Assessing investment returns in an outcome-based investment context

The Momentum Target Factor Portfolio Range is managed in terms of our outcome-based investing philosophy, where we design the portfolios to maximise the probability of achieving the inflation-plus return target of each portfolio over the relevant period, while continuing to meet the portfolios’ risk targets. To achieve this, our 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.

Given this outcome-based investing framework, when assessing the returns of the Momentum Target 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 Target Factor Portfolio Range Portfolio returns

The portfolios within the Momentum Target Factor Portfolio Range outperformed their strategic benchmarks for the quarter. The respective inflation objectives of the portfolios have, however, been difficult to attain, given the low return from growth asset classes for the last five years. However, the portfolios managed to outperform their respective benchmarks for all 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>4.89%</td>
<td></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**

As explained above, our outcome-based investing philosophy starts at the asset class level and then goes down to an investment strategy (if appropriate) and investment mandate choice level within each asset class. We thus construct building blocks that reflect our 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 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 ended 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%.

The target equity building block returned 2.9%, which was marginally below the benchmark return. The value and quality smart-beta components outperformed, while the trending strategy underperformed. The allocation to the value smart beta strategy was increased further during the quarter, which was funded from marginal reductions across the other strategies (passive, trending and quality).

The value smart beta component returned 4.7%, which was well ahead of the benchmark return. The strategy is assertively positioned to have a material tilt towards shares that exhibit strong value qualities, including price-to-book and price-to-sales ratios as well as earnings and dividend yields. At quarter end, the component’s equity exposure was 99.1% and was materially overweight the Financial sector and underweight the Industrial sector. Within the resource sector, the component was mainly overweight general mining companies and underweight gold shares. Within the Industrial sector, it was overweight media,
healthcare and retail companies as well as overweight telecommunication companies. Within the Financial sector, it was overweight insurance companies.

The quality smart beta component returned 3.5%, which was ahead of the benchmark return. The strategy is assertively positioned to have a material tilt towards shares in companies that exhibit strong quality attributes such as companies that are profitable and stable and that also have high quality reported earnings. At quarter end, the component’s equity exposure was 99.2%. It was underweight the Resource and Financial sectors and overweight the Industrial sector. Within the Resource sector, it was mainly underweight gold mining companies. Within the Industrial sector, it was overweight retail, food and beverages and telecommunication companies, while it was underweight personal and household goods, healthcare and industrial goods and services companies. Within the Financial sector, it was underweight bank shares.

The trending smart beta component returned 0.6%. Being overweight Resources was the main detractor from returns, and being underweight financial and property also detracted from returns. Within the Resource sector, the component was overweight general mining shares and underweight gold shares, while, within the Industrial sector, it was overweight retail companies and underweight insurance shares within the Financial sector.

Local property building block
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 5.96% for the period, in line with the benchmark return.

Local real return portfolio
The real return portfolio, which is a conservative strategy and more focused on capital protection, returned 2.5% for the quarter and 15.9% for the year. These returns outperformed the inflation objective by a healthy margin.

Absa Asset Management returned 2.8% for the quarter. The investment manager remains very conservatively positioned but is finding opportunities for growth in the local market, which appears attractive relative to developed markets that seem priced-for-perfection. The view for the remainder of 2021 is to be overweight property and bonds, neutral cash and equities.
Prescient delivered a return of 1.9% for the quarter. Preference shares were the strongest contributors to returns for the quarter, while equities detracted. The component has a sizeable exposure to growth and high yielding investments given low cash rates.

**The local bond building block**

After a very strong half year 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 looks a lot more uncertain and this was reflected in the risk premiums embedded in fixed income asset classes. Bond yields sold off, ILB yields were a mixed bag and listed property yields rallied strongly. The ALBI returned a mere 0.37%, ILBs delivered a respectable 2.00%, although this was largely driven by a big rally in the short end of the curve, and 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 yielded 0.19%, thus underperforming the ALBI benchmark at 0.37%. It returned 13.90% and thus outperformed the benchmark at 12.46% for the year.

The spread between a long nominal bond (20-year) and three-month JIBAR (a popular reference rate for most floating-rate credit instruments) was close to a decade high. The nominal yield curve in 2016 was comparatively flat and provided very little term premium, but it did provide reasonably high yields (7.5% to 8.5%) throughout the curve.

This means that five years ago, one need not have assumed much duration risk to secure reasonably high cashflow yields that comfortably outperform inflation from the nominal bond market. The same cannot be said today.

The initial part of the nominal yield curve (5.0%) was only marginally positive in real terms, and the long end was extremely elevated. To secure healthy real yields (and to outperform an ALBI benchmark), one needs to exploit the long end of the term structure and espouse duration risk.

Credit was stable, as it took a breather from the tumultuous period during the pandemic. Spreads were largely range-bound, with high quality issuers continuing to benefit from the uncertainty.

At the end of the quarter, the portfolio was substantially overweight the 12-plus-years sector (57.6% against the ALBI’s 48.3%). The portfolio was slightly underweight the other sectors. The ILB exposure was at 2.3% and this contributed to the overall return. The modified duration of the portfolio was 6.9 years against the ALBI of 6.4 years.

**Local cash building block**

In the third quarter of 2021, there was again no change in the repo rate, as it remained at an all-time low of 3.5%. There were MPC meetings in July and September and both delivered unanimous (5-0) decisions to leave monetary policy at what is considered an accommodative level. The traded money market was largely sanguine as well, as the expected path for the repo rate has been well communicated and there have been no material surprises. The three-month JIBAR rate was anchored at 3.68% for the entire quarter, as there remains no immediate threat of interest rates rising. However, the 12-month rate continued to edge up an additional 13 basis points to close at 4.92%, reflective of the normalisation of monetary policy to a more neutral level that is likely to occur during 2022. Based on these JIBAR rate levels the total return for the SteFI composite index was 0.95% for the quarter.

For the quarter, the building block delivered a return of 1.27% compared to 0.95% for the SteFI benchmark.
For the year, the building block delivered a return of 4.8% against the SteFl benchmark of 3.8%. It 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 fair degree of liquidity, while also providing above-benchmark yields.

**Local inflation-linked bond building block**

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 yielded 1.53% against the benchmark IGOV (2.00%).

For the year, the building block yielded a return of 14.83%, compared to the benchmark of 15.0%. It had a modified duration of 9.0 years, which was slightly shorter than the IGOV at 9.3 years. The investment manager was overweight the 7-12-year and 12-plus sectors and underweight all the other sectors.

**Commodities building block**

Commodity supercycles are rare but long lasting. Since the mid-19th century there have been just four supercycles – each underscored by major historical events. The most recent supercycle, which started in 2000, was driven by urbanisation, investment and an ascendant middle class in emerging markets – most notably China – but was interrupted by the 2008 Global Financial Crisis.

Proponents of the resumption of the supercycle argue that commodity prices will be driven by stimulus spending (which places greater emphasis on job creation and environmental sustainability than on inflation control), rising inflation and a weaker dollar. This macroeconomic backdrop should prove to be more supportive of real assets like commodities than financial assets.

Endorsing this are the captains of the commodity suppliers. Across the energy and metals sectors they state that current supply and demand dynamics easily justify current prices, but question where the supply will come from to satisfy future demand growth.

The building block’s commodity exposure was increased from 43% to 57% during the quarter. Agriculture and metals were increased. Diesel, which began the quarter at benchmark, was closed out during the downturn in mid-August. This is topical because the building block’s investment universe does not include the many large movers in the energy sector, and so was unable to fully participate in the sector’s activity. Consequently, returns did not keep pace with the index.

The building block returned negative 1.75% for the quarter, outperforming the SteFl’s 0.95% and returned 1.17% for the last year, underperforming the SteFl’s 3.79%.
**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 shake out in the property sector are damaging to growth in the world’s second-largest economy.

Against this backdrop, the building block returned 4.9% for the quarter, outperforming its MSCI AC World Index benchmark, which returned 4.7% for the same period. For the year, the building block returned 15.6%, marginally underperforming the benchmark return of 16.1%.

**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.