PRUDENTIAL **INSIGHTS**

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Asset valuations signal "middle of the road" returns ahead

Coming off of a strong year of above-average investment returns in 2017, investors can currently expect to earn somewhat lower returns over the medium term that are generally more in line with their historic averages. This is indicated by our assessment of the latest valuations across most asset classes, which are neither very cheap nor expensive, but broadly trading around their longer-term fair values. For example, an investor in the Prudential Balanced Fund could expect a return of around 4%-6% above inflation (or low double-digits including inflation) over the next five years or so – a common return target range for high-equity multi-asset funds.

When it comes to our latest “house view” on fund positioning, offshore exposure remains an important diversifier, we believe.

Prudential's model portfolio weighting is around 25% currently, while considering the new 30% offshore limit. This is largely held in global equities, where valuations have fallen nearer their long-term averages after the sharp market correction in February. Despite recent concerns over the possibility of more aggressive interest rate hikes in the US and other major economies this year, fundamentals remain positive for global growth and corporate earnings. Meanwhile, we continue to avoid global government bonds, which still offer very low yields compared to history.

In South Africa, equities are our preferred asset class. On a price-to-book-value basis they are slightly cheap at 2.0x compared to their longer-term median value of 2.1x, while on a 12-month forward price-to-earnings metric they appear somewhat expensive at 14.9x versus their 14.5x longer-term fair value. This gives us a valuation near their average; yet their prospective real return of 6.3% is still attractive relative to other local asset classes.

Local bonds, meanwhile, have rallied substantially in 2018 amid positive sentiment arising from the new ANC President, the improved budget, falling inflation and diminishing chances of further credit rating downgrades. The yield on the benchmark 10-year government bond, for example, has fallen from 8.6% at the start of the year to 8.1% at the end of February. While this level is close to longer-term fair value, longer-dated bonds are more attractive, such as the 20-year bond which is offering 8.9%, ample compensation for the risks the market faces. We are moderately overweight longer-dated bonds in our model portfolios.

Finally, the listed property sector was badly hit in January and February, returning -9.9% in each month on the back of rumours of accounting irregularities and share price manipulation within the Resilient group of companies. These four companies accounted for over 40% of the market capitalisation of the SAPY index at 1 January. Consequently, SA listed property valuations as a whole fell to relatively cheap levels. However, other property companies' share prices rose approximately 5% over the period, meaning that the broader valuation does not accurately reflect the fundamentals of the asset class (which would otherwise be trading around its longer-term fair value). At the same time, there is some doubt about a recovery in the Resilient companies' share prices. As such, we have opted to maintain our neutral positioning in SA listed property in the absence of further information.

To conclude, it’s important to stay invested. Although investors could expect to earn average returns over the medium term (based on current asset valuations), we never know exactly when these returns will be delivered - everyone should expect them to come unevenly, with a significant amount of volatility in the shorter term.

https://www.prudential.co.za/insights/articlesreleases/asset-valuations-signal-middle-of-the-road-returns-ahead/