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Investing for a
world of change

What's on investors' minds?



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Investing during the past 18 months or so has not been for the faint-hearted, leaving many with more questions than answers. In our ongoing discussions with financial advisors, four key questions continue to be raised, namely:

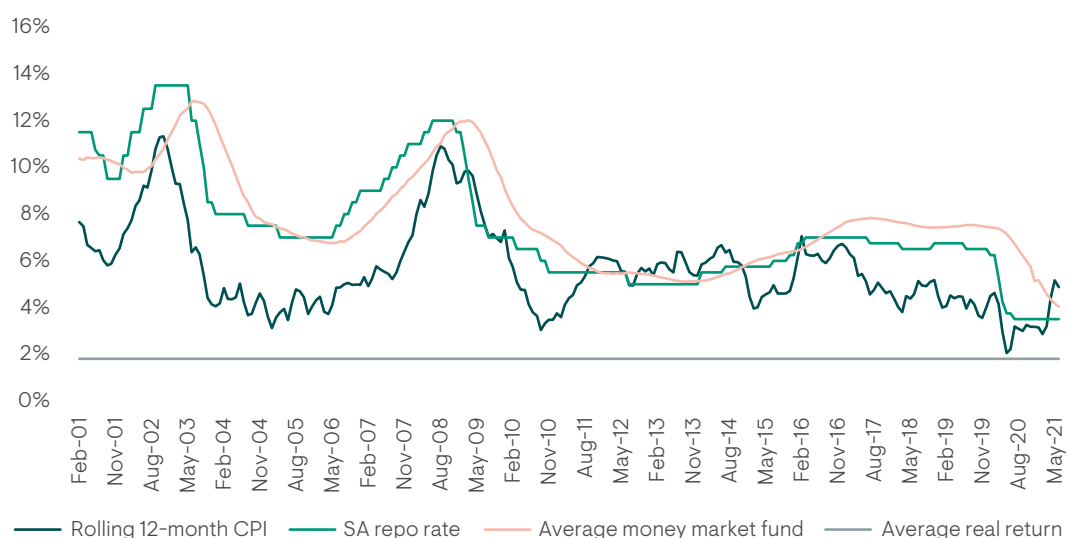
- 1 As the money market is likely to underperform inflation from here, what are the alternatives to cash?
- 2 Offshore. . . how much is enough?
- 3 South African equities. . . is it too late?
- 4 Value, growth, momentum, quality. . . are we seeing a change in style leadership?

We briefly discuss each in turn, providing broad insight from Ninety One. Please note that we have addressed each question independently, and not with a subsequent answer building on the prior question.

1. Cash continues to trend lower

As we predicted in January 2021¹, investors in money market funds are now earning negative real returns. Given the expected path of the repo rate (lower for longer, with the first 25 basis point rate hike only penciled in for late 2021 / early 2022), money market investors can expect to earn negative real returns for the foreseeable future. We can therefore expect money market returns to continue to trend lower and bottom out at 3.5%, being the current level of the repo rate. As is evident in the chart below, this will be the lowest annualised money market return since the introduction of inflation targeting in 2000!

Figure 1: South African inflation, interest rates and money market returns



Source: Ninety One benchmark database 31 July 2021.

Now, more than ever, financial advisors and investors need to look beyond the perceived safety of money market funds to deliver attractive real returns – perceived safety because cash will increasingly prove to be a poor investment in preserving the purchasing power of your money over the medium to long term.

Conservative investors with an investment time horizon of 12-18 months+ should consider flexible fixed income funds like the Ninety One Diversified Income Fund, where the current gross effective yield of 6.5% is almost 2% above the gross effective yield of the Money Market Fund. Unfortunately, this cash plus return may still not be sufficient for many investors, who will therefore need to introduce some exposure to growth assets in their portfolio. Investors with a slightly longer time horizon can consider the Ninety One Cautious Managed Fund: a multi-asset, inflation-targeted solution that importantly also seeks to shield investors from negative market corrections (as the fund so ably did during the Covid-correction in March last year).

¹ [Cash trending towards trash.](#)

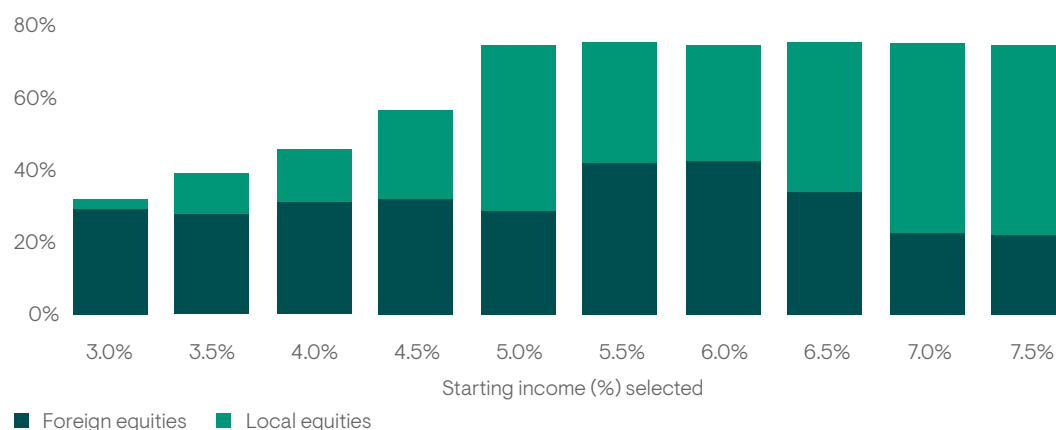
2. How much should we invest offshore?

The short answer is that it depends. It depends on each investor's personal circumstances, risk profile and longer-term financial planning objectives.

The following, however, provides some guidelines/considerations:

- Studies recommend a minimum strategic offshore allocation of at least 30% for long-term investors targeting inflation plus returns to ensure their comfortable retirement i.e., all investors can benefit from a meaningful offshore allocation. For those targeting inflation plus 6% and more, the required offshore allocation rises to above 40%.
- Pensioners have very specific portfolio requirements, as they require a monthly income in retirement. Research² conducted by Ninety One, as illustrated in figure 2 below, indicates that a living annuity typically requires a consistent 20–40% exposure to offshore equities, irrespective of the level of starting income.

Figure 2: Portfolio inclusion of domestic and offshore equities



Source: Ninety One SA (Pty) Ltd, 31 July 2021.

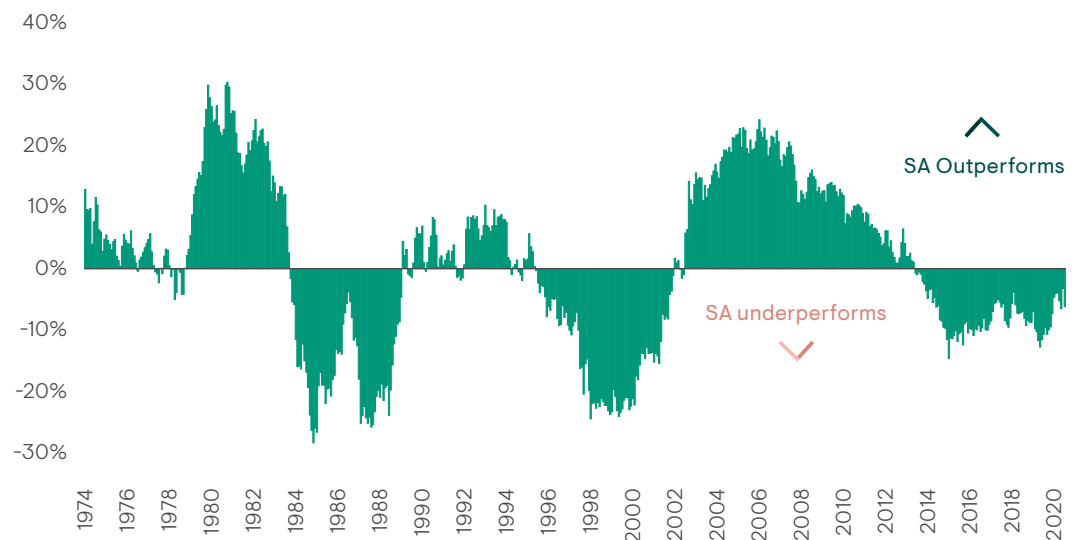
- Wealthier investors not requiring an income to match any South African liabilities are able to invest significantly more offshore (up to 100%), depending on their objectives and tolerance for risk.

Importantly, while the rand is trading at below R15 to the dollar and seemingly providing investors with an attractive entry point to offshore markets, it is only one consideration and investors need to be selective in their approach given the valuation and financial planning risks. We believe that when investing in offshore assets, investors need to take a longer-term view and look past the shorter-term movements of the currency. Furthermore, South Africans investing offshore should look to global equities or high-equity global multi-asset solutions with long-term track records that have proven their mettle through investment cycles, such as the Ninety One Global Franchise and Global Strategic Managed Funds.

3. Too late for South African equities?

Global equities have outperformed South African equities over the past ten years, so it would seem that 100% allocation to offshore may therefore be warranted. However, this relative outperformance is cyclical, as illustrated in the following chart.

Figure 3: SA equities out/underperform global equities over rolling 5 years periods



Source: Infront. Data as at 30 June 2021. All returns in South African Rand.

The portfolio managers of the Ninety One Equity Fund (Chris Freund, Hannes van den Berg and Rehana Kahn) have become increasingly positive about the investment opportunities arising in the South African equity market. Macroeconomic data, admittedly off a very low base and still precarious, has turned positive, and SA has benefited greatly from strong commodity prices. Further good news is evident in excellent tax receipts from the mining sector, which has helped narrow the budget deficit. The record terms of trade have resulted in a current account surplus, and, unlike risks of rising inflation globally, SA inflation appears well under control, providing further support to our economic recovery.

While risks clearly remain, the team is focused on their disciplined investment process of picking stocks with positive earnings revisions at reasonable valuations. As such, they are positive local cyclical stocks, and to select retailers, banks, and industrial shares.

And, while underweight SA equities in the Ninety One Cautious Managed and Opportunity Funds, our Quality capability has identified several stock-specific real-return opportunities. These select, high-quality stocks have attractive valuation underpins and therefore lower downside risk.

Importantly, across the Ninety One firm, we believe that it is too simplistic and increasingly risky to look at overall index metrics. We see attractive SA equity opportunities for active managers away from the broad indices.

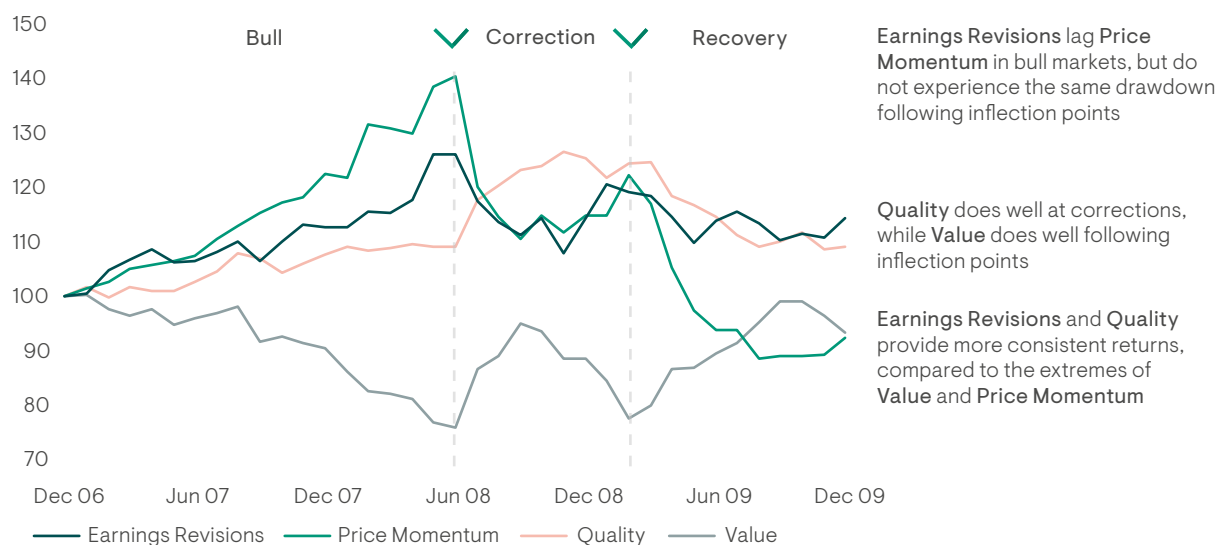
4. Value, growth, momentum, quality?

Portfolio managers apply different investment philosophies to managing money, be it growth, value, earnings revisions, price momentum or quality. While value and growth may be the more recognisable and better understood investment styles, each has its own unique approach to analysing and selecting assets.

- **Value** investors actively seek stocks they believe the market has undervalued, i.e. stocks are selected that trade for less than their intrinsic value.
- **Growth** investors invest in companies that exhibit signs of above-average growth, even if the share price appears expensive in terms of metrics such as price-to-earnings or price-to-book ratios.
- **Earnings revisions** investors invest in companies where the expected future earnings are being revised upwards.
- **Price momentum** investors seek to take advantage of the continuance of existing trends in the market, i.e. investing in assets that have upward trending prices and selling those that look to have peaked.
- **Quality** investors invest in companies with outstanding quality characteristics – these companies have hard-to-replicate enduring competitive advantages that create barriers to entry, enabling such companies to sustain high levels of profitability over the long term.

Importantly, there is no single route to investment success and each of these styles tends to perform differently under different market conditions, as illustrated in the following chart.

Figure 4: Extreme market conditions give a sense of how different styles behaved globally (2008 crash, 2009 recovery market inflection points)



Source: Citi Research, Ninety One, Period = January 2007 to December 2009; Long-short style portfolios 31 December 2009.

The key challenge then is to identify the market environment we are entering and position your portfolio accordingly. Unfortunately, that is easier said than done and timing a switch between different investment styles is very difficult. John Biccard, manager of the Ninety One Value Fund, for example, argues that the pause in the global value recovery stems from the market's more sanguine view on inflation (that it is transitory), which has resulted in the equity market reverting to growth and quality stocks. John, however, believes that the unprecedented amount of quantitative easing (and the fact that some of it has found its way into the banking sector) will lead to sustainably higher inflation. This, he argues, will be negative for growth and value stocks, and positive the positions he holds in the Ninety One Value Fund.

Clyde Rossouw, and the Quality capability, on the other hand, do not believe that the current environment has significantly changed the fundamentals of the companies that they own, which continue to compound cashflows at attractive rates. They remain comfortable that the Quality attributes they seek (enduring competitive advantages, dominant market positions, strong balance sheets, lower cyclicity, low capital intensity, sustainable cash generation and disciplined capital allocation) are all well suited to both current conditions and for the uncertain times ahead.

Given the uncertain market environment and the resultant differing views, for many, a blend of different styles may be the most suited investment solution to ensure the highest probability of consistent outperformance. In addition, it is essential that advisors and investors verify that a fund delivers performance over time consistent with its investment mandate and the fund manager's investment philosophy.

Conclusion

Investors faced with one or more of the issues raised above may well be best served by seeking professional financial advice, tailored to their individual circumstances.

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