OLD MUTUAL MULTI-MANAGERS
TARGETED RETURN FUNDS PERFORMANCE IN PERSPECTIVE JANUARY 2019

WHAT WENT WRONG IN 2018?

Last year was the first negative calendar year for local equities since 2008. Global equities were also negative in dollar terms, but marginally positive in rand terms due to the decline of the local currency. Only local bonds and cash gave a return above inflation, while offshore asset class returns were only positive due to a weaker rand. In other words it has been a tough year for all investors, not only those in the Old Mutual Multi-Manager funds.

GLOBAL VOLATILITY

Led by US stocks, global equities had a flying start to 2018 on the back of strong global growth and a surge in company earnings, partly due to US corporate tax cuts. But from February onwards, equity market volatility picked up considerably. Fears that the US Federal Reserve (and other central banks) would hike interest rates too aggressively combined with the uncertainty of a trade dispute between the US and China, the world's two largest economies, weighed on global markets. A stronger dollar also placed severe pressure on emerging markets (EMs), especially Turkey and Argentina. In December, concerns over a slowing global economy, rising interest rates and lingering US-China trade tensions turned into outright anxiety and the major global equity indices slumped. The US market's 9% sell-off in December turned a positive year into negative.

LOCAL MARKET LAGGED

The JSE was battered by the volatility in global markets, but also by the impact of EM outflows, a weak domestic economy, political uncertainty and importantly, a number of company specific problems. Despite the rand losing 15% against the dollar in 2018, the large cap non-resource rand hedges including Naspers, British American Tobacco, Richemont, MTN and Aspen declined between 15% and 50% for reasons largely unrelated to the macro-economy, but rather due to company or industry specific issues. Fortunately, the JSE sidestepped the December global sell-off, but one strong month was not enough to offset the losses made earlier in the year and the FTSE/JSE Capped SWIX index ended the year down 11%.

Local listed property was pummelled by corporate governance concerns at the Resilient group of companies, which in turn put a spotlight on some of the income-generating practices of its local peers. All this occurred against the backdrop of an extremely tough domestic economic environment for the property sector.

Table 1: Asset class returns to end December 2018 in rand

	1 year	2 years	3 years
SA Equity – FTSE/JSE Capped SWIX	-10.9%	1.9%	2.9%
Global Equity – MSCI All Countries World Index	5.1%	8.5%	4.0%
SA Property – FTSE/JSE All Property Index	-27.3%	-7.7%	-2.1%
Global Property – FTSE EPRA/NAREIT Developed Index	9.6%	4.7%	0.2%
SA Bonds – JSE All Bond Index (ALBI)	7.7%	8.9%	11.1%
SA Cash – STeFI Composite	7.2%	7.4%	7.4%
Currency: ZAR/$	16.0%	2.4%	-2.5%

Source: Iress, internal systems

HOW OUR DECISIONS IMPACTED THE FUNDS

We also made a number of changes to the funds last year, set out in Table 2, that were communicated at the time they were made. Our big tactical asset allocation (TAA) position has for some time been overweight local fixed income, underweight local equities and property, overweight global equities and global property, with a zero allocation to global bonds. Outside of the underweight to global fixed income, these calls have proved to be correct in 2018. So why did the funds underperform their peer group?

- Our global equity managers had a fantastic 2017 but really struggled in 2018. While the global equity benchmark returned 6% in rands in 2018, our managers delivered -5%. Each of the four active managers in the building block underperformed the benchmark, but Coronation and Orbis had a particularly torrid year as EMs lagged developed markets.
- Our local equity managers were only slightly behind their benchmark, and we had an underweight tactical position to local equity. However, to achieve inflation-plus returns over time, the strategic asset allocations (SAA) of our funds has a very high weighting to equity. Regulation 28 limits also mean that most of this allocation will be in the local market.
- Our local property managers outperformed their benchmark last year, and we have had an underweight tactical position but losses from property still negatively impacted fund returns. The specialist asset class approach we apply means we had exposure to the full property universe, despite being underweight the Resilient companies.

Table 2: Changes to the funds in 2018

Managers	
Global Property	Appointment of Resolution Capital at 25% of building block (Aug)
SA Equity	Appointed Sentio and Mazi as boutique equity managers (Feb)
	Down-weighted Coronation by 10% with 5% allocated to Prudential and 5% to Visio (Oct)
Hedge Funds	Terminated Visio, Laurium and Obsidian and appointed 36One (Feb)
	Consolidated Steyn exposure into Steyn Long/Short Fund (Oct)
Benchmarks	
SA Equity	Changed from FTSE/JSE SWIX to Capped SWIX (Feb)
SA Property	Changed from FTSE/JSE SA Listed Property index (SAPY) to All Property index (ALPI) (Jul)
Tactical asset allocation	
	Reduced SA Equity in favour of Global Equity in (Jun and Oct)
Strategic asset allocation	
	Reduced Hedge Fund exposure to lower overall fees (Feb)
	Changed SAA in response to new Regulation 28 limits (Apr)

OLDMUTUAL

WHAT ARE WE DOING NOW?

We have started making changes to the inflation-linked bond (ILB) mandate. As a start we have moved this exposure in the Old Mutual Multi-Managers Inflation Plus 1-3% strategy to the enhanced income building block. With high real cash rates, the enhanced income mandate can deliver the expected ILB real return of 1.5% but at a lower level of volatility. The ILB exposure in the other funds will switch to the current flexible fixed income mandate, which allows greater flexibility in accessing value across the yield curve, including ILBs when appropriate.

In our global equity building block, we are introducing a new emerging market equity manager alongside Coronation to diversify the EM exposure. We are also introducing a new quality-focused global equity manager (by cutting the weight of the index tracker) which will bring greater diversification to the overall solution. These changes will be communicated as soon as they're implemented.

WHAT HASN'T CHANGED?

We have not made any fundamental changes to our investment process. We start with the strategic asset allocation most likely to achieve the target for each fund over time, make tactical tilts based on valuations and the macro outlook, and select the most appropriate managers for each asset class. This approach has worked well in the past, and there is no reason to believe it won't work in the future.

WHAT TO EXPECT IN 2019

GLOBAL OUTLOOK STILL REASONABLE

Though global growth is slowing after a patch of strong and synchronised growth in 2017 and early 2018, it remains positive and the major central banks, wary of repeating past mistakes, will be very careful in returning interest rates to more normal levels, especially as inflation is not a threat. Skittish investors have probably overreacted to slowing growth in certain countries and regions, as we do not see any signs of a looming global recession.

There are always macro risks, even when things are going well. The US-China trade negotiations seem to be going well but the situation remains unpredictable. The US Federal Reserve appears to have adopted a wait-and-see attitude when it comes to interest rates, but should they for whatever reason aggressively push rates higher, it will hurt markets. No-one, not even Prime Minister Theresa May, seems to know how Brexit will play out, but it is unlikely to have a global impact. Italy's populist government probably poses a bigger risk for European markets than Brexit. Locally, it is an election year and that is always associated with a lot of noise, but looking through the clatter, things are slowly getting better here. Rather than try to forecast how these events will play out, our approach is to let diversification across sectors, asset classes, regions and managers shield our investors from extreme outcomes.

VALUATIONS ATTRACTIVE

Probably the most important point for investors at the start of the year is that valuations across the major asset classes (except global bonds) are as attractive as they have been in several years. Equity prices have fallen, but the ability of companies to grow profits remains intact globally, and is improving locally. In other words, precisely when most investors want to throw in the towel after a period of disappointing returns is when one should be looking for opportunities. On the fixed income side, the SA Reserve Bank is maintaining high real interest rates even as inflation is likely to remain subdued. It is a good time to be a lender (i.e. invest in bonds and cash), but not to be a borrower.

Table 3: Summary of asset class positioning

Fixed Income	Overweight SA versus global as real rates very attractive locally.
Equity	Valuations at the best levels in many years; prefer global equity due to better outlook and broadly diversified market. Within global equity, we are overweight emerging markets. Overall equity exposure (local plus global) is neutral – we have maintained our exposure as valuations are offering good value.
Property	Overweight global property versus local property given better fundamentals and fair valuation. SA valuations appear attractive but headwinds to earnings persist in our view.

HANG IN THERE

We recognise that our investors are disappointed with the recent returns and anxious about market conditions. In tough times, the only way to maintain trust in our investment process is to communicate openly, honestly and as frequently as needed. So please do not hesitate to contact us to discuss this note or any other concerns. However, we also remind our investors that investment performance is always cyclical, to benefit from the fat years in markets and generating long-term inflation-beating returns, one has to sit through the lean years. We thank you for your support through a tough year. We are confident that, longer term, our strategies will continue to deliver on their return objectives.

OLDMUTUAL