

SPRING 2019



# Taking Stock



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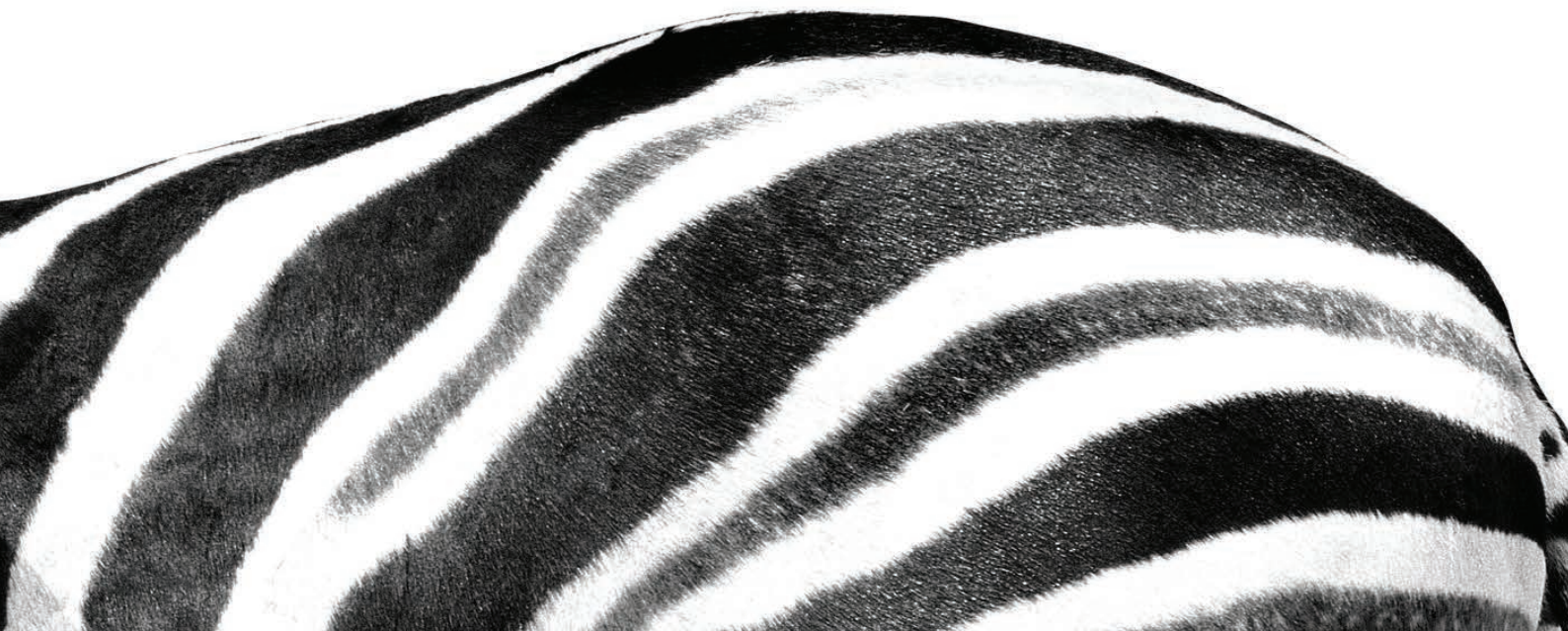
 **Investec**  
Asset Management





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# Welcome to Taking Stock



**SANGEETH SEWNATH**

Deputy Managing Director

Domestic stocks fell 4.6% in the three months to the end of September. Before getting too despondent, it's worth noting that the year-to-date returns still look healthy. The All Share Index delivered 7.1% over the nine months; the All Bond Index was up 8.4% and the property sector managed to stem the bleeding to end 1.5% down.

At the Taking Stock event at the beginning of the year, Clyde Rossouw predicted double-digit returns for SA and global equities. So, the dismal third quarter notwithstanding, his five-year predictions remain intact. It is encouraging that the Quality range over which he presides has performed particularly well.

## **Continuing to invest for the future**

We do not have to look beyond the daily newspaper headlines to know that the South African economy remains in the doldrums. For the first time in five years, advisors are telling us their businesses are more affected by market conditions than regulation. Many advisors have asked us how to navigate this difficult environment. From our experience, it is critical that you keep a tight rein on costs to ensure your business is sustainable for the long term, but also that you continue to invest in the right places to grow for the future.

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It is critical to rein in costs but  
still invest in future growth.

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In our case, despite flat markets and revenues to some extent flatlining, we have continued to invest in talent. Testament to this is the recent hire of Duane Cable as Portfolio Manager and Head of our SA Quality team, and the appointment of Rehana Khan, who will join us shortly as Portfolio Manager in the SA Equity & Multi-Asset team.

### **Passive versus active: cost versus value**

We welcome the discussion around the perceived benefits of passive investing, with much of the focus on costs. Investec Asset Management is unashamedly an active manager, and we believe that consistent active returns deliver significant value to investors.

Consider the Investec Equity Fund, which over 25 years has outperformed the benchmark by 2% net of fees.<sup>1</sup> This outperformance of 2% net of fees delivers a fund value that is 60% better than a passive outcome (assuming no fees for passive) after 25 years. The difference is stark when you view the value of 2% additional returns in terms of your income after retirement. If the active portfolio provides an income of R100 (assuming a 5% income drawdown), the passive portfolio will only deliver an income of R65 at zero fees.

The focus on the short term misses the value add of active returns in the long term. Investors forget that by taking into account their pre- and post-retirement years, they actually have an investment horizon of 40 to 60 years.

### **Considerations when selling**

Most investment letters have started to become a bit predictable in that – without fail – they reiterate the importance of staying invested. What is equally important, as highlighted by the above statistics, is that investors also ensure they are in the right investment. Sales Manager, Paul Hutchinson, recently wrote an article on the warning signals that should trigger a re-evaluation of the investment.<sup>2</sup> For investors and advisors alike, however, selling is not easy behaviourally. The reason is quite simple – making an investment is only one decision, but selling requires two separate decisions – not only what and when to sell but also what to buy.

Capital gains tax (CGT) is frequently cited as a deterrent to selling. While that is true, it is useful to understand the actual value of the CGT impact. Paul has also considered this question in further detail.<sup>3</sup> The conclusion is if you're targeting a real return of 5-6% and switch every five years, the fund into which you switch must generate an additional 40-50 basis points per annum over the five-year period to justify the CGT impact. If you assume the period is longer, the additional return required reduces.

<sup>1</sup> Morningstar, as at 30.09.19, R class to 30.04.00 and then A class onwards, NAV based, inclusive of all annual management fees but excluding any initial charges, gross income reinvested. Comparison index: 87.5% Capped SWIX +12.5% MSCI ACWI; 87.5% ALSI + 12.5% MSCI ACWI pre 01.11.2017; ALSI pre 15.07.2016. Highest and lowest annualised return (12-month rolling): April 2006: 65.8% and Feb 2009: -34.8%, respectively.

<sup>2</sup> Viewpoint: When to sell? September 2019, [www.investecassetmanagement.com](http://www.investecassetmanagement.com).

<sup>3</sup> Viewpoint: When selling, what about capital gains tax? October 2019, [www.investecassetmanagement.com](http://www.investecassetmanagement.com).

## **Retirement tax benefits are material**

Emigration is an emotional decision and the Moody's outlook downgrade will no doubt likely add further impetus to those considering greener pastures abroad. From an investment point of view, it raises questions about the merits of continuing to contribute to a Regulation 28-compliant fund. In this edition of *Taking Stock*, we interrogate the tax benefits of Regulation 28-compliant investments versus the impact of the investment restrictions imposed by the legislation. While the emotional decision is harder, the maths is simple: continue investing in your Regulation 28-compliant fund, as a fully discretionary portfolio has to generate returns of approximately 2.5% per annum more than a Regulation 28 portfolio to exceed the tax benefit you receive from the latter.

## **In conclusion**

As we have recently communicated to you, our demerger is on track. When we speak about the global business we have built, our clients continue to be surprised by our size and reach. We now have assets under management in excess of R2.1 trillion. Ours is a truly South African success story, but none of this would have been possible without the partnerships we have built with you over the last three decades.

Thank you for your continued support.



**Sangeeth Sewnath**  
Deputy Managing Director

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Ours is a truly South  
African success story.

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# It's now or never



**JEREMY GARDINER**

## **At a glance:**

- Despite South Africa's issues, the SA bond and equity markets have strengthened year to date.
- Finance Minister Tito Mboweni's economic plan is good, but now we need to see it implemented.
- A benign global environment could give our president some much-needed tailwinds to assist with growth.
- The case for emerging markets will remain intact, depending on global factors such as trade, the stability of the dollar and the US interest rate environment.

Finally, some great news! And my goodness, did South Africa need it. Mind you, most South Africans confidently expected our team to successfully "Brexite" their English counterparts, but few expected the result to be as comprehensive as it was. The big surprise, it appears, was for the English, with one commentator on Sky News asking, "how it was possible for a team not expected to make the semi-finals, to beat England in the finals."

Many have written about the hard work, grit, determination and tough choices that both coach and team had to make along the way to get there, with many parallels being drawn with our country. Watching the president lift the trophy along with captain Siya Kolisi was magnificent and by far the most published photo. Hopefully, on the long flight back from Japan, the president reflected on the tough decisions and hard work that lie ahead for us as a country.







Because, as Finance Minister Tito Mboweni said recently, it's "now or never." For a year, analysts have been saying we need to make some hard policy decisions to get growth going. We also need a comprehensive plan for Eskom "sooner rather than later". Well, it didn't happen "sooner", and it is now "later".

The question is how much longer we have before Moody's runs out of patience. Until now, the ratings agency has been like an overly permissive parent constantly forgiving an errant child. An outlook downgrade means that we now find ourselves precariously balanced on the edge of the cliff. Theoretically, it gives us 12-18 months of breathing space, but in reality, it's only two to three months. Tito Mboweni has to get his way by the time he delivers the national budget in February, or else.

His "We are broke" speech during the medium-term budget policy statement, has hopefully introduced some level of economic reality and understanding in the minds of those who are hostile. Government and the unions need to sit down together and hammer out a workable solution. We are running out of options. Succeed, and we will survive February. Fail, and then we're pretty much done.

Despite all of the above, the SA equity market this year has finally managed to produce a reasonable performance. During our first Taking Stock event of the year, we put up a chart predicting a 15% return from both SA and international equities. At the time, after five years of flat SA equity markets, this was a bold call, and many described it as way too optimistic, given the potential risks of Eskom and junk downgrades, among others.

And this is the dilemma South African investors face, as they try to keep their investment noses above the political water. The fact that despite all our issues, the SA bond and equity markets have strengthened year to date.

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The question is how much longer we have before  
Moody's runs out of patience.

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We also said in the August edition of *Taking Stock* that South Africa was struggling with a crisis of confidence, and in order for confidence to return, we would need certain circumstances to bounce in our favour.

- Firstly, from an international perspective, we needed global trade wars not to worsen. We felt this was a reasonable expectation given that Trump has elections in November next year and needs a strong US economy and stock market if he's to have any chance of re-election. This has finally eventuated, and it looks like some sort of US-China deal is imminent.
- We also cautioned that a no-deal Brexit would result in a risk-off environment, damaging us collectively as an emerging market, and individually from a fixed direct investment perspective. Fortunately, a no-deal Brexit is off the table, and a smooth, managed exit is now the most likely Brexit outcome.
- We said declining US interest rates would help. We've seen several cuts so far, and although now officially on hold, there may still be more to come.
- We need a stable dollar, which is currently the prediction from most analysts.
- If all of the above conspire favourably, the case for emerging markets remains intact.
- Domestically, the picture is less pretty, and we had been expecting more progress by now.
- Consistent policy progress, to encourage investment and get growth going, is sorely needed. Mboweni's plan is good and what we need, but now we need to see it implemented, and there's a fight coming which he may or may not win.
- Several high-profile arrests are needed in order to restore confidence. The lack of progress is understandable given how the crime-fighting agencies were hollowed out under the previous administration. However, the media has already done a lot of the work. In addition, the National Prosecuting Authority has enlisted four of the country's top legal minds and received a significant cash injection (R1.3 billion) from government. Expect results soon.

A benign global environment, as potentially illustrated above, could give our president some much-needed tailwinds to assist with growth, as opposed to the Trump-induced headwinds he's had to face thus far. Any resultant rand strength also goes a long way to restoring South Africans' confidence in the country.

And then finally, at the first Taking Stock event of the year, I mentioned the factors needed to restore confidence. For good measure, I ended by saying all we needed to do was to win the Cricket and Rugby World Cups. So, we only managed to get half of that right, but still, the odds then would have been good. We're a pretty up-and-down nation when it comes to confidence, and the victory in Japan will go a long way!



# Is inflation dead in South Africa?



**BRIAN KAHN**  
Consultant, Fixed Income

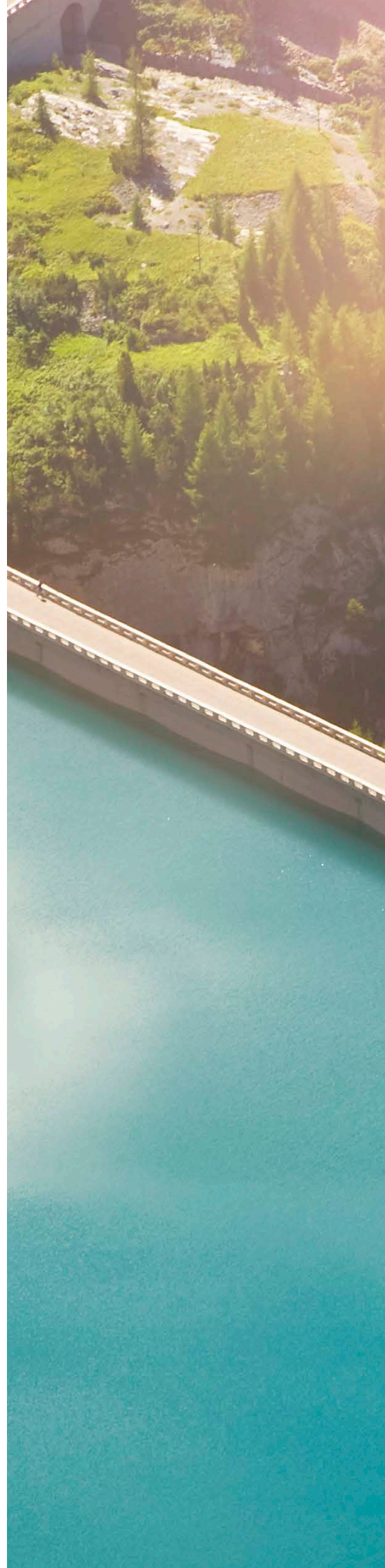


**SISAMKELE KOBUS**  
Analyst, Fixed Income

## At a glance:

- Investec Asset Management's model suggests that inflation will remain contained in the absence of any major unexpected shocks.
- Our current forecast is for headline inflation to average 4.2% in 2019 and 4.5% in 2020, compared with the SARB's forecasts of 4.2% and 5.1%.
- The rand remains a key risk to the inflation outlook, buffeted by global factors (risk-on, risk-off scenarios and monetary policy decisions in the advanced economies), as well as domestic idiosyncratic factors such as burgeoning fiscal risks.
- Asset allocators should assume longer-term inflation rates of below 5%, rather than the 6-7% levels that are currently assumed.

This question is close to the heart of most asset managers and business owners as it affects asset allocation decisions. Inflation has a significant impact on the purchasing power of income and wealth, and we have seen how episodes of hyperinflation can have devastating social consequences.









We need look no further than north of our border for evidence of this. Yet, apart from a few notable exceptions, high inflation has not been the global norm for some time. We are far from the double-digit inflation levels that prevailed in the 1970s and 1980s, including in many of the advanced economies.

In fact, the problem in the advanced economies is one of inflation being too low, and the fear of deflation is very much alive. While inflation remains a non-issue, developed market monetary policies continue to be accommodative. Low interest rates and quantitative easing have fuelled asset prices, which means that financial stability risks have increased. Ironically, although low inflation protects the poor from erosion of the purchasing power of their incomes, asset price developments have favoured the wealthy, widening disparities in wealth.

### **What drives our inflation?**

Unlike the advanced economies, South Africa's inflation rate, most recently at 4.1%, is still far from the risk of deflation. The repo rate, at 6.5%, is also far from the zero lower bound. Small, open, emerging market (EM) economies like ours generally face a different set of inflation risks, and inflation dynamics differ from those in the advanced economies. For example, EM inflation rates are more sensitive to exchange rate and volatile food price changes. The structure of the economy and the relatively less developed financial markets imply that the transmission mechanism of monetary policy is also often less effective. Therefore, changes in interest rates may have a smaller impact on cyclical growth, and ultimately, on inflation. Monetary policy is also generally less effective when inflation is driven by supply-side shocks, rather than standard demand-side pressures.

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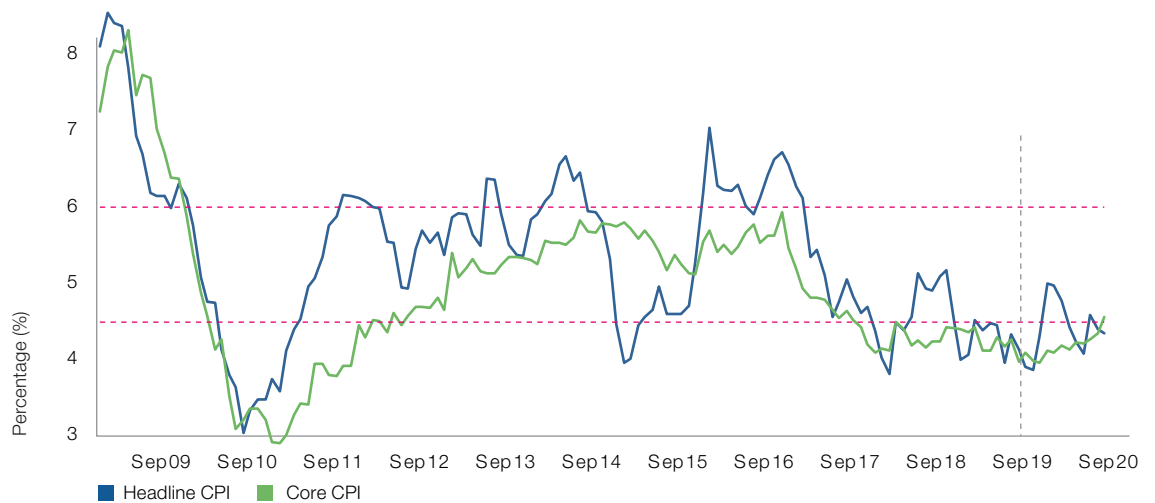
Low interest rates and quantitative easing have fuelled asset prices, which means that financial stability risks have increased.

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During the past two decades, the significant swings in South Africa's inflation rate have been driven to a large extent by exogenous shocks, mainly in the form of energy prices (international oil prices and domestic electricity tariffs), food prices and the exchange rate. More recently, inflation appears to be firmly under control, as shown in Figure 1. Headline inflation has been within the target range of 3-6% since April 2017, and at or below the mid-point of the target since December 2018. Core inflation, which gives a better indication of the underlying inflation pressures, has been remarkably stable. Since early 2010, core inflation has been within the 3-6% target range, and since April 2017 it has been below 4.5%. Services price inflation, which is generally stickier than goods prices, has declined gradually to 4.2%. Most forecasts of inflation, including those of the South African Reserve Bank (SARB), have consistently surprised on the downside.



Figure 1: Inflation surprising on the downside



Source: Statistics South Africa and Investec Asset Management, as at 31.10.19. Investec Asset Management forecasts are from 01.10.19 onwards.

This benign inflation environment is a result of several factors. First, domestic demand has been extremely weak, with retailers in particular finding it difficult to pass through price increases. The resulting margin squeeze is clearly reflected in the recent poor financial results of the retail sector. In sharp contrast to much of the inflation targeting era, inflation is being strongly influenced by a lack of domestic demand, rather than exogenous shocks. Reinforcing this trend is the significant moderation in average remuneration growth in South Africa, notwithstanding the high initial wage demands that tend to attract the headlines. Lower wage growth feeds through to lower cost pressures, but also constrains demand.

Second, while the economy is still vulnerable to exogenous shocks, the second-round effects of these shocks have been moderated by the weak demand environment. Additionally, the shocks themselves have also been more muted. The emergence of the US as a major oil exporter has changed the international oil price dynamics. Prices are less subject to the strong moves (in both directions) than was the case in the 2000s, despite continued geopolitical tensions.

Third, the SARB has been focusing more explicitly on the mid-point of the target range in an attempt to entrench inflation and inflation expectations around that level. During the early post-crisis period, monetary policy was more tolerant of inflation at the upper end of the target range. This new focus inevitably results in a tighter policy stance than might otherwise have been the case in the short to medium term. While inflation expectations have been moderating, the downward trajectory has been slower than that of actual inflation. The relative stickiness of inflation expectations is not unusual given that the process of expectations formation is partly backward looking.

## **Inflation outlook**

Investec Asset Management's model suggests that inflation will remain contained in the absence of any major unexpected shocks (in either direction). Our current forecast is for headline inflation to average 4.2% in 2019 and 4.5% in 2020, compared with the SARB's forecasts of 4.2% and 5.1%. We expect core inflation to average 4.2% in 2019 and 4.3% in 2020. By historical standards, inflation is subdued, but not dead, and not without risks. We assess these risks, however, to be fairly balanced. This benign inflation outlook can be easily disrupted by unexpected external or internal shocks.

The rand remains a key risk to the inflation outlook, buffeted by global factors (risk-on, risk-off scenarios and monetary policy decisions in the advanced economies), as well as domestic idiosyncratic factors such as burgeoning fiscal risks. However, the risks to inflation from the rand are mitigated by the lower pass-through from the local currency over the past few years.

Above-average administered price increases, particularly electricity and water tariffs, are likely to be with us for some time. Trying to reduce inflation to lower levels could require a tighter monetary policy to squeeze the other components of the CPI basket. While the benefits of low inflation are clear, the trade-off between lower inflation and tighter monetary policy could become severe against the backdrop of a very weak economy. Asset allocators should assume longer-term inflation rates of below 5%, rather than the 6-7% levels that are currently assumed.



### How do consumers perceive inflation?



There is a fair amount of scepticism in the minds of the public as to the accuracy of the inflation figures. A former Reserve Bank of Australia governor once lamented that ten years after inflation had been close to the target range of around 3%, surveys showed that many households still believed inflation to be around 10%.



In reality, inflation experiences of different households can vary widely. Inflation is an average of the weighted price changes of the consumption basket of surveyed households. Because preferences and incomes vary, expenditure patterns and therefore household inflation experiences will differ.



In addition, people often focus on large price increases which distort their perception of overall inflation. An example is the recent electricity tariff increases.



The distinction between high prices and high inflation is also often misunderstood. For example, while we know that South Africa's data prices are high, these prices have in fact been falling, or rising very slowly, putting downward pressure on average inflation in the process.



# A key year for SA bonds



**PETER KENT**

Co-Head of SA & Africa  
Fixed Income

## **At a glance:**

- SA bond yields and valuations are still attractive.
- The overspend by the government needs to be financed from offshore sources.
- South Africa therefore needs enticing real interest rates to attract foreign investors into our government bond market.
- We expect higher real interest rates and the positive income environment of the last two years to remain in place.
- While we are positioned to take advantage of appealing real bond yields, our offshore exposure acts as a buffer against risks.

## **Q Going into 2019, the SA Fixed Income investment team was bullish about the domestic fixed income space. How has this view panned out?**

Our assessment was based on a positive inflation outlook and attractive South African bond valuations – relative to emerging market peers and inflation. This view turned out to be correct. Inflation has remained contained around the South African Reserve Bank's (SARB's) mid-point target of 4.5%, averaging 4.3% over the year. Government bonds have provided a generous yield well ahead of inflation (around 9% annualised) and a capital uplift of close to 1%, year to date. Investment-grade credit has yielded a significant amount above cash (approximately 1.5-2%). These yields should be seen against a backdrop of inflation at 4.3%.





### **Q What does 2020 hold for the South African fixed income market?**

Bond yields and valuations are still attractive. While there are local and global risks, we believe the South African fixed income environment will remain favourable for investors seeking an income. Why do we think the income environment will continue to be rewarding?

The mid-term budget once again highlighted the South African government's propensity to spend more than it earns as a percentage of GDP. Currently, our budget deficit hovers around 5% of GDP. On top of that, our current account, which records South Africa's transactions with the rest of the world, shows that we are running a deficit of approximately 3-4% of GDP. Essentially, as the value of our imports exceeds the value of our exports, more money is flowing from South Africa to our trading partners than the other way round.

The two deficits are related, meaning the overspend by the government needs to be financed from offshore sources. South Africa therefore needs enticing real interest rates to attract foreign investors into our government bond market. To maintain this fragile equilibrium, the SARB has to keep real interest rates higher than it otherwise would have done. Sustaining this delicate balance has kept the rand from unhinging and inflation under control.

This fiscal predicament is unlikely to be resolved any time soon and therefore these higher real interest rates and the positive income environment of the last two years, will remain in place. However, this is not without its risks.

### **Q What are the major risks and how are they influencing your portfolio positioning?**

Key domestic risks are the state of the fiscus, progress of essential economic reforms, and Moody's downgrading South Africa's sovereign debt to below investment grade. This would trigger foreign capital outflows, which could lead to bond market weakness and rand depreciation.

Growth in South Africa is too low. If these economic reforms are not successful, and growth and tax revenues continue to disappoint, South Africa could find itself in a classic debt trap.

Given the credibility of the SARB and weak domestic demand, we are still convinced that inflation will remain under control and stay close to the mid-point of the target band. However, it is possible that if some of these risks are realised, a weak rand could lead to higher inflation.

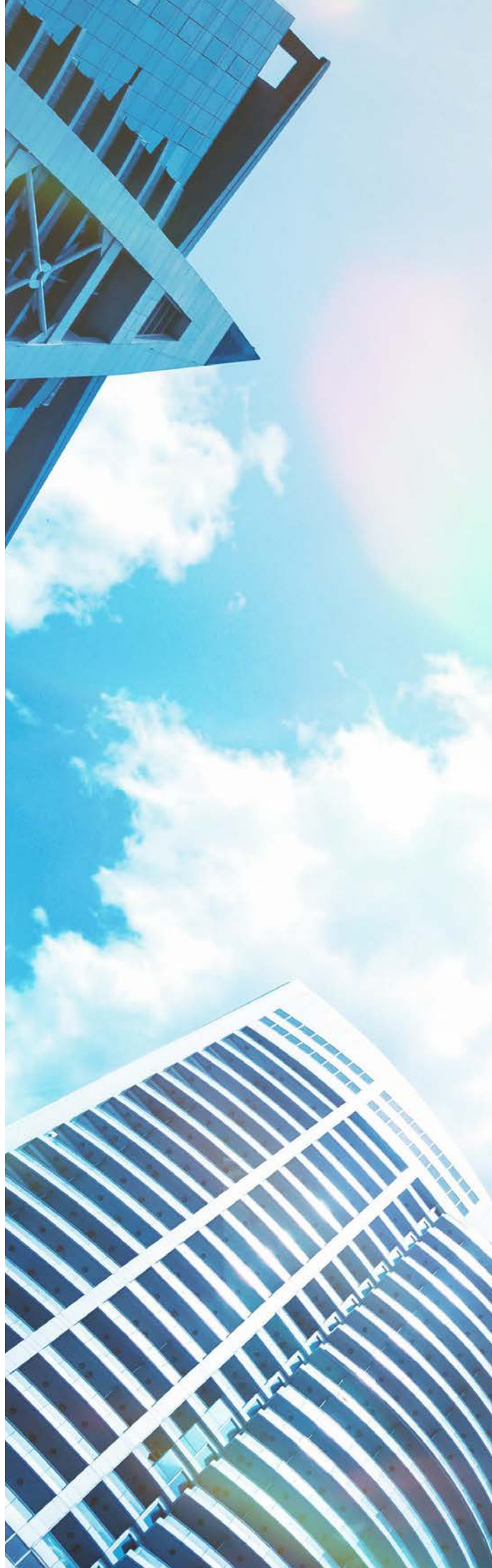
Key global risks are the US-China trade war and the possibility of a global recession.

Risks and uncertainties abound, but due to the inflation-beating income environment, we believe SA fixed income still offers very attractive opportunities. We have a balance of exposures to provide some protection against the multitude of risks locally and globally. While we are positioned to take advantage of appealing real bond yields, our offshore exposure acts as a buffer should any of these risks arise. This investment strategy has worked well for us during periods where we have experienced bond market volatility or rand weakness.

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Our offshore exposure  
acts as a buffer  
against risks.

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# Counting on resilience rather than monetary stimulus



**CLYDE ROSSOUW**  
Co-Head of Quality

## At a glance:

- We've had a reasonable rebound in stock markets in 2019 and global equity prices overall are higher than they were at this point last year.
- If we see more money being put into the system, will that extra liquidity kick-start the global economy?
- If so, that could create a slightly better backdrop for corporate earnings growth, and I think perhaps a slightly better environment for stock markets in general.
- Geopolitics is still the big risk. Investors need to be aware of the potential for the cross-currents from events like the trade war to derail a prospective economic recovery.
- We continue to invest in companies that we think have enough 'self-help' within their business models — in other words, that are less sensitive to the global economic cycle.
- The key theme flowing through our portfolio is searching for companies that can drive their own earnings growth and that do not require investors to second-guess the growth cycle or currency movements.





**Q You said last year that prudent stock selection will be needed to separate the winners from the losers in 2019. How has the backdrop changed for investors?**

The environment has not improved massively. We have been through an industrial recession across the world – albeit a mild one – which has created a host of obstacles for corporate earnings, particularly for more cyclical companies. Semiconductors, autos, chemicals and other industries have struggled. Fortunately, we have not been exposed in a large way to these parts of the market.

More positively, we've had a reasonable rebound in stock markets in 2019 and global equity prices overall are higher than they were at this point last year. Developed markets particularly have surprised somewhat to the upside.

**Q What do investors need to keep an eye on as we head into a new year?**

A key issue is what sort of stimulus we'll see from the US Federal Reserve, which has started talking about quantitative easing of various kinds. But essentially, more money is being put into the system. The question is whether that extra liquidity will kick-start the global economy. If so, that could create a slightly better backdrop for corporate earnings growth, which slowed in Q3 and Q4 2019. Overall, we enter 2020 with a low base for earnings, a reasonably positive liquidity environment, and I think perhaps a slightly better environment for stock markets in general.

**Q What are the major risks?**

Geopolitics is still the big risk. Investors need to be aware of the potential for the cross-currents from events like the trade war to derail a prospective economic recovery. We've had yet another Brexit delay and it still isn't clear how that story will pan out. And there is still no resolution to the US-China dispute, which appears to be spreading further and involving other countries.

Another risk to watch is the gradual slowing in China. Its growth is hovering around 6%, which has always been Beijing's policy goal. But given the size of the economy, it is going to be difficult for China to sustain that rate of growth.

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We search for companies that can drive their own earnings growth.

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**Q How is your outlook influencing portfolio positioning?**

We continue to invest in companies that we think have enough ‘self-help’ within their business models – in other words, that are less sensitive to the global economic cycle. Microsoft, for example, continues to grow in cloud computing. As a theme, I think cloud adoption by corporates will run for the next 3-5 years, irrespective of the economic cycle. Visa continues to grow at a double-digit pace in the payment space.

The key theme flowing through our portfolio is searching for companies that can drive their own earnings growth and that do not require investors to second-guess the growth cycle or currency movements.

**Q What are the risks of that approach?**

If you’re investing in less cyclically-sensitive businesses, there’s clearly a risk you’ll underperform if stock markets are very strong or the economy outperforms the cautious expectations that many people have at present. But the way we see it, that would be a small price to pay for what we hope would be resilient performance in a flat or more volatile market environment.



# Regulation 28 is restrictive – but not in the way you might think



**SANGEETH SEWNATH**  
Deputy Managing Director

## At a glance:

- The tax benefits associated with a Regulation 28 retirement portfolio provide a material boost to retirement savings, which more than compensate for prevailing asset class restrictions.
- Significantly increased offshore exposure is not as important a return driver over the long term as recent performance would suggest.
- The forced allocation to fixed income assets has a significantly bigger impact on the long-term returns of Regulation 28 portfolios than the size of the offshore restriction.

Many of the questions around Regulation 28 appear to stem from the appropriateness of the offshore restrictions. For example, if you have a discretionary portfolio targeting CPI plus 6% and a long-term horizon, you would probably have significantly more invested offshore than the maximum allocation of 30% currently imposed by Regulation 28.

However, while the question is appropriate, timing matters. The last ten years saw very strong global equity markets. In rand terms, global equities produced returns of approximately 5% per annum ahead of SA equities over this period.\*

So, forgetting the last ten years, given that they may not be an accurate representation of the last twenty or thirty years, or for that matter, the next ten years, does Regulation 28 make sense in its entirety? Or should it change?

\*As at the end of October 2019. Global equities are represented by the MSCI ACWI and SA equities by the FTSE/JSE ALSI.









## **Tax benefits and asset class restrictions**

There are two dimensions to consider when addressing this question – on the one hand you're faced with restrictions relating to the assets you may hold, and on the other, there is the tax benefit that you enjoy if you're invested in retirement assets via a Regulation 28-compliant fund.

This juxtaposition suggests that the question you should be considering foremost is whether the tax benefit compensates for the asset allocation restrictions. Our analysis indicates that a fully discretionary portfolio must generate returns of approximately 2.5% per annum more than a Regulation 28 portfolio to exceed the tax benefit you receive from the latter.

This is based on certain parameters where we have made reasonable assumptions. The most sensitive consideration is whether we are in a decreasing or increasing tax environment, given the tax treatment of a retirement annuity and living annuity versus a discretionary investment. A decreasing income tax environment over time would benefit the retirement annuity and living annuity combination, whereas an increasing tax environment would benefit the discretionary savings combination (thereby shrinking the performance gap).

### **Is an additional 2.5% per annum attainable?**

The question then becomes whether it is possible to generate an additional return of 2.5% per annum in a fully flexible portfolio. To explore this within the context of the South African environment, we compared the median performance of the multi-asset high-equity sector (which only consists of Regulation 28 funds) and the worldwide flexible sector, which comprises fully flexible discretionary portfolios. Over five years, the median of the worldwide flexible fund sector outperformed the median of the multi-asset high-equity sector by just under 2% per annum (Morningstar, as at 30 September 2019, NAV-based, net of fees, with gross income reinvested). The outperformance over ten years was just below 1.5% per annum.

The differential reduces further over longer periods, but the number of funds also becomes too small to draw meaningful conclusions. Looking at the theoretical 117 years of past data, we would expect the differential to be 1.9% per annum.

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You need to consider whether the tax benefit compensates for the asset allocation restrictions.

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Based on this historical performance data, we can therefore conclude that the tax benefit of a Regulation 28 fund in a retirement product still outweighs the potential investment outperformance of a fully flexible portfolio.

### **Asset class restrictions don't hurt performance in the way you expect them to**

However, this comparison still hasn't fully addressed concerns relating to the investment restrictions imposed by Regulation 28. We believe the next question then is, if you were to change the investment restrictions, where would you have the most impact? The default response to this question would be to remove the offshore restrictions, largely driven by the outperformance of offshore equities over the last decade.

However, if you look at the longer-term history beyond the last decade, SA equities have a track record of generating higher returns than offshore equities. As investors saving for retirement generally have a long investment horizon, they need significant exposure to 'high octane' assets like SA equities to improve the return profile, while the offshore allocation provides diversification benefits and lowers the overall volatility of the portfolio.

### **Bonds are the bigger detractor**

The real issue with Regulation 28, in our view, is the bond allocation. Regulation 28 limits the total equity exposure to 75%; in combination with property exposure the cap is at 90%. This means the portfolio will have anywhere between 10-25% exposure to bonds at a minimum. The forced allocation to fixed income assets has a significantly bigger impact on the long-term returns of Regulation 28 portfolios than the size of the offshore restriction.

In our view, the best way therefore to increase the return profile of a Regulation 28 portfolio is to allow flexibility to reduce the allocation to bonds rather than lifting the offshore limits.



# Why defence makes sense



**JOHN STOPFORD**  
Head of Multi-Asset Income



**JASON BORBORA-SHEEN**  
Portfolio Manager, Multi-Asset

## At a glance:

- The worst drawdowns typically happen in recessions. Investors have experienced even worse drawdowns in this bull market than previous ones.
- This is particularly harmful to investors with nearer-term horizons, who are relying on assets they have built up previously. For example, retirees who need attractive, sustainable income in their later years could be hard hit – especially now they're living longer.
- Why is this happening now? We believe a changing market structure caused by slower economic growth, central bank intervention and more passive investors in the market could be the culprit.

## Recession obsession

Many commentators are talking about an increasing risk of recession. Our own recession probability models agree, with Figure 1 showing more than a 50% chance of a recession happening in the next two years. As recessions are typically associated with much worse market returns, this increasing risk has led investors to look for defensive strategies that emphasise drawdown management.

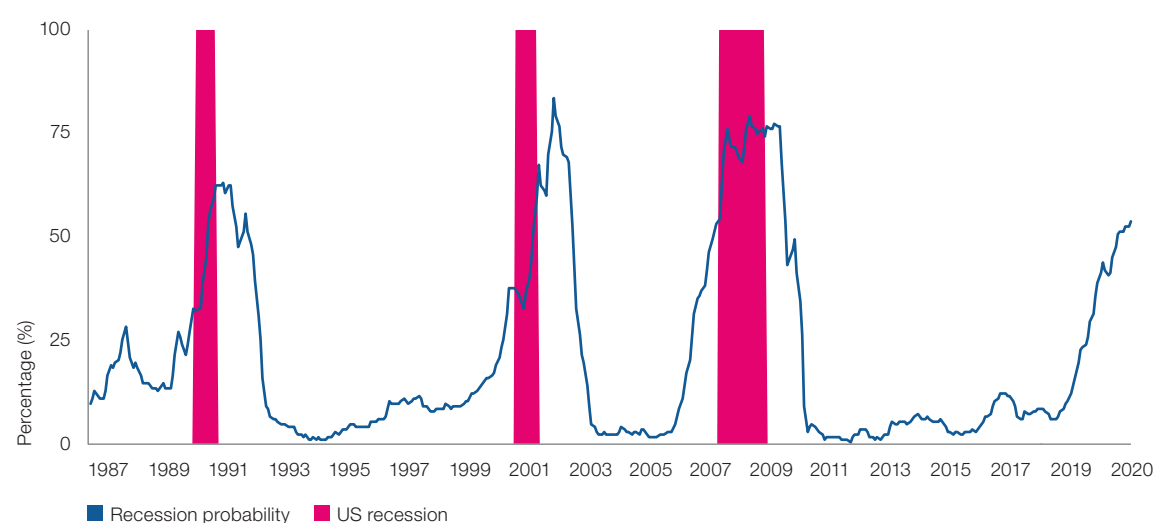






We believe that even outside of periods of increased recession risk, defence makes good sense for investors – particularly for those whose investment horizon is limited.

Figure 1: US recessions and Investec two year ahead recession probability model



Forecasts are inherently limited and not a reliable indicator of future results.  
Source: Investec Asset Management, 31.08.19.

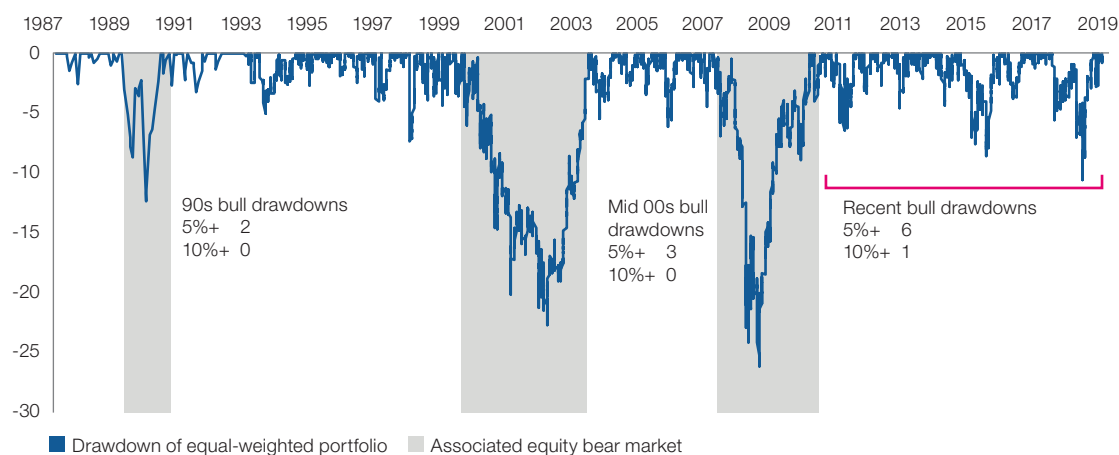
## Misbehaving drawdowns

We think the nature of markets has evolved since the global financial crisis. Our analysis of markets since 1987 (the year of the Black Monday crash) shows that before 2009, outside of the 'bear markets' often associated with recessions – when stock markets drop 20% or more from recent highs – investors tended to see drawdowns that were 'well-behaved': an equal weighted bond-equity portfolio suffered very few drawdowns of more than 5%, and never as much as 10%.

By contrast, in the current cycle we have so far seen six episodes of more than 5% drawdown including one of more than 10% – an unprecedented frequency and magnitude of drawdown for a bull market over the last 30 years. This can be seen in Figure 2.



Figure 2: Drawdown of an equal-weighted bond/equity portfolio



Source: Bloomberg and Investec Asset Management, 31.07.19.  
 Drawdown of equal weighted portfolio refers to MSCI ACWI & WGBI.

### Is a changing market structure to blame?

We think there may be multiple drivers of this increased fragility across asset classes:

- The rate of economic growth has been slower over this cycle than in past cycles, meaning the global economy has teetered closer to the edge of recession (and therefore to the risk of severe drawdowns) than it did before.
- To deal with this, central bank market intervention has become more significant and creative than it was previously, potentially leading to a 'feast or famine' environment for liquidity.
- The ability of private sector banks to absorb risk has been curtailed by regulation and shareholder demand for their business models to become more dependable.
- Passive ETFs/tracker indices make up a greater proportion of the investor base, potentially leading to more herding into and out of positions, thereby exacerbating market moves.

The number of US-listed ETFs has grown exponentially over the years



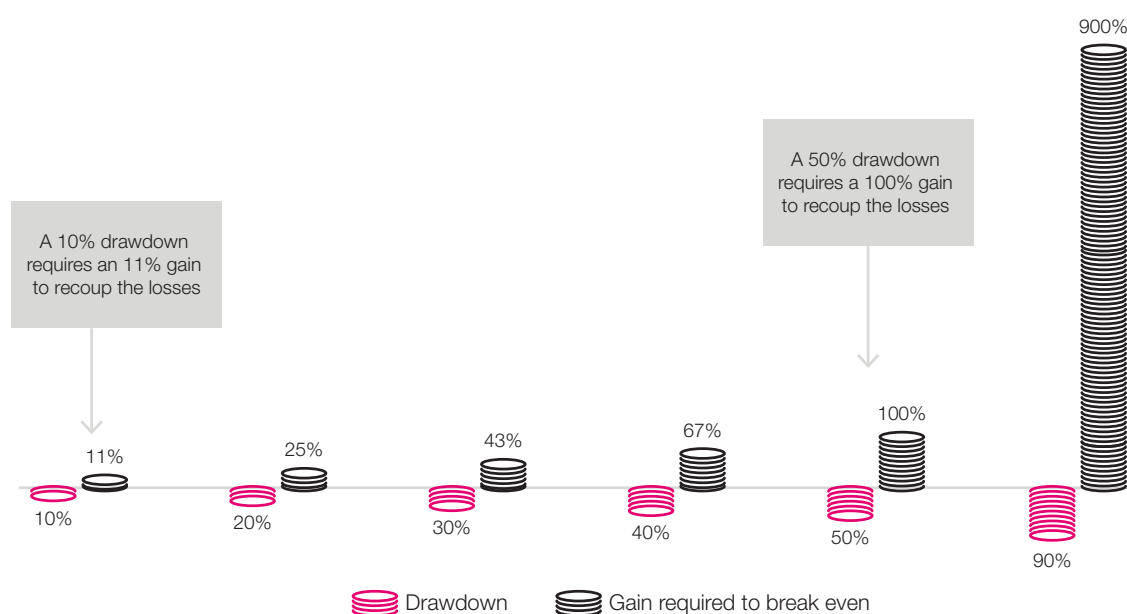
The impact of these changes is evident in the number of ‘flash crashes’ – instances when asset values changed significantly over a short period of time – seen in this bull market. These flash crashes aren’t just confined to equity markets (as can be seen in the timeline on the next page) and are likely a consequence of liquidity becoming more susceptible to drying up than before.

### Impact for investors

This changing market structure and the resulting increased frequency in drawdowns has a significant impact for investors. This risk is particularly relevant for those investors whose horizons are not aligned to the economic environment but rather to their own specific needs for returns, as their assets may not be able to recover from a drawdown in time to meet their liabilities.

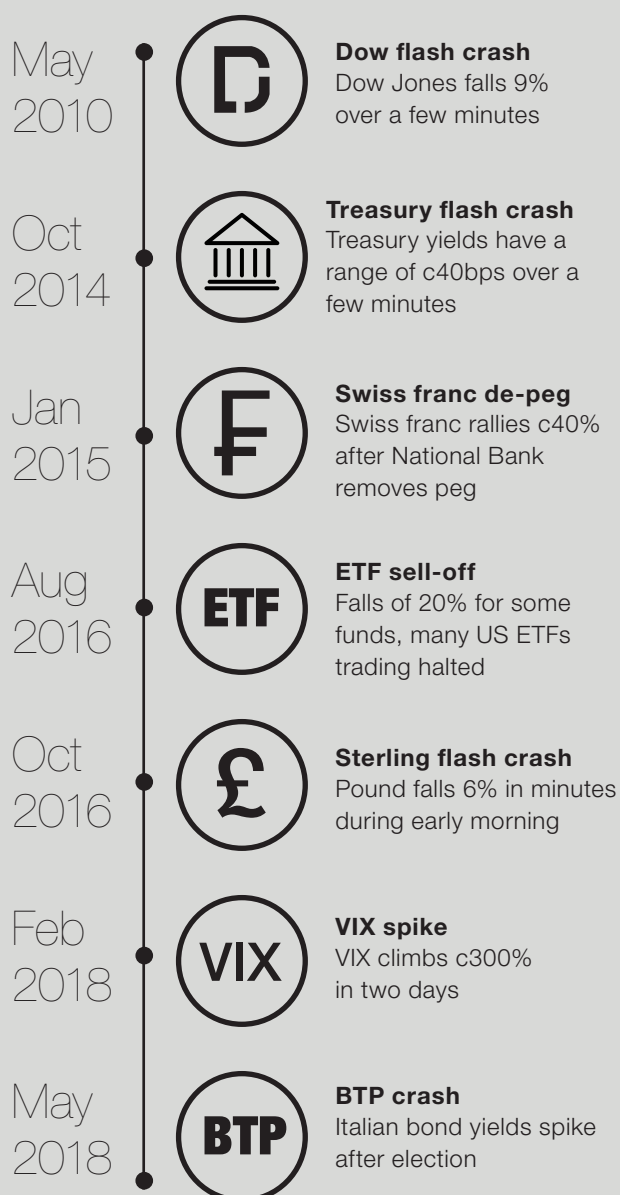
One cohort of investors particularly impacted are retirees, or those approaching retirement. These investors are not able to rely on future earnings being able to fund shortfalls caused by investment losses and so have to depend on the assets they have already built up through their working life. With the world population ageing, these investors are living for longer and so need to make their wealth last longer. For these investors, drawdowns can be fatal to their investment objectives.

Figure 3: Drawdowns – what is needed to recoup losses



The value of investments, and any income generated from them, can fall as well as rise.  
Source: Investec Asset Management, for illustrative purposes only.



**Recent flash crashes**

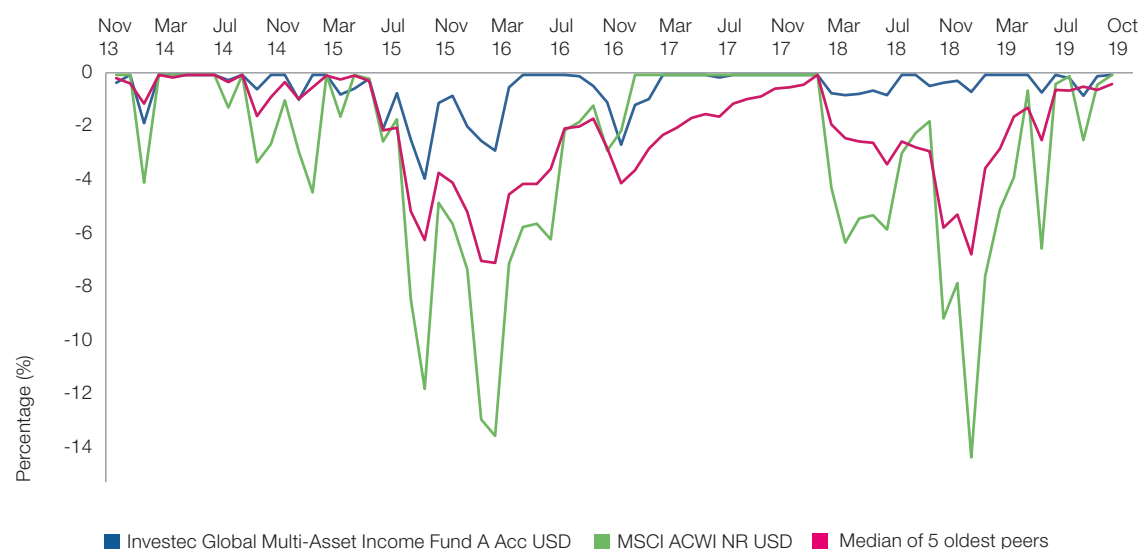
Source: Redburn and Investec Asset Management, 31.08.19.

## Why defence makes sense

The Global Multi-Asset Income Fund focuses on defensive returns, which we define as having a lower downside capture than upside. We believe this focus makes sense irrespective of the market backdrop to investments.

Figure 4 shows the peak-to-trough performance of the Fund and its peers in the most severe recent drawdown episodes. The blue line shows the least dramatic falls during these challenging periods, meaning our approach shielded against capital losses more so than our comparative peers. By then 'un-hedging' risk when appropriate, we were able to recover losses more quickly and so avoided the worst of the negative impact.

Figure 4: Peak to trough performance during drawdown episodes



Past performance is not a reliable indicator of future results, losses may be made.

Calendar year returns for the Fund; 2018: 0.5%; 2017: 6.0%; 2016: 4.4%; 2015: 0.9%; 2014: 3.7%. Highest and lowest returns achieved during a rolling 12-month period since inception: Aug-14: 8.7% and Feb-16: -2.8%. Source: Morningstar, 31.10.19. \*See the Important information section for more detail.

## Conclusion

For investors, the benefit of investing in a defensive fund during a recessionary period should be clear, as the aim to reduce drawdowns in significantly falling markets makes it easier to regain capital in the future.

However, with market structure changes leading to the increased frequency and magnitude of bull market drawdowns and flash crashes, a defensive strategy has an important role in an investor's portfolio throughout the cycle, particularly for those investors with nearer-term liabilities and needs.

We believe this is why defence always makes sense.

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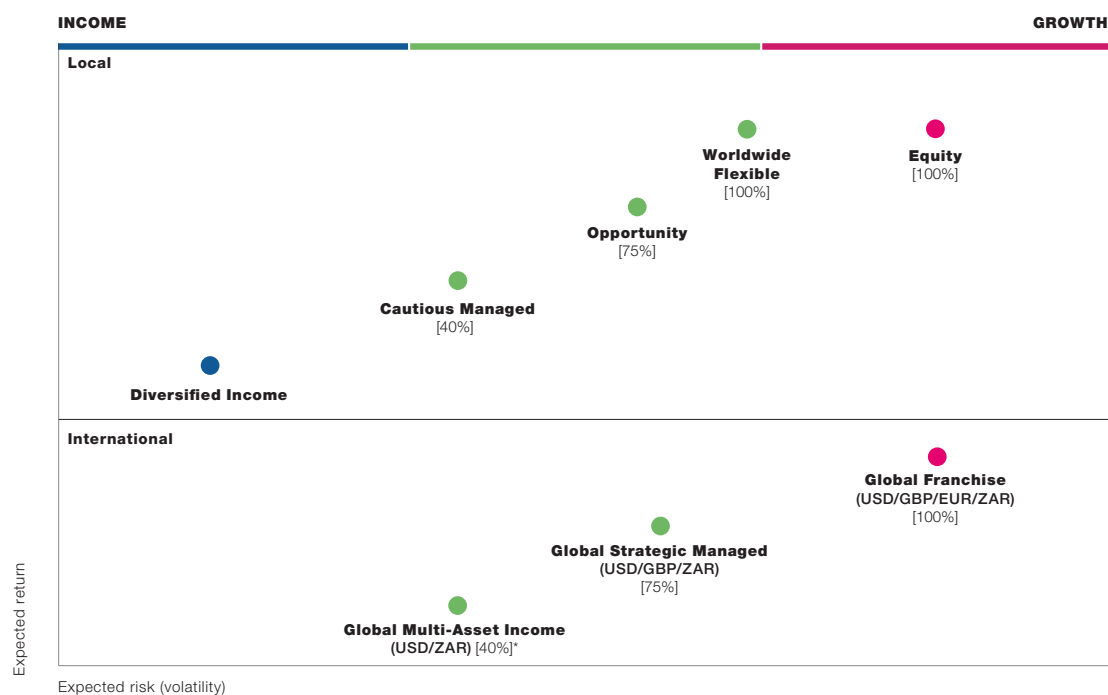
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# Core fund range



Note: [ ] indicates maximum in equities. \*As an internal limit, the Fund will normally invest no more than 40% of its value in the shares of companies. The Investec Global Multi-Asset Income, Investec Global Strategic Managed and Investec Global Franchise Funds are available as ZAR feeders. The Investec Global Strategic Managed and Investec Global Franchise Funds are available in hedged GBP classes.



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## CONTACT INFORMATION

36 Hans Strijdom Avenue  
Foreshore, Cape Town 8001  
Telephone: +27 (0)21 416 2000  
Client service support: 0860 500 100  
Email: [comcentre@investecmail.com](mailto:comcentre@investecmail.com)

**[www.investecassetmanagement.com](http://www.investecassetmanagement.com)**



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‡Period shown is since 30 November 2013. Performance is net of fees (NAV based, including ongoing charges, excluding initial charges), gross income reinvested, USD. If the share class currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. The MSCI ACWI Index is included to illustrate prevailing market conditions/events. The competitors shown for comparison purposes are the five oldest funds in the Morningstar USD Cautious Allocation category.

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