Momentum Passive Lifestage Portfolio Range

quarterly commentary to end September 2021

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.

Momentum’s 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 Momentum Investments’ 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 the 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 Momentum Investments to answer the question: Did the portfolio achieve its desired outcome over the most recent relevant time period? The returns are then further assessed 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 portfolios against their asset class (or strategic) benchmarks.

This quarterly review thus starts with a review of the investment returns generated by the portfolios against their targeted investment outcomes over the most recent periods. This is followed by an assessment of the economic environment and the returns generated by the asset classes (beta) in the most recent quarter against those Momentum Investments expects them to achieve on average. The returns from the building blocks used in the portfolios against their strategic investment benchmarks for this period are then reviewed.

**Momentum Passive Factor Portfolio Range returns**

The respective inflation objectives of the portfolios have been difficult to attain, given the low return from growth asset classes for the last five years. However, the factors outperformed their strategic benchmarks for most periods.

**Economic overview**

Regional economic fortunes are likely to remain highly divergent despite a strong rebound pencilled in for the globe. Less available fiscal and monetary policy space, as well as new and more severe virus strains in lower vaccinated countries, will likely keep the relative pace of economic recovery in emerging markets on the back foot. Despite a rapid narrowing of output gaps in many developed markets, we are not anticipating a persistent inflationary episode to follow given that demand is unlikely to remain above supply, above productivity-related wage increases are unlikely to persist and longer-term inflation expectations remain reasonably well anchored.

Unless a double-dip recession becomes a reality in the United States, a reset in bond yields to higher levels seems likely. Although further earnings upside should provide some underpin for global equities, the anticipated declining profit momentum and prospective tapering of asset purchases could lead to more choppiness in market returns going forward. In relative terms, global equities remain cheaply priced against global bonds.

While growth in the local economy staged a firmer-than-expected 7.5% rebound in the first half of the year, we expect growth to soften from here given ongoing supply constraints, a lagging vaccination rollout plan, elevated unemployment and an adverse effect of the riots on sentiment. Although the commodity price windfall has boosted revenues for this fiscal year, medium-term risks remain high in the context of shorter-term wage agreements and a push for pro-poor spending. We expect inflation to average close to the midpoint of the 3% to 6% inflation target range for the next three years in the absence of any currency, food or oil price shocks. As such, we view no immediate pressure on the South African Reserve Bank to raise interest rates and therefore see the risks to the first interest rate hike as being tilted towards the first quarter of 2022. We expect a gradual normalisation in interest rates to follow.

Strong earnings upgrades have been the norm for local equities this year. This has forced valuations down into very attractive territory, significantly enhancing the potential return upside. The main drawcard for investment in the local nominal bond market remains the high level of real yields available. Meanwhile, smaller monthly inflation accruals should provide less fundamental support for inflation-linked bonds until the second quarter of 2022. Despite weak property sector fundamentals, the expected limited further property value declines from here point to significant return upside in coming years, despite the many uncertainties in the sector.
Portfolio management

Our portfolios had another strong quarter, with all factors recording positive returns despite the market volatility experienced locally and globally. All asset classes posted positive returns and rand weakness contributed to global asset class returns. There were no significant asset allocation changes during the quarter. However, we increased local equity and bonds marginally, funded from global equity and local cash.

Asset class returns

The returns for the asset class benchmarks for the third quarter of 2021 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 (4.89%) 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>Q2 2021 returns</th>
<th>Nominal returns for the previous 12 months</th>
<th>Real returns for previous 12 months*</th>
<th>Expected real return (p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local equity (Capped SWIX)</td>
<td>3.19%</td>
<td>30.34%</td>
<td>25.45%</td>
<td>5.75%</td>
</tr>
<tr>
<td>Local bonds (ALBI)</td>
<td>0.37%</td>
<td>12.46%</td>
<td>7.57%</td>
<td>3.25%</td>
</tr>
<tr>
<td>Local property (SAPY)</td>
<td>5.94%</td>
<td>54.43%</td>
<td>49.54%</td>
<td>7.00%</td>
</tr>
<tr>
<td>Local ILBs (ILBI)</td>
<td>1.85%</td>
<td>14.99%</td>
<td>10.10%</td>
<td>2.75%</td>
</tr>
<tr>
<td>Local cash (SteFI)</td>
<td>0.95%</td>
<td>3.80%</td>
<td>-1.09%</td>
<td>1.25%</td>
</tr>
<tr>
<td>Global equity (MSCI ACWI)</td>
<td>5.08%</td>
<td>15.66%</td>
<td>10.77%</td>
<td>6.50%</td>
</tr>
<tr>
<td>Global bonds (WGBI)</td>
<td>4.36%</td>
<td>-11.36%</td>
<td>-16.25%</td>
<td>-0.25%</td>
</tr>
<tr>
<td>Offshore property</td>
<td>4.65%</td>
<td>18.05%</td>
<td>13.16%</td>
<td>4.00%</td>
</tr>
<tr>
<td>US dollar/rand**</td>
<td>1.75%</td>
<td>-13.32%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SA CPI*</td>
<td>1.75%</td>
<td></td>
<td>4.89%</td>
<td></td>
</tr>
</tbody>
</table>

*CPI is lagged by 1 month
**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.

Building block return assessment

Local equity building block

South African equities ended the month and quarter in negative territory, as positive local currents were largely offset by global shocks. The benchmark ALSI returned negative 0.8% for the quarter, with regulatory headwinds from China affecting the Naspers-Prosus stable. In contrast, capped indices fared much better as the Capped SWIX posted gains of 3.2% for the quarter. At a super-sector level, Financials (12%) delivered a robust return, while Resources and Industrials experienced a tough quarter, as both closed 4% weaker. The biggest contribution to the index return came from MTN, which delivered a return of 36.9%, while the biggest detraction came from Naspers, which was down 16.9%.

During the quarter, the building block return 3.3%, in line with the Capped SWIX Top 40 Index.

Local property building block

The South African listed property sector continued to post a recovery in the second quarter of the year, following oversold levels. The third quarter of 2021 started on a sombre note, with widespread looting and destruction to property in KZN and some parts
of Gauteng. While the lootings were limited to these two provinces, township and rural malls have been disproportionately affected. The cost of the destruction has been limited to between 1% to 3% of total portfolio value on average for SA REITS. Diversification has also helped minimise the effect of the lootings for SA REITS. Most SA REITS have been adequately insured for damage to property and loss of income. They have proactively started repairing properties using their own cash, while waiting for insurance proceeds. This was possible because the cost of damage to property has been palatable without putting balance sheets at risk.

The third quarter of 2021 was also a reporting period for the majority of South African listed property companies. Despite the benefit of a low base created by COVID-19 hard lockdowns in the second quarter of 2020, financial results continue to be weakened by lease escalations trending down, increasing office vacancies and pervasive negative rental reversions. The third wave of COVID-19 hampered recovery in retail but community shopping centres continued to buck the trend by reaching or surpassing pre-COVID-19 tenant sales levels.

The strong property market rally extended into the third quarter of 2021 with ALPI (6.5%) and SAPY (5.9%) outperforming equities (negative 0.8%), bonds (0.4%) and cash (1.0%), notwithstanding the operating environment.

The building block achieved a return of 5.8% for the period, which was in line with the benchmark return.

**Local bond building blocks**

After a very strong first half of 2021, the third quarter was a bit more of a mixed bag for local fixed income asset classes. Suddenly, the strong risk-on environment that markets have enjoyed looked a lot more uncertain and this was reflected in the risk premiums embedded in fixed income asset classes. Bond yields sold off, inflation-linked bond (ILB) yields were a mixed bag and listed property yields rallied strongly. The ALBI limped to a 0.37% return and ILBs delivered a respectable 2.00%, although this was largely driven by a big rally in the short end of the curve. Listed property continued its stellar, yet bumpy recovery, returning 5.94%. The risk-free cash benchmark (SteFI) returned 0.95%.

For the quarter, the building block delivered a return of 0.37%, in line with the ALBI benchmark.

**Inflation-linked bond building blocks**

ILB’s delivered another good quarter, buoyed by rising inflation risk and a further decline in real yields, although the move was very specific to the short end (R212 & R197) of the yield curve. The total return from ILBs 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 was the monthly accrual from the yield on the bonds and the inflation uplift. This component of the total return continues to be substantial given rising inflation and the elevated level of real yields, delivering 1.77%, with 1.00% from inflation uplift and around 0.77% from yield accrual. The second component of the return was determined by the move in real yields of the bonds and there were large declines in short-dated yields while the rest of the curve was largely stable. The curve declined an average 10bps over the quarter but steepened prodigiously in the process. This bull steepening of the curve generated capital gains to the tune of 0.23%. These components combined thus explain the index (IGOV) total return of 2.00%.

For the quarter, the building block delivered a return of 2% in line with the IGOV benchmark.
**Local cash building block**

The building block returned 1.3% for the quarter, outperforming the Stefi’s return of 1%. For the year, it produced 5.1% compared to the Stefi’s return of 3.8%.

**Global equity building block**

In the face of strengthening and broadening headwinds, the unbroken run of seven months of gains in equities came to an abrupt halt in September, with the MSCI World Index wiping out all the gains of the preceding two months. The possibility of a more sustained rise in inflation remains the key risk for markets in coming months. While the major central banks continue to see the rise as transitory, they have become more hawkish and expect the inflation surge to continue for longer than previously anticipated.

Investors have been given much to worry about in recent weeks. The peak rate of growth after the surge following the end of COVID-19 lockdowns is behind us; supply chain constraints are impeding growth and proving to be more persistent and damaging than previously expected; and rises in energy prices are leading to concerns that the rise in inflation will be stickier and more persistent than previously forecast, as well as directly affecting household disposable incomes and corporate profit margins. The US debt ceiling and fiscal spending package negotiations are going to the wire and unnerving investors, while, in China, the fallout from the regulatory clampdown this year and the shakeout in the property sector are damaging to growth in the world’s second-largest economy.

Against this backdrop, the building block returned 6.6% for the quarter, outperforming its MSCI AC World Index benchmark, which returned 6.2% for the same period. For the year, the building block returned 16.9%, marginally underperforming the benchmark return of 17.0%.

Against this backdrop, the global equity building block returned 4.4% and 15.3% in the quarter and year respectively.

**Global property building block**

Global property continued to recover from the fallout experienced in 2020, as the pace of the vaccine rollout and re-opening of more sectors exceeded initial forecasts. Furthermore, data points signaling a pickup in inflation supported the positive sentiment towards real estate markets during the course of 2021.

Against this backdrop, the global property building block returned 6.0%, which was above its respective benchmark return of 4.7%.

**Global fixed income building block**

At its September meeting, the Federal Open Market Committee (FOMC) provided advance notice that tapering may soon be introduced. Some commentators are of the opinion that the FOMC will likely announce the start of tapering at its November 2021 meeting, with proviso that tapering will be dependent on the economic recovery. Global bond indices were negative for the quarter in US dollar terms. However, rand weakness during the period aided returns of the building block. The building block returned 4.4% for the quarter, which was marginally above the benchmark return.
Conclusion

We continue to manage the portfolios actively, taking economic and valuations into account. We are confident that our portfolios are well positioned and are suitably diversified across asset classes and strategies. We remain overweight local and global equity, despite the recent volatility.