

LOW RETURN IN CONTEXT

22 JUNE 2018



OLDMUTUAL
WEALTH

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The year started off on an extremely positive note with an upward surge in global equity markets and positive political change locally. Yet as we approach the halfway mark of 2018, local investors are confronted with very disappointing returns from most asset classes. Naturally, investors are concerned and the following questions are raised.

WHAT HAVE **MARKETS BEEN DOING?**

Chart 1 shows asset class returns in rand to end May. The latest available annual inflation rate is 4.4% for May. The inflation hurdle is therefore currently easier to clear than in the past, but has still been tough to beat. Only local bonds and cash and global equities have beaten inflation over the two periods. In the 12 months to end May, the rand gained 3% against the US dollar. This has depressed returns from offshore asset classes but also of the sizable component of the earnings of JSE-listed companies that are generated abroad.

IS IT JUST MY FUND **THAT IS STRUGGLING?**

It is important to understand that that while each fund manager has its own unique recipe for baking the cake, we all use the same ingredients – the returns of markets give. No one can conjure returns out of thin air.

The biggest component of the typical balanced fund (including ours) is local equities. The disappointing performance from this asset class is the main reason for overall muted returns from balanced funds across the industry. The average balanced fund delivered just 3.2% over twelve months to end May and 3.6% annualised over three years according to Morningstar. Longer term returns of 6.8% p.a. over five years and 8.2% p.a. over 10 years are better and ahead of inflation. The Old Mutual Multi-Managers Balanced Fund of Funds has delivered above-average performance over all these periods.

SHOULD I JUST **GIVE UP AND GO INTO CASH?**

Equities is the asset class that gives the best return over time. But it can be very volatile in the short term, and returns tend to be cyclical, even over slightly longer periods.



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Chart 2 shows the rolling three-year annual excess real returns of local equities over cash since 1925. In other words, each point on the line represents three years' worth of annual equity returns subtracting inflation and cash returns. Three points stand out.

- What we are experiencing now is perfectly normal. There are periods of rising real returns and periods of falling returns.
- The line spends more time above zero than below zero, but it is only by remaining invested over long periods that one can capture those returns and benefit from the power of compounding.
- Unfortunately, the temptation is to switch out into cash when the line dips below zero. Historically, that is the worst time to do it. Although no one knows when things will turn around and timing the markets doesn't work, the data suggests that periods of low real returns are followed by periods of strong returns. Since 1925, when real returns from local equities were between -2.5% and 0% over three years, the average subsequent three-year real return has been 11% per year.

SO, ARE THESE RETURNS NORMAL?

While disappointing, the returns are within the expected range as illustrated in the various Old Mutual Wealth financial planning tools. The 'funnel' chart (Chart 3) shows that in any given one-year period, the expected return of the inflation plus 4% to 5% strategy (Old Mutual Multi-Managers Balanced Fund of Funds) is between -14% and 32%. This range narrows to 0.7% to 18% per year over five to seven years, the expected minimum recommended investment term.

WHAT CAN WE EXPECT LOOKING AHEAD?

The global economy is still strong and there is no recession expected in any major economy. The South African economy is slowly recovering from a very tough period. Local and global equities are priced reasonably. Importantly, the rand has stopped appreciating (in fact it has weakened quite a bit in June so far) and this supports returns from global asset classes and rand-hedges on the JSE. Overall, the JSE will take its tone from global markets. Local fixed interest is attractive with bond yields well in excess of inflation. There is no reason to expect that patient investors won't be rewarded with decent real returns from a diversified portfolio over the next few years.

SO WHAT SHOULD I DO?

The key is not to panic and make emotional decisions, especially when news headlines highlight all the uncertainties investors face. The Strategy funds are actively managed and we will make adjustments to asset allocation depending on the outlook for each asset class (looking forward, not backwards). The time to make a change in your investment strategy is when your personal circumstances have changed (e.g. having children, changing careers, retiring, emigrating) not when market conditions change.

CHART 1:

ASSET CLASS RETURNS IN RAND TO END MAY 2018



CHART 2:

SA EQUITY - SA CASH REAL RETURN

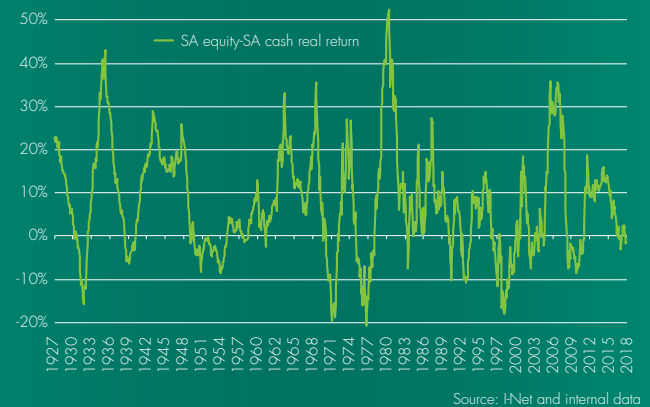


CHART 3:

OLD MUTUAL MULTI-MANAGERS BALANCED FUND OF FUNDS (INFLATION PLUS 4-5% STRATEGY) EXPECTED RANGE OF ANNUAL RETURNS WITH ACTUAL RETURN DENOTED BY A TRIANGLE

