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DISAPPOINTING RETURNS IN PERSPECTIVE

The half-year mark allows an opportunity to take stock of some difficult realities faced by local investors. The local economy remains weak and is technically in a recession while there is widespread political uncertainty and continued anxiety over the implications of credit ratings downgrades.

Compounding this situation, market returns over the previous three or so years have been disappointing, barely keeping up with inflation. These are summarised in the table below (the latest available official inflation number was 5.4% in May). Considering the major asset classes, there are a number of important observations to be made.

- Firstly, despite downgrades by all three major ratings agencies, local bonds held up well. In other words, there was no interest rate jump as a result of the downgrades. The All Bond Index returned 4% for the first six months of the year, and 8% over the past twelve months, just ahead of cash (3.7% and 7.6% over the same respective periods). The 10-year government bond yield rose during June to end the month at 8.7% (bond prices and yields move in opposite directions). However, this is still below the 8.9% level at the start of the year. Therefore, investors have benefited from a high yield (much higher than available in developed markets and most major emerging markets) and capital appreciation. That bonds have rallied despite downgrades is due largely to the fact that the downgrades were priced in already. Global demand for high-yielding emerging market debt remains high and inflation is expected to decline (which matters the most for local bondholders), helped along by a 12% year-on-year appreciation of the rand against the US dollar.

- Secondly, global equities have done well over the past year. The US S&P 500 is close to its all-time record high, and returned 18% over 12 months. US equities have responded to an improved global economic growth outlook, while a softer dollar allows multinationals to benefit. The prospect of corporate tax cuts is also still alive, though it is not thought of as a sure-thing anymore. Other developed markets have had a similarly strong gain over the past year. Emerging market equities, which suffered negative calendar years in 2013, 2014 and 2015, returned 24% over the twelve months to end June in US dollars. Despite outperforming developed markets over this period, emerging markets are still attractively priced relative to developed markets.

- Thirdly, the local equity market has gone nowhere. The FTSE/JSE All Share Index (the ALSI) returned only 1.7% over the one-year period to end June. Moreover, the ALSI level is still below where it was in June 2014, meaning that over this three-year period, dividends have been the only source of return at an asset class level. The big detractor has been the collapse of commodity prices. As a result, the Resources Index has declined 40% over the past three years (and this is after a rally in the first half of 2016). Financials, in turn, fell sharply in late 2015 with the axing of Finance Minister Nene, and have been under pressure since then with a weak economy and ratings downgrades. Industrials, where the large rand-hedge shares are located, has been the best performing major sector over this three-year period. Which brings us to the final key observation:

- The impact of the currency has become more pronounced on the local market. In the past, the main rand hedges were mining companies and Sasol. Today, the JSE is dominated by dual-listed global giants such as British American Tobacco, Compagnie Financiere Richemont and Naspers (through its stake in Chinese internet titan, Tencent). These companies have very little exposure to the local economy, and are listed on the JSE for historical reasons. As the rand declined from 2011 to 2015, these shares benefited. When the rand turned in early 2016, it became a headwind. More recently, even some traditional 'S.A. Inc.' companies such as hospital groups, retailers and property companies have increased their offshore exposure. South African companies invested R300bn abroad over the past five years according to SARB data. This means the local economy has a much bigger built-in hedge against a weak currency. But it also means the exchange rate will have an even larger role in portfolio returns in the future, over and above the direct offshore portion. Given the unpredictability of the rand, this strengthens the argument for diversification.

TABLE 1: ONE-YEAR RETURNS OF MAIN ASSET CLASSES IN RAND AND US DOLLAR, AS AT END JUNE 2017

	RETURNS IN RAND	RETURN IN US DOLLAR
SA equities	1.7%	14%
SA bonds	7.9%	20%
SA money market	7.6%	20%
SA listed property	2.9%	15%
Global equities (developed markets)	6.5%	19%
Emerging market equities	12%	24%
Global property	-11%	1%
Global bonds	-16%	-4%

Source: Datastream

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RESPONDING TO DISAPPOINTING RETURNS

The net result of the above has been disappointing returns for investors. Local equities have given below-inflation returns over the past year, while global equities have not contributed much in rand terms. We select asset managers for each asset class (i.e. for bonds, equities, property, etc.) who have track records of consistent outperformance. We expect these managers to continue adding value to the funds' overall long-term performance and we are not envisaging any changes in the near term. However, while skilled asset managers will be able to beat the market by a percent or two, ultimately we are all takers of market returns, not makers. Through tactical asset allocation – shifting the funds' exposure to the various asset classes – we can also add some value. Being overweight global equities and local fixed interest (bonds and money market) and being underweight local equities have been correct asset allocation calls on our part. Within global equities, we have also been overweight emerging market equities, which has added value.

Also remember that the global portion of our funds (limited to 25% by Regulation 28) have performed very well in US dollars. This means that when the rand weakens again – which is bound to happen at some point – our investors will benefit from a larger base of hard currency assets.

The obvious question is: what now? Do I stick it out in my current portfolio, or is it time to switch? Many investors are considering moving into the stability of a bank deposit or want to take all their money offshore. Obviously everyone needs to assess their own risk tolerance with their financial adviser, but the general principle is to only change investment strategy when personal circumstances change, not market conditions. However, remember that appropriately diversified portfolios offer a more robust solution to a broad range of uncertain outcomes than a concentrated portfolio that only delivers in a handful of outcomes. When it comes to markets, there are a lot of moving parts – politics, economic growth, exchange rates, fund manager performance – and obsessing about one area and ignoring others can be to investors' detriment. It is our job to think about all these things and build appropriately positioned strategies.