Momentum Target Factor Portfolio Range
quarterly commentary to end June 2019

Assessing investment returns in an outcome-based investment context

The Momentum Target 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 targeted inflation-plus return targets of each portfolio over the relevant time periods, while continuing to meet these portfolios’ individual 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 Target Factor Portfolio Range differs from the other Momentum Factor portfolio ranges, as it is designed to give clients access to Momentum Investments’ outcome-based investing philosophy on a more cost-effective basis. This is achieved by managed exposure to various asset classes, using predominantly passive solutions, such as indexation (through full index replication). In addition, enhanced-index (or smart beta) strategies are used in the local equity asset class, where the portfolios are given access to desired investment strategies’ risk premia at a minimal additional cost. This enhances the probability of achieving the desired investment outcomes across the portfolio range. Where it is vitally necessary and sensible (after the deduction of fees), specialist active strategies are added to increase the probability of achieving above-benchmark returns. For example, active investment mandates are used in the money market space in this portfolio range, as there is not a passive alternative, and these investment mandates consistently outperform their benchmarks on an after-fee basis. In addition, these specialist building blocks are complemented by investments in absolute-return strategies in the Target Factor 3 and 4 portfolios, where capital preservation is of particular importance, given the shorter-term nature of their investment objectives. Again, this is designed to enhance the probability of achieving the desired investment outcomes for these portfolios.

When assessing the returns of the Momentum Target Factor 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 (beta) 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 is explained by:
  - The returns from the investment strategies (or styles) used in the building blocks (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 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 and the underlying investment managers used in the portfolios against their strategic investment benchmarks for this period are then reviewed.

**Momentum Target Factor Portfolio Range Portfolio returns**

The portfolios within the Momentum Target Factor Portfolio Range outperformed their strategic benchmarks for the quarter and year to March 2019. 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 most periods.

**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 (SteFl)</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 growth asset classes have experienced in the last year. The best-performing asset class for the period was global equities, while local property was the worst-performing asset class.

**Building block return assessment**

As explained above, Momentum Investments’ 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. The company thus has constructed 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 equity building block**

During the second quarter of 2019, the FTSE/JSE All Share Index (Alsi) posted a total return of 3.9% compared to the 8% for the first three months of 2019. The TSE/JSE Financials was the best performer, returning 5.4%, followed by the FTSE/JSE Industrials with a total return of 4%. The FTSE/JSE Resources only managed a gain of 2.4% in the second quarter after the large 17.8% total return in the previous quarter. The Assa All Bond Index (Albi) returned 3.7%, after posting a similar return of 3.8% in the first quarter. The SA Property Index (Sapy) managed to outperform bonds, posting a total return of 4.5%. Among the other important indices the FTSE/JSE Shareholder Weighted Index (Swix) (2.86%) performed in line with the FTSE/JSE Capped Shareholder Weighted All Share Index (Capped Swix) (2.90%).

The local equity building block outperformed its benchmark by 0.48% for the quarter, producing a return of 3.38%, The building block returned 8.84% for the year to date, which was 1.98% above the benchmark return.

Two of the three active components, Salient Quants Value Smart Beta and Satrix Momentum, produced significant outperformance for the quarter, outperforming the benchmark by 3.48% and 3.26% respectively.
The building block is in the process of being transitioned and we will provide further details on the completion thereof.

Local property building block

The South African 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 NPI Rockcastle (NRP) share prices in the quarter were the key driver 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.

A number of property portfolios announced possible merging and acquisition 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 SA Corporate Real Estate (Sac) board also received several non-binding expressions of interest for the company while Safari Investments (Sar) made a firm offer to acquire Fairvest Property Fund (FVT).

The building block returned 4.34% compared to the benchmark return of 4.52%. The one-year return of the property building block was 0.48%, compared to the benchmark return of 0.78%.

Local bond building block

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 limit 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 SA 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, the company anticipates the cutting cycle to be shallow, given the structural nature of South Africa’s low-growth quandary.

For the quarter ending 30 June 2019, the building block yielded 3.63%, thus underperforming the Albi benchmark (3.70%). The building block did not manage to outperform the benchmark for the year either (11.33% compared to the benchmark return of 11.50%).

For the year, the building block benefited from its exposure to cash and shorter-dated instruments (4.8%). It was overweight cash, the 3-to-7-years and the 7-to-12-years sectors, and underweight the 1-to3-years and the 7-to-12-years sectors. The building block had a small exposure to inflation-linked bonds (2.9%) and this detracted
from the overall returns. The building block had duration less than the ALBI (6.6 compared to 7.1). This conservative positioning detracted from returns for this period.

**Local cash building block**

With the pace of reform likely to be gradual in the near term only, the outlook for growth in SA 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, the company anticipates the cutting cycle to be shallow, given the structural nature of South Africa’s low-growth quandary.

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 inflation-linked bond building block**

With the pace of reform likely to be gradual in the near term only, the outlook for growth in SA 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, the company anticipates the cutting cycle to be shallow, given the structural nature of South Africa’s low-growth quandary.

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 (Igov) 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.

**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.

**Local real return portfolio**
The real return building block delivered 9.6% for the year, outperforming the 7.5% return of the inflation plus 3% target for the period. When compared to its internal strategic asset allocation benchmark, the building block also outperformed for the most recent one-year period (9.6% compared to 5.8%). For three years, the building block returned 7.9% a year, outperforming the strategic benchmark (5.6% a year) and the inflation plus 3% target (7.8% a year).

The underlying investment managers were well positioned to deliver on their objectives, as Prescient and Absa were overweight defensive asset classes and underweight growth asset classes.

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. The portfolio was defensively positioned at the end of the quarter, with 73% in local fixed interest and cash, 20.4% in local equities and 7.6% in listed property.

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 total building block was overweight bonds, underweight inflation-linked bonds, cash and equity, and neutral on listed property.
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%.

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.

Conclusion
Momentum Investments still strongly believes in the appropriateness of the investment strategies of the portfolios within the Momentum Target Factor Portfolio Range. While the current market environment has been tough, the company’s outcome-based investing approach is limiting the underperformance against their targeted investment outcomes during this difficult time. The portfolios continue to deliver enhanced passive returns with lower-than-benchmark risk by diversifying across multiple asset classes and investment strategies. The philosophy of using indexation and enhanced-index strategies within the building blocks and the portfolio range contributed to the success of the portfolios.