>
<td>-4.4%</td>
<td>-2.7%</td>
<td>-7.0%</td>
<td>7.00%</td>
</tr>
<tr>
<td>Local ILBs (IGOV)</td>
<td>0.1%</td>
<td>3.7%</td>
<td>-0.6%</td>
<td>2.75%</td>
</tr>
<tr>
<td>Local cash (Stefi)</td>
<td>1.8%</td>
<td>7.3%</td>
<td>3.0%</td>
<td>1.25%</td>
</tr>
<tr>
<td>Global equity (MSCI World)</td>
<td>7.8%</td>
<td>7.1%</td>
<td>2.7%</td>
<td>6.50%</td>
</tr>
<tr>
<td>Global bonds (WGBI)</td>
<td>8.8%</td>
<td>15.8%</td>
<td>11.5%</td>
<td>-0.25%</td>
</tr>
<tr>
<td>US dollar/rand**</td>
<td>7.5%</td>
<td>7.2%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SA CPI</td>
<td></td>
<td></td>
<td></td>
<td>4.3%</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 growth asset classes have experienced in the last year. The best-performing asset class for the period was local bonds, while local property was the worst-performing asset class.

Building block return assessment

Local equity building block

The third quarter remained a challenging environment in SA as local equities continued to deliver poor returns. July and August were particularly weak months, while September ended flat, resulting in the Alsi and the Swix delivering negative 4.6% and negative 4.3% respectively for the third quarter. Industrials returned negative 2.5%, outperforming resources at negative 6.4% and financials at negative 6.8%. Given the differences in weightings of key shares in the most-widely-used SA equity indices, year-to-date returns posted notable differences with the Alsi posting 7.1%, the Swix and Capped Swix lower at 4.3% and 1.4% respectively.

The local equity building block performed in line with its benchmark, the FTSE/JSE Capped Shareholder-weighted Top 40 Index, producing a return of negative 5.5% over the quarter. For the year, the building block returned negative 4.3% and the benchmark negative 4.2%.

Local property building block

A weak operating environment in South Africa continues to detract from the returns in the listed property sector. Demand for space remains subdued and key property portfolio metrics required to drive rental income growth
continue to be under some pressure. Growth in rental income was under pressure and, on the back of this, property valuations have started to adjust marginally to reflect realised and expected weakness in rentals.

On the back of the weakness observed in fundamentals and the volatility in equity markets, yields on the benchmark index, the SA Listed Property Index (Sapy), sold off by 0.3% to end the period at 9.3%. For the same period, yields on the SA 10-year bond sold off by 0.2% to close the period at 8.9%.

As a result, the Sapy posted a total return of negative 4.4% for the quarter ending September 2019. The sell off experienced by the listed property asset class during the quarter resulted in the erosion of most of the gains made during the first half of the year. For the nine months ending September 2019, listed property posted total returns of 1.3%.

The building block returned negative 4.4% and negative 2.9% for the quarter and year respectively.

**Local bond and inflation-linked bond building blocks**
The third quarter was a tough quarter for local fixed income asset classes as global and local headwinds prevailed for investors. A more widespread global growth slowdown, which increasingly includes China, Europe and more recently, the US is underway. Locally, the authorities managed to cut the repo rate in response to the benign growth and inflation conditions, but this was ignored by fixed income asset classes, as we move inexorably toward the all-important event risks of the Eskom restructuring announcement, Moody’s rating update and the medium-term budget statement.

The local bond and inflation-linked bond building blocks produced 1.57% and 0.1%, relative to the Govi and Igov benchmarks, which returned 0.8% and 0.05% for the quarter respectively. For the year, the bond building block returned 11.3% compared to a benchmark return of 11.4% and inflation-linked bond s returned 3.7%, which was in line with the benchmark.

**Local cash building block**
For the quarter ending 30 September 2019, the building block delivered a return of 2.2% compared to 1.8% for the benchmark. For the year, it 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.

The underlying investment manager continues to remain neutral duration (60 days) and is not looking to increase this materially, as any further move lower by the authorities is not the start of a meaningful easing cycle. With one-year fixed rates now approaching the lowest levels in the last four years (7.50%), there is not much appeal in adding duration. In addition, credit spreads have now tightened to levels last seen five years ago and the economic environment is more challenging than it was then. The underlying investment manager remains selective on what credit exposure is added in sectors and to individual issuers as opportunities for yield enhancement are becoming distinctly fewer.

**Global equity building block**
Global equities posted positive returns for the quarter, despite increasing fears of a global slowdown. Developed equity markets gained 0.5% for the past three months, which was a much smaller return than experienced in the first two quarters, bringing the year-to-date growth to 17.6%. Their emerging market counterparts returned negative 4.2% for the quarter. Central banks increasingly took a dovish stance during the quarter, as many made cuts to their base rates in an attempt to stimulate slowing economies.
Although, the US equity market performed weakly in comparison to prior quarters, returning 1.4%, it increased the year-to-date return to 20.0%. Trade war tensions continued, with the direction of trade talks with China remaining highly uncertain and global trade suffering as a consequence. Continental European equities advanced 2.8% in euro terms, despite further evidence of a manufacturing recession and wider eurozone slowdown.

UK equities gained 0.7% in sterling terms, with underperformance continuing to be driven by Brexit-related uncertainty, as the next key deadline on 31 October approaches. Japanese equities performed well for the past quarter, returning 3.1%.

Against this backdrop, the global equity building block returned 8.1% for the quarter, which was below the benchmark return of 8.9%. The building block returned 8.2% for the year, compared to the 9.0% of the MSCI World Index.

**Global fixed income building block**
The global bond building block returned 8.3% for the quarter and 14.6% for the year. The positive return for the quarter and the year was mostly due to the weakening of the rand and the low interest rate environment.

**Global property building block**
The global property building block was introduced to the portfolio range during 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. This building block has been supported by the low global interest rate environment and has produced exceptional absolute returns since the inclusion in the portfolio range. The building block returned 13.7% for the quarter and 26.5% for the year to date.

**Conclusion**
While the market environment has been tough, our outcome-based investing approach is limiting the underperformance against the portfolios’ targeted investment outcomes during this difficult time, by diversifying across multiple asset classes and investment strategies. Portfolio enhancements and other initiatives are continually being considered, as we aim to provide clients with well-diversified, risk-managed and risk-controlled investment solutions that give them the best chance of achieving their targeted investment outcomes.