THE CORONAVIRUS-CRISIS AND YOUR FUNDS

QUARTER 1, 2020

As you read this, you are probably locked down at home to prevent the spread of the deadly new coronavirus. This has already resulted in many economies adopting 'social distancing' measures, including full-blown lockdowns. It is easy to understand how these measures bring economic activity to a sudden and shuddering halt. Recessions usually take place when businesses and consumers are unwilling to spend. In this instance, the problem is that they are largely unable to spend and this will remain the case as long as quarantines and lockdowns remain in place.

HOW MARKETS WERE AFFECTED

What is almost incomprehensible is the thought of so many countries doing it at once. We've never seen anything like it and the market response was brutal. It was the fastest slide into bear market territory since the 1930s.

There are three big drivers of the sell-off. The first two are typical: Firstly, a global recession means company profits will decline and share prices adjust to reflect that. The second is that sentiment takes a knock and investors shift to less risky investments, and demand more compensation for remaining in risky assets (the technical term for this is de-rating). The third main driver has been fairly unique to this episode: a dash for cash. As companies and households realised they would face a decline in income for the next few weeks (or months), they sold some of their financial assets. This explains why even so-called safe-haven assets declined in value in the past few weeks: people are desperate for cash.

Even though this is a global crisis and South Africa is in no way to blame for this, South African bonds and equities and the rand sold off heavily. We are seen as riskier by global investors, along with other emerging markets, and since our markets are liquid (easy to trade in an out of) they could sell South African assets to raise cash.

As a result, we saw the unusual but unfortunate occurrence where local bond and equity prices declined at the same time. In other words, there was no diversification benefit. The only place to hide was short-term cash. Even conservative cash-plus or enhanced income products experienced capital losses.

This lack of diversification benefit amongst South African assets hurt the performance of our funds in the first quarter. We expect equities to be volatile, but the sell-off in bonds at the same time was unexpected. Our fixed income managers were also positioned in longer-dated bonds that offered higher yields, but these sold off the most.

However, bond returns can recover much quicker than equity returns because they still pay very high levels of interest (also known as the coupon). To put it slightly differently, bond investors who only care about interest income will still receive the full amount. If they don't sell, the fluctuation in price will not affect them. We have not reduced exposure to local fixed income and our fixed income managers have taken advantage of higher yields by increasing duration where possible. We have already seen yields retrace somewhat from their pre-downgrade levels.

One area where diversification helped was global exposure. Although global markets sold off heavily, the rand weakened by about 25% against the dollar in the first quarter. This offset some of the losses from global markets. We maintained maximum global weights throughout.

IMPLICATIONS OF JUNK STATUS

In this incredibly volatile and uncertain period, the least surprising development was the announcement that Moody's removed South Africa's final investment grade credit rating.

It means that South African bonds will no longer be included in the FTSE World Government Bond Index as of May. Investors who track this index will have to sell their South African holdings. Many feared that this exclusion would lead to massive capital outflows. In fact, hardly a day went by over the past two years without some mention of Moody's sword hanging over our heads. And in the end, the thing we feared – a slumping rand and massive bond sell-off – happened before the downgrade as corona-panic gripped global markets. Emerging markets have seen bigger capital outflows than during any other crisis. We have thus already seen big selling of South African bonds leading up to the downgrade. It is difficult to know how much will flow out before the end of April.

One of the biggest scare stories about a downgrade was that consumers would end up paying more to service their home loans. But the SA Reserve Bank joined other global central banks in cutting rates by 100 basis points and is likely to cut again.

WHAT WE HAVE BEEN DOING

Our full exposure to offshore assets as well as being underweight the worst performing asset classes locally, equity and property, gives us the opportunity to reposition the funds going forward. We are busy reducing our offshore exposure, as this weight has increased in the portfolios, and will look to gradually redeploy this into local assets that are looking extremely cheap. There is however a high level of uncertainty regarding how the virus and its impacts will play out, and we remain focused on ensuring our portfolios are well diversified.

HOW OUR MANAGERS HAVE PERFORMED

While a quarter is a very short period, it is worth noting that our managers have achieved their objectives over this period. Our property managers have been defensively positioned and outperformed their benchmarks. While performance amongst our equity managers was mixed, the building blocks have performed in line or slightly above benchmark. The exception is the fixed income building block where our managers had already increased exposure to longer dated bonds as these yields increased relative to money market rates. This, together with a small property exposure in this building block, meant the performance was below benchmark. We expect very good future returns given the higher yields, and the expectation that inflation will remain low.

WHAT YOU SHOULD EXPECT FROM US

What you should expect from us now, is not to try to predict the future but to stick to our knitting. Our investment approach is built firstly on diversifying across managers, asset classes and regions to spread the risk, and secondly on tilting towards assets that are cheaper and away from those that are expensive. Thirdly, it is about being patient enough to realise the benefits of the first two steps. This approach does not work every single day, but has delivered over time.

MONENE WATSON
CHIEF INVESTMENT OFFICER