A time for diversification amid market uncertainty

Over the last few years, asset managers in South Africa have generally had very similar views on the various asset classes:

- Concerns that the South African equity market was expensive,
- Widespread consensus that local and offshore listed property shares were overvalued,
- Bonds should be avoided in a world with record low interest rates facing a rising interest rate cycle,
- Global equities have been the default choice, not necessarily because they offered high expected future returns rather they were "less worse" than the other options

It was very difficult to find material differences in the asset allocation calls of the major funds. However, roll forward to today things have changed. The views of those asset allocation managers are now very diverse.

There is so much uncertainty surrounding global and local markets, whether you are discussing the currency, the oil price, interest rates, commodity prices, or global growth rates. It is very rare at the moment to find a consensus view or to have a high level of conviction in the future direction of the global economy and markets. All this uncertainty has led to material volatility in asset prices and periods of market weakness. Which in turn means we now see significant discrepancies in views with asset managers finding value in differing assets.

This can be best illustrated by taking a look at the current asset allocation in the balanced funds of four of South Africa's largest asset managers, as shown in the table below.

Asset Allocation - 29 February 2016	**Allan Gray** Balanced	**Coronation** Balanced Plus	**Foord** Balanced	**Prudential** Balanced Plus
SA Equity	47%	43%	39%	39%
SA Hedged Equity	1%	-	-	-
SA Bonds	11%	11%	8%	18%
SA Property	1%	13%	2%	2%
SA Commodity linked	5%	1%	5%	-
SA Cash	8%	3%	18%	13%
Foreign Equity	13%	28%	22%	22%
Foreign Hedged Equity	9%	-	-	-
Foreign Bonds	2%	0%	-	4%
Foreign Property	1%	1%	1%	-
Foreign Cash	2%	1%	5%	2%
Currency futures	-	-2%	-	-
Total Offshore	**27%**	**28%**	**28%**	**27%**
Total Growth Assets	**67%**	**86%**	**69%**	**63%**

Coronation have increased their exposure to riskier growth assets over the last 9 months (up to 86% of the fund). Their allocation to local and offshore equities, and in particular local property is by far the most aggressive in the group. Markets have come off their highs over the past few months, amid global economic growth uncertainty, and Coronation has viewed this as an opportunity to buy equities at the lower market levels. Coronation have gained comfort that the yields on property compensate sufficiently for the risks, while the other managers are still concerned that listed property is expensive and that the risks facing the property sector have not been priced in appropriately.

Allan Gray are the most bullish about local equities and have been increasing their exposure over the last 3 -4 months. This is driven by their view that pockets of the local equity market are starting to offer value combined with the material depreciation in the rand over 2015 adding to the appeal of local investments compared to foreign.

Prudential are the only manager with a material holding in fixed rate bonds both locally and offshore. The other managers have not followed suit, being put off by the combination of most economies globally entering an interest rate hiking cycle and South Africa facing a ratings downgrade this year, Prudential however feel that most of the negative sentiment about the potential downgrade has already been priced into the yields, and are comfortable that the level of yield offered compensates for the risks relative to other investment options.

With the other managers starting to see opportunities in the different asset classes, Foord remains concerned about market levels across the asset classes and has therefore maintained a large allocation to cash. This is intended to serve two purposes: the first is to protect the fund from a potential market fall but also to ensure that they have enough cash on hand to be able to react quickly when buying opportunities arise.

It is clear from even a high level look at the positioning of the four funds that they view the current market conditions very differently. The diversity in the way the portfolios are currently constructed should result in significantly different levels of investment return over the next year or two. For the first time in many years, fund selection is going to be crucial. How does one avoid picking the underperforming manager? This is an exceptionally difficult task, which is why we recommend diversifying your investments through blending a number of highly rated funds which can work together in your portfolio. If one of the funds does have a poor outcome, it affects only a portion of your portfolio increasing the probability of reaching your investment objective.

Asset Class Review: Q1 2016

Broad asset class returns over the quarter showed a welcome recovery for investors across the board, however in context there is no broad level asset class in SA which has managed to outperform inflation over the past 12 months. The only counter to this lack of options has been a depreciating Rand which has served to boost local returns and mask weak global markets. Local and global investing remains a case of buyer beware: risk aversion, growth concerns and inflation pressures maintains the status quo of short to medium term prospects being below long term averages. It is a 'least worst' investment market at present.

Locally, markets were caught up in the early sell-off around the globe where we experienced the worst start to a year in decades – partially as a result of actions taken in China (allowing the Yuan to devalue and the closure of the stock exchange for two days spooked markets). In addition, concerns around the longer term impact of quantitative easing on global banks led to financials being at the bottom of the performance tables.

The VIX (see chart below) otherwise known as the Volatility or 'Fear' index has shown a general upward trend in risk expectations from investors over the past few months. The reality is that there are very few asset classes globally which are not affected by the cul-de-sac in which we find ourselves: low growth, low interest rates, deflation – which all have a material impact on SA investors through mechanisms like the currency and interest rates.



We have seen local annual inflation push up from 4.0 - 4.5% in 2015 to 7.0% now. This has raised investment hurdles in a market which looks increasingly less likely to deliver on them. The JSE is currently trading on a PE multiple of 21x earnings, its highest level in over 20 years, within a market where company earnings are trending weaker. Industrial shares – the star performers over the past few years, have been growing earnings at a lower rate than inflation for the past 3 years (5.4% compared with peaks of 25-30%). This trend also shows no sign of recovering at present, resulting in current equity valuations which are at cyclical highs (high valuation on declining earnings).

The other key driver for investment returns is the currency. The rand has shown some recovery post Nenegate, around 5% relative to the US$ over the quarter. There is still substantial risk around our currency as we navigate the combination of inflationary pressures, increasing rates and political risk.

Local interest rate sensitive assets like bonds and property recovered somewhat in Q1 post Nenegate, however over the prior 12 months are still at the bottom end of asset class returns. These asset classes need positive news with respect to our sovereign credit rating, inflation expectations, currency recovery and political stability. This is a lot to ask and we remain circumspect around these asset class returns at present.

Globally, the chasm between developed and emerging market valuations remains with MSCI Developed markets trading on 16x forward earnings, and Emerging markets on 11.9x. To some extent this reflects the risk appetite of global investors, particularly those based in US$ where the local market returns have been made to look worse by a strong US$. It does seem like a lot of this dollar strength, EM weakness has played out and markets are finding more of a balance, so going forward we don't expect the dollar to play as significant a detractor from emerging market returns. The US has also come to realize that a continuing strong dollar is negative for a country trying to normalize growth and inflation, and the Fed will be very cognizant of this balance when considering interest rate hikes for the remainder of the year.

All in all, local and global risks remain high and our general view remains the same for client portfolios: diversification is the first port of call and the only 'free lunch', and it pays to be defensively positioned for now to preserve client capital in a market which is unlikely to reward aggressive positions.

31 March 2016

Sector		1m	3m	6m	YTD	1yr	3yr pa	5yr pa	10yr pa	10yr Vol
LOCAL MARKET INDICES (In Rands)										
FTSE/JSE All Share Index (ALSI)	ZAR	6.4%	3.9%	5.6%	3.9%	3.2%	12.8%	13.6%	13.1%	15.2%
FTSE/JSE SA Listed Property	ZAR	9.5%	10.1%	5.0%	10.1%	4.6%	14.4%	19.8%	16.4%	16.9%
SA All Bond Index (ALBI)	ZAR	2.6%	6.6%	-0.3%	6.6%	-0.6%	4.0%	7.8%	7.5%	7.5%
SA Cash Index (SteFI)	ZAR	0.6%	1.7%	3.3%	1.7%	6.6%	6.0%	5.8%	7.3%	0.6%
Balanced Benchmark [2]	ZAR	3.9%	3.1%	6.0%	3.1%	6.7%	13.2%	14.4%	12.8%	7.1%
SA Inflation (1 month lag)	ZAR	1.4%	2.4%	2.8%	2.1%	7.0%	5.6%	5.7%	6.2%	1.4%
GLOBAL MARKET INDICES (in USD)										
Global Equity (MSCI World)	USD	6.5%	-0.9%	4.2%	-0.9%	-5.3%	4.7%	4.3%	2.1%	16.6%
Emerging Markets Equity (MSCI EM)	USD	13.2%	5.7%	6.4%	5.7%	-12.0%	-4.5%	-4.1%	3.0%	23.8%
Global Bonds (Barclays Global Bond Index)	USD	2.7%	5.9%	4.9%	5.9%	4.6%	0.9%	1.8%	4.3%	5.7%
Global Cash	USD	0.0%	0.1%	0.2%	0.1%	0.2%	0.2%	0.2%	1.5%	0.6%
MAJOR INDICES BASED TO RANDS										
FTSE/JSE All Share Index (ALSI)	ZAR	6.4%	3.9%	5.6%	3.9%	3.2%	12.8%	13.6%	13.1%	15.2%
Global Equity (MSCI World)	ZAR	-0.7%	-5.9%	10.8%	-5.9%	14.9%	22.6%	21.9%	11.4%	13.5%
Emerging Markets Equity (MSCI EM)	ZAR	5.5%	0.3%	13.2%	0.3%	6.8%	11.8%	12.0%	12.4%	15.6%
COMMODITIES										
Gold (US Dollars)	USD	-0.7%	16.7%	10.1%	16.7%	4.1%	-8.4%	-2.8%	7.8%	19.4%
Gold (Rands)	ZAR	-7.5%	10.8%	17.1%	10.8%	26.3%	7.2%	13.5%	17.6%	22.0%
Currencies (positive return = Rand weakening)										
Rand / Dollar	ZAR	-6.8%	-5.1%	6.4%	-5.1%	21.4%	17.0%	16.8%	9.1%	16.4%
Rand / GBP Pound	ZAR	-3.9%	-7.4%	0.9%	-7.4%	17.5%	14.9%	14.3%	7.1%	14.5%
Rand / Euro	ZAR	-2.3%	-0.4%	8.6%	-0.4%	28.8%	12.5%	11.8%	8.4%	13.9%

Spot Rates

31-Mar-16		6-Apr-16	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Rand/US$	Rand	15.07	14.65	12.13	6.75	6.13	3.98
Rand/GBP	Rand	21.29	21.09	17.97	10.84	10.64	6.08
Rand/EUR	Rand	17.18	16.70	13.14	9.58	7.46	4.73
Rand/Aus $	Rand	11.46	11.26	9.29	6.99	4.41	3.11
Libor 6m $	US$	0.90	0.90	0.40	0.46	5.14	N/a
Prime	Rand	10.50	10.50	9.25	9.00	10.50	18.50
Repo Rate	Rand	7.00	7.00	5.75	5.50	7.00	N/a
All Bond Index Yield	Rand	9.12	9.01	8.15	8.89	9.44	13.86
Gold ($/oz)	US$	1,229.60	1,232.65	1,183.24	1,432.36	583.65	395.35
Palladium	US$	542.00	569.00	729.00	766.00	332.00	139.00
Platinum	US$	946.50	977.50	1,142.50	1,766.50	1,060.00	408.25
Oil (Brent Crude) $	US$	39.76	40.05	55.84	117.38	66.17	19.14
SA Inflation	Rand	N/a	7.00	4.00	4.10	3.40	6.30

data provided by Profile Data Analytics and INET BFA