PRUDENTIAL **INSIGHTS**

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INVESTMENT MANAGERS

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# Diversification and patience will pay off

Investors are facing a high degree of uncertainty going into the last quarter of the year. Many are seeking to limit potential downside to their portfolios by taking more funds offshore, or by holding higher-than-usual cash exposure. Others have already exercised both of these options. Yet selling equities now to move into offshore assets or cash could prove to be a costly exercise in the long term. Equally, not being appropriately exposed to equities over time is also likely to mean missing out on potentially strong returns over time.

**Why move?**

Most investors look at historical returns before making investment decisions. But the best performing asset classes over the past 3-5 years are typically unlikely to outperform over the next 3-5 years. Given that the rand is undervalued against the major global currencies and that the SA equity market is trading at a 20%-25% discount (based on most valuation metrics), it is not necessarily an ideal time to be selling the rand or SA equities in favour of more expensive currencies or assets. At the same time, you need to examine your investment goals: why would you reduce your equity exposure if you're still investing towards retirement or other longer-term aims? You will need an appropriate exposure to riskier growth assets to be able to beat inflation and grow your capital sufficiently over time.

Meanwhile, you will also need to be in the equity market to take advantage of potential rallies. In the past, there have been many upturns that were not triggered by clearly identifiable events – rather, it has proved impossible to time the market correctly, even for experts. It therefore makes most sense to buy equities while they are cheap and their future return potential high. According to Prudential's valuation-based analysis, SA equities are priced to return around 14% over the next three to five years (should all things remain the same with no increase in the PE multiple). However, if the PE multiple rises back to its historic long-term average and company earnings growth doesn't disappoint, then they could offer an even higher return over the longer term.

**Balanced funds offer sensible exposure**

For those longer-term investors who want equity exposure but are wary of further shorter-term downturns, it makes sense to consider a high-equity "balanced" fund, where broad diversification can help to both limit the downside and increase the potential upside for returns. Choosing an investment manager with a strong and consistent long-term track record for outperformance, like Prudential Investment Managers, is another way to help cope with the uncertain environment, since these managers have successfully navigated poor conditions many times in the past.

For example, the Prudential Balanced Fund celebrated its 20$^{th}$ anniversary in August 2019, and has consistently outperformed its benchmark: it has returned 13.2% p.a. versus 11.5% p.a. from its benchmark over the 20 years to 30 September 2019. Central to its outperformance has been Prudential's valuation-based approach combined with patience, active asset allocation and astute stock selection, while also avoiding major meltdowns like African Bank and Steinhoff.

Balanced funds like the Prudential Balanced Fund are very well diversified across different geographies, asset classes, sectors and financial instruments, without investors having to go offshore directly. For example, the fund currently has approximately 27% of its exposure directly offshore – mainly in equities across developed and emerging markets like Italy, Japan, South Korea and China. There is even a small holding in African (ex-South Africa) equities. Another 23% or so is invested in large SA-listed companies with significant global earnings like Naspers, Anglo American, British American Tobacco, MTN, Sasol, Prosus, Richemont and Exxaro. The fund is underweight US equities, which we find expensive, and is avoiding most developed market government bonds because of their very high prices and low yields. It is, however, holding investment-grade corporate bonds and selected emerging market bonds. This gives investors a substantial variety of return sources outside of South Africa and across different countries and sectors.

For more locally focused companies, the fund is overweight financial shares including Investec, Standard Bank and Absa, which have offered attractive valuations with relatively high dividend yields. It is underweight retail stocks like Mr Price, Shoprite and Truworths, given the pressure under which local consumers find themselves. Additionally, it is underweight listed property given the higher risks to earnings going forward despite the attractive valuations prevailing in the asset class.

South African nominal bonds are offering attractively low prices and high yields – the market is already reflecting another credit rating downgrade for the country. Bonds with maturities of 20-plus years offer yields of over 9.5%, well above our view of their long-run fair value and at levels similar to other emerging markets with worse credit ratings. We believe investors are being well compensated for the risk involved. Consequently, the Prudential Balanced Fund is overweight these assets, which offer additional excellent diversification benefits. With some patience and a diversified balanced portfolio, investors should be well positioned to benefit going forward.

For more information, speak to your financial adviser or call our Client Services Team on 0860 105 775 or email us at query@prudential.co.za