Momentum Target Factor Portfolio Range
quarterly commentary to end September 2019

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 Factor 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 and year to September 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

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 5%.

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 Momentum expects to get (on average) for these asset classes for a full market cycle.
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, 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**

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.

Changes were made to the building block during the third quarter. Some of the changes included the introduction of the quality smart beta strategy and the review of the allocations to the respective smart beta strategies and index components. We also implemented some investment manager changes with Momentum Asset Management replacing Salient Quants, RAFI and Satrix.

The building block now consists of a 30% allocation to Capped Swix Index mandate and Momentum Trending Equity, 28% to Momentum Quality and 12% to the Momentum Value. We are confident that the changes implemented will enhance the return profile of the building block in the long term.

During the quarter, the building block achieved a return of negative 5% compared to the benchmark return of negative 5.1%.

```
<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 trending equity component is assertively positioned to have a material tilt towards shares that exhibit strong trending qualities. At the end of the quarter, its equity exposure was 99.5%. It was materially overweight in the resources sector and underweight the industrial sector. It was also slightly underweight financial shares. Within the resources sector, it was overweight general mining and precious metals shares. Within the industrial sector, it was underweight media and personal as well as household goods companies. Within the financial sector, it was underweight diversified financial services and overweight banking shares.

The value equity component is 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 the end of the quarter, its equity exposure was 99.5%. It was materially overweight the financial sector, underweight the industrial sector and marginally overweight the resources sector. Within the financial sector, it was materially overweight insurance companies. Within the resources sector, it was overweight general mining companies. Within the industrial sector, it was underweight the media and retail sub-sectors.

The quality component is positioned to have a material tilt towards shares that exhibit strong quality qualities, including profitability and also stability and credibility of profits. At the end of the quarter, its equity exposure was 99.5%. It was overweight the industrial sector and underweight financial and resource share. Within the industrial sector, it was materially overweight retail shares and food and beverage shares, but underweight media shares. No strong sub-sector positions were taken within the resource sector. Within the financial sector, it was overweight insurance companies and underweight property shares.

**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. This weakness was evident in the returns from property portfolios that reported results during the third quarter. For most, 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.

**The local bond building block**
For the quarter, the building block yielded 0.9%, thus marginally outperforming the Albi benchmark (0.7%). The building block matched the return from the benchmark for the year (11.4%).

For the year, the building block benefited from its overweight exposure to the 7-to-12-years sectors and the 12+ years sectors. It had a small exposure to inflation-linked bonds (1.8%) and this detracted from the overall returns. It had a modified duration marginally less than the Albi (7.0 compared to 7.1).
Local cash building block
For the quarter, the building block delivered a return of 2.2% compared to 1.8% for the benchmark. The quarter’s return was primarily driven by the compression of credit spreads, a trend that has persisted in the last few quarters. The portfolio, therefore, benefitted from the income derived from the underlying instruments and capital gains derived from lower spreads. Credit spreads across the board continued to compress despite that issuance in the primary market increased significantly during the quarter. Credit spreads on average are now at levels last seen five years ago, despite the current economic backdrop being substantially worse. Investment managers have started to adopt a more conservative approach with regards to credit, i.e. focusing on quality companies and investing in shorter-dated instruments.

For the year ending 30 September 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
Inflation-linked bonds continued to struggle after a temporary reprieve last quarter. The inflation environment remains benign and real yields moved an average 19 basis points higher across the curve. The move higher in yields was in line with that of nominal bonds, as risk sentiment deteriorated on a more widespread global growth slowdown, which increasingly includes China, Europe and more recently, the U.S. The move higher keeps the long-dated maturities well above 3.5% and the medium maturities above 3%.

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 2.1% this quarter, with 1.3% from inflation uplift and around 0.8% from yield accrual. The second component of the return was determined by the move in real yields of the bonds. Real yields moved higher during the quarter, thereby generating capital losses to the tune of almost 2.0%. These components combined thus explain the index (igov) total return of 0.1%.

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 a mere 0.2% against the benchmark IGOV (0.1%). For the year, it yielded a return of 4.4%, compared to the benchmark of 3.7%. The building block had a modified duration of 10.0 years, compared with the Igov of 9.8 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 an impressive 6.5% for the quarter and contributed to the absolute returns of the portfolios that invest in this building block. This return was comfortably ahead of Stefi and was driven by the weak rand and increase in commodity prices.
Local real return portfolio
The real return building block delivered 8.4% for the past year, outperforming the 7.5% return of the inflation plus 3% target for the period. When compared to its internal strategic asset class benchmark, the building block also outperformed for the most recent one-year period (8.4% compared to 4.5%). For three years, the building block returned 7.5% per year, outperforming the strategic benchmark (4.8% per year) and just behind the inflation plus 3% target (7.8% per year).

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

Prescient returned negative 2.5% for the quarter (compared to the strategic benchmark return of negative 0.9%) and 8.4% for the year. Contributors to returns for the quarter were local bonds and preference shares, with marginal contribution from equity and property. The cost of protection used in the portfolio detracted from returns. The portfolio had a net effective equity exposure of 39%, 7% in property and 54% in fixed interest and cash.

Absa returned 1.5% for the quarter, outperforming the strategic benchmark by 2.4% and 8.9% for the year. The portfolio was defensively positioned at the end of the quarter, with 86% in local fixed interest and cash, 11% in local equities and 3% in listed property.

On a look-through basis, the total portfolio was overweight bonds, underweight ILBs and cash, while neutral to listed property and equity.

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 7.9% for the quarter, in line with the benchmark return of 7.8%. The building block returned 8.4% for the year compared to the 8.3% of the MSCI All Country Index.

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.

**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.

**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 outcome.